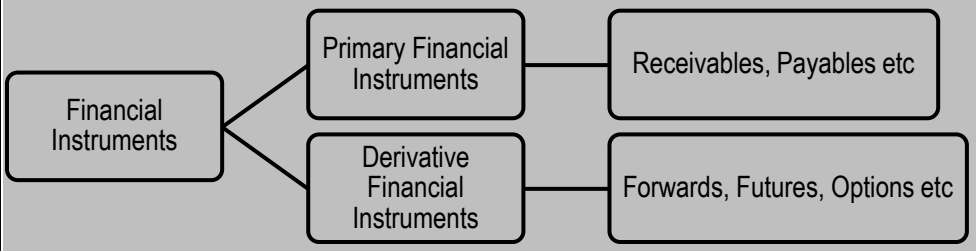
6

Accounting and Reporting of Financial Instruments

BASIC CONCEPTS

A financial instrument is any ***contract*** that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

Financial Instruments may be classified as primary and derivative financial instruments. The classifications can be shown as:



A financial asset is any asset that is

(a) cash,

(b) an equity instrument of another entity,

(c) a contractual right to:

  (i) receive

    ♦ cash or

    ♦ another financial asset from another entity; or

  (ii) to exchange financial assets or financial liabilities with another entity under conditions that are ***potentially favourable*** to the entity; or

(d) a contract that ***will or may be*** settled in the entity's ***own equity instruments*** and is:

  (i) a ***non-derivative*** for which the entity is or may be obliged to receive a ***variable number*** of the entity's own equity instruments; or

  (ii) a ***derivative*** that will or may be settled ***other than by*** the exchange of a fixed

amount of cash or another financial asset for a ***fixed number*** of the entity's own equity instruments.

A financial liability is any liability that is:

(a) A contractual obligation:

(i) to deliver

- cash or
- **another financial asset** to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are **potentially unfavourable** to the entity; or

(b) a contract that **will or may be** settled in the entity's own equity instruments and is:

i. a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

ii. a **derivative** that will or may be settled **other than** by the exchange of a fixed amount of cash or another financial asset for a **fixed number** of the entity's own equity instruments.

Note:

1. A contractual right or contractual obligation to receive, deliver or exchange financial instruments is itself a financial instrument.
2. A ***chain*** of contractual rights or contractual obligations meets the definition of a financial instrument if it will ***ultimately lead to the receipt or payment of cash*** or to the acquisition or issue of an equity instrument.
3. The ability to exercise a contractual right or the requirement to satisfy a contractual obligation may be absolute or contingent on the occurrence of a future event.
4. A contingent right and obligation meet the definition of a financial asset and a financial liability, even though such assets and liabilities are not always recognised in the financial statements.

Meaning of Equity Instrument

An equity instrument is any contract that evidences a ***residual interest*** in the assets of an entity after deducting all of its liabilities.

Preference Shares

Preference shares may be issued with various rights.

In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability.

Preference share is the name given to any share that has some preferential rights in relation to other classes of shares, particularly in relation to ordinary shares. These preferential rights are of great variety, but refer normally to the right to a fixed dividend, although they could also refer to the right on winding up to receive a fixed part of the capital or otherwise to participate in the distribution of the company's assets (share with such rights are often known as participating preference shares).

When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the **discretion of the issuer**, the shares are equity instruments.

Derivatives

Financial instrument or other contract within the scope of this Standard with all three of the following characteristics.

1. Its value changes in response to the change in an underlying which can be a specified interest rate, financial instrument price, commodity price, foreign exchange rate, prices of indices, credit rating or credit index, or other variable provided in the case of a non-financial variables.
2. It requires no initial or very less investment than it would be required otherwise to enter into a contract in normal course.
3. It is settled at a future period. The settlement can either by delivery of the underlying or cash settlement. In case of cash settlement no delivery of underlying takes place rather difference is settled in cash.

Forward Contracts

Forward Contract is the simplest form of a Derivatives Contract. Basically forward contract is a valid contract settled at some future point of time.

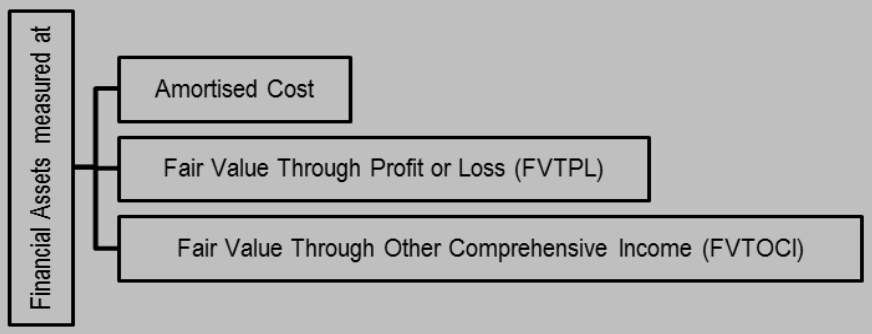
Option

As mentioned above both parties to a forward contract have an obligation to perform at the agreed time. However under Option contract the option-holder has a right not an obligation to exchange the financial asset but the writer (seller) of the option has the obligation to exchange the financial asset upon exercise of the option. The nature of the holder's right and writer's obligation are not affected by the likelihood that the option will be exercised.

Thus, the purchaser has a contractual right (a financial asset) similar to the right under a call option held and a contractual obligation (a financial liability) similar to the obligation under a put option written. The seller has a contractual right (a financial asset) similar to the right under a put option held and a contractual obligation (a financial liability) similar to the obligation under a call option written. As with options, these contractual rights and obligations constitute financial assets and financial liabilities separate and distinct from the underlying financial instruments (the bonds and cash to be exchanged). Both parties to a forward contract have an obligation to perform at the agreed time, whereas performance under an option contract occurs only if and

when the holder of the option chooses to exercise it.

1. Classification of Financial Assets



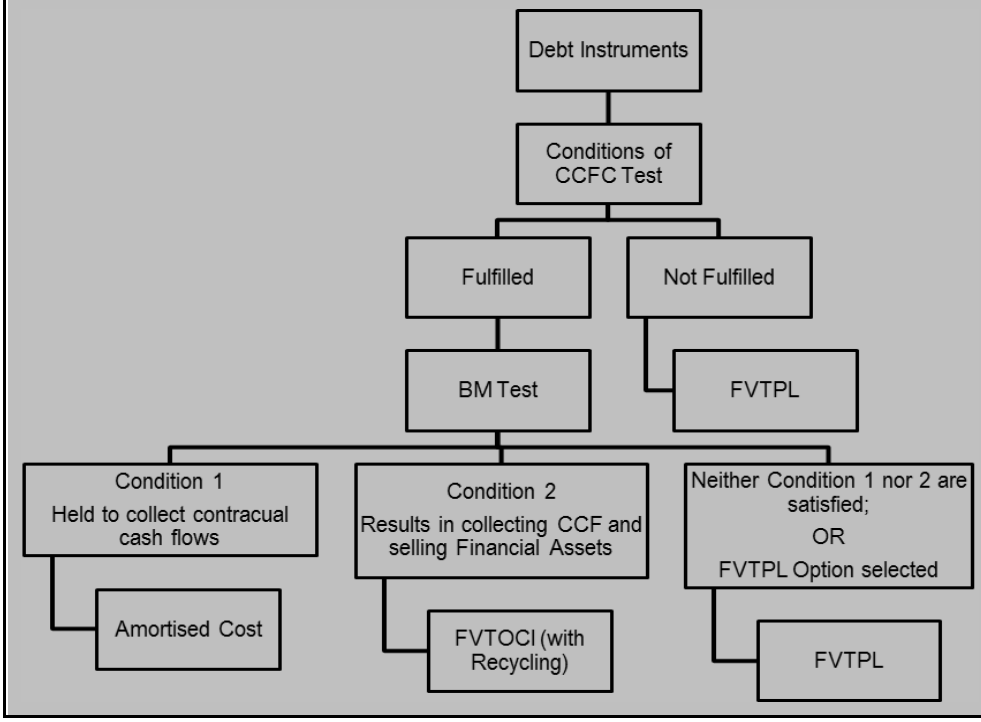
An entity shall classify financial assets depending upon the ***following 2 criteria and options*** elected by the entity:

(a) the entity's **Business Model (BM)** for managing the financial assets and

(b) the Contractual Cash Flow Characteristics (CCFC) of the financial asset

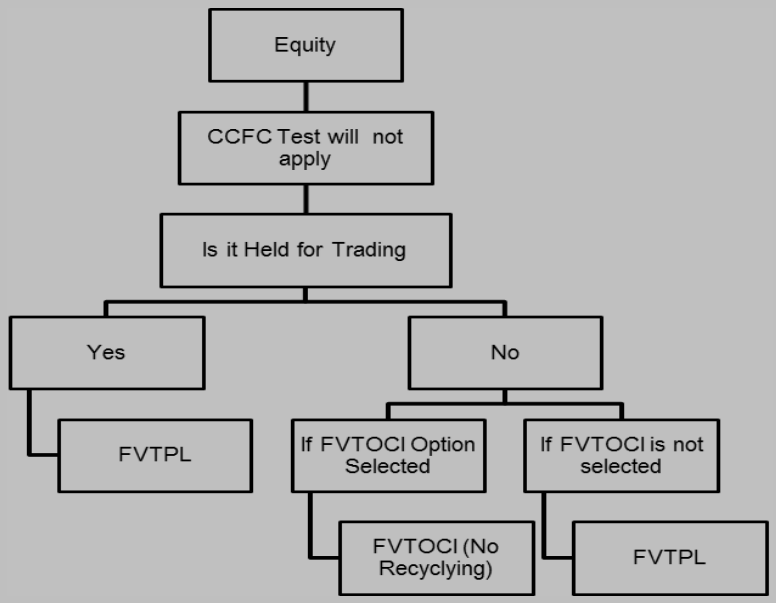
1.1 Classification of Debt Instruments (Financial Assets)

Classification of Debt Instruments has been explain by way of following flowchart:



1.2 Classification of Equity (Financial Asset)

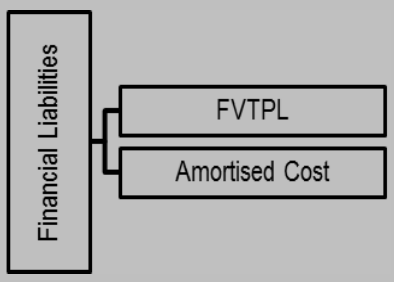
Classification of Equity which is a Financial Asset has been explained as follows:



1.3 Classification of Derivatives (Financial Asset)

Derivative classified as financial asset would be measured at Fair Value Through Profit and Loss (FVTPL) only. The classification of derivatives is only as per one basis i.e. Fair Value Through Profit and Loss (FVTPL)

2. Classification of Financial Liabilities



Financial Liabilities are classified as financial liability measured at fair value through profit or loss and financial liability measured at amortised cost.

Recognition of Financial Instrument

Initial recognition

An entity shall recognise a financial asset or a financial liability in its balance sheet when, and only when, the entity becomes party to the contractual provisions of the instrument.

Trade Date

The trade date is the date that an entity **commits itself to purchase or sell an asset**.

Settlement Date

The settlement date is the date that an **asset is delivered to or by an entity**.

When settlement date accounting is applied an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset.

Initial measurement

At **initial recognition**, an entity shall measure a financial asset or financial liability at its **fair value plus or minus**, in the case of a financial asset or financial liability subsequently not measured at fair value through profit or loss, **transaction costs** that are directly attributable to the acquisition or issue of the financial asset or financial liability.

Reclassification of Financial Assets and Liabilities

When, and only when, an entity **changes its business model for managing** financial assets it shall reclassify all affected financial assets.

If an entity reclassifies financial assets, it shall apply the reclassification **prospectively** from the reclassification date.

The entity shall **not restate** any previously recognised gains, losses (including impairment gains or losses) or interest.

An entity shall derecognise a financial asset **when, and only when:**

a) the contractual rights to the cash flows from the financial asset expire, or

b) it transfers the financial asset as set out in paragraphs 3.2.4 and 3.2.5 and the transfer qualifies for derecognition in accordance with paragraph 3.2.6 of Ind AS 109.

On derecognition of a financial asset in its entirety, the difference between:

a) the carrying amount (measured at the date of derecognition) and

b) the consideration received (including any new asset obtained less any new liability assumed) shall be recognised in profit or loss.

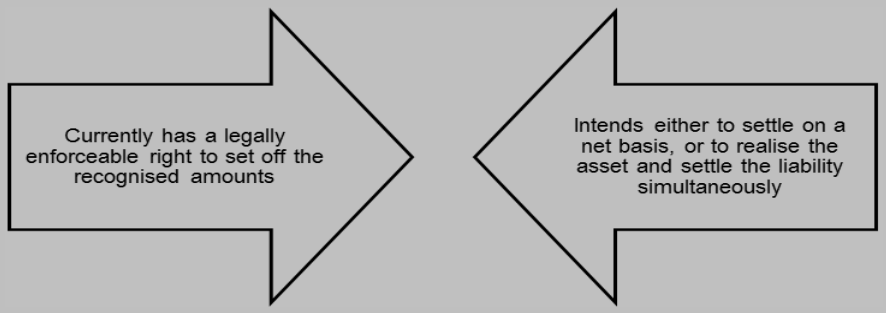
Embedded Derivatives

An embedded derivative is a component of a hybrid contract that also includes a non-derivative host—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.

A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty, is not an embedded

derivative, but a separate financial instrument.

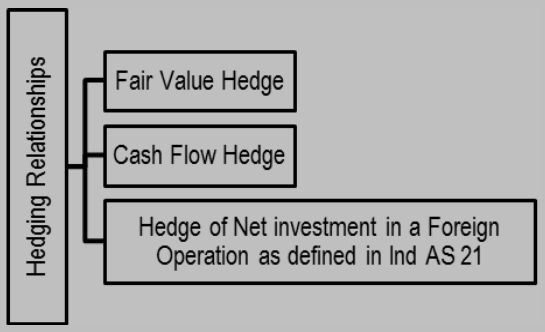
A financial asset and a financial liability shall be offset and the net amount presented in the balance sheet when, and only when, an entity:



Types of Hedging Relationships

An entity applies hedge accounting to hedging relationships that meet the qualifying criteria.

There are three types of hedging relationships:



1. Fair value hedge

A hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss.

2 Cash flow hedge

A hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognised asset or liability (such as all or some future interest payments on variable-rate debt) or a highly probable forecast transaction, and could affect profit or loss.

3 Hedge of a Net Investment in a Foreign Operation as Defined in Ind AS 21

Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment

Illustration 1

A Company has issued 9% mandatorily redeemable preference shares with mandatory fixed dividends. Evaluate whether such preference shares are an equity instrument or a financial liability to the issuer entity?

Solution

In determining whether a mandatorily redeemable preference share is a financial liability or an equity instrument, it is necessary to examine the particular contractual rights attaching to the instrument's principal and return components.

The instrument in the question provides for mandatory periodic fixed dividend payments and mandatory redemption by the issuer for a fixed amount at a fixed future date. Since there is a contractual obligation to deliver cash (for both dividends and repayment of principal) to the shareholder that cannot be avoided, the instrument is a financial liability in its entirety.

Illustration 2

An entity is about to purchase a portfolio of fixed rate assets that will be financed by fixed rate debentures. Both financial assets and financial liabilities are subject to the same interest rate risk that gives rise to opposite changes in fair value that tend to offset each other. Comment?

Solution

In the absence of the fair value option, the entity may have classified the fixed rate assets as FVTOCI with gains and losses on changes in fair value recognised in other comprehensive income and the fixed rate debentures at amortised cost. Reporting both the assets and the liabilities at fair value through profit and loss i.e. FVTPL corrects the measurement inconsistency and produces more relevant information.

Illustration 3

Entity ABC enters into a fixed price forward contract to purchase 50,00,000 kilograms of copper in accordance with its expected usage requirements.

The contract permits ABC to take physical delivery of the copper at the end of 12 months or to pay or receive a net settlement in cash, based on the change in fair value of copper. Is the contract covered under Financial Instruments standard?

Solution

The above contract needs to be evaluated to determine whether it falls within the scope of the financial instruments standards.

The contract is a derivative instrument because there is no initial net investment, the contract is based on the price of copper and it is to be settled at a future date.

However, if ABC intends to settle the contract by taking delivery and has no history for similar contracts of settling net in cash, or of taking delivery of the copper and selling it within a short

period after delivery for the purpose of generating a profit from short term fluctuations in price or dealer's margin, the contract is not accounted for as a derivative under Ind AS 109.

Instead, it is accounted for as an executory contract and if it becomes onerous then Ind AS 37 would apply.

Illustration 4

Entity X holds an option to purchase equity shares in a listed entity Y for ₹ 100 per share at the end of a 120 day period. Evaluate the contract whether a financial asset or a financial liability? What if the entity X has written the option?

Solution

The above call option gives entity X, a contractual right to exchange cash of ₹ 100 for an equity share in another entity and will be exercised if the market value of the share exceeds ₹100 at the end of the 120 day period. If the market value of a share will be such that the entity X will gain on the exercise date, it will exercise the call option.

Since entity X stands to gain if the call option is exercised, the exchange is potentially favourable to the entity. Therefore, the option is a derivative financial asset from the time the entity becomes a party to the option contract.

On the other hand, if entity X writes an option under which the counterparty can force the entity to sell equity shares in the listed entity Y for ₹ 100 per share at any time in the next 120 days, then entity X will be said to have a contractual obligation to exchange its equity shares to another entity for cash of ₹ 100 per share on potentially unfavourable terms i.e. if the holder exercises the option, on account of the market price per share being above the exercise price of ₹ 100 per share at the end of the 120 day period.

Since entity X stands to lose if the option is exercised, the exchange is potentially unfavourable and the option is a derivative financial liability from the time the entity becomes a party to the option contract.

Illustration 5

Entity X (the transferor) holds a portfolio of receivables with a carrying value of ₹1,00,000. It enters into a factoring arrangement with entity Y (the transferee) under which it transfers the portfolio to entity Y in exchange for ₹90,000 of cash.

Entity Y will service the loans after their transfer and debtors will pay amounts due directly to entity Y. Entity X has no obligations whatsoever to repay any sums received from the factor and has no rights to any additional sums regardless of the timing or the level of collection from the underlying debts. Evaluate

Solution

Entity X has transferred its rights to receive the cash flows from the asset via an assignment to entity Y. Furthermore, as entity Y has no recourse to entity X for either late payment risk or

credit risk, entity X has transferred substantially all the risks and rewards of ownership of the portfolio.

Hence, entity X derecognises the entire portfolio. The difference between the carrying value of ₹1,00,000 and cash received of ₹90,000 i.e. ₹10,000 is recognised immediately as a financing cost in profit or loss.

Had Entity X not transferred its rights to receive the cash flows from the asset or there would have been any credit default guarantee given by entity X, then it would have not led to complete transfer of risk and rewards and entity X could not derecognise the portfolio due to the same.

Illustration 6

Entity G places its privately held ordinary shares that are classified as equity with a stock exchange and simultaneously raises new capital by issuing new ordinary shares on the stock exchange.

Transaction costs are incurred in respect of both transactions. Determine the treatment of the incurred transactions costs?

Solution

Since the issue of new shares is the issue of an equity instrument, but the placing of the existing equity instruments with the exchange is not, the transaction costs will need to be allocated between the two transactions.

Transaction costs in respect of the new shares issued will be recognised in equity whereas the transaction costs incurred in placing the existing shares with the stock exchange will be recognised in profit or loss.

Illustration 7

An entity issues a non-redeemable callable subordinated bond with a fixed 8% coupon. The coupon can be deferred in perpetuity at the issuer's option. The issuer has a history of paying the coupon each year and the current bond price is predicated on the holders expectation that the coupon will continue to be paid each year. In addition the stated policy of the issuer is that the coupon will be paid each year, which has been publicly communicated. Evaluate?

Solution

Although there is both pressure on the issuer to pay the coupon, to maintain the bond price, and a constructive obligation to pay the coupon, there is no contractual obligation to do so. Therefore the bond is classified as an equity instrument.

Illustration 8

A zero coupon bond is an instrument where no interest is payable during the instrument's life and that is normally issued at a deep discount to the value at which it will be redeemed. Evaluate?

Solution

Although there are no mandatory periodic interest payments, the instrument provides for mandatory redemption by the issuer for a determinable amount at a fixed or determinable future date. Since there is a contractual obligation to deliver cash for the value at which the bond will be redeemed, the instrument is classified as a financial liability.

Illustration 9

On 30th March 2015 an entity enters into an agreement to purchase a Financial Asset for ₹ 1,000 which is the Fair Value on that date.

On Balance Sheet date i.e. 31/3/2017 the Fair Value is ₹1,020 and on Settlement date i.e. 2/4/2017 Fair Value is ₹ 1,030.

Pass necessary Journal entries on trade date and settlement date when the asset acquired is measured at

(a) Amortised cost

(b) FVTPL

(c) FVTOCI.

Solution

Case (a) (i) Financial Asset at Amortised Cost – Trade Date Accounting

Dates	Journal Entry		Amount	Amount
			(₹)	(₹)
30/3/2017	Financial Asset	Dr.	1,000	
	To Payables			1,000
31/3/2017	No Entry			
2/4/2017	Payables	Dr.	1,000	
	To Cash			1,000

(ii) Financial Asset at Amortised Cost – Settlement Date Accounting

Dates	Journal Entry		Amount	Amount
			(₹)	(₹)
30/3/2017	No Entry			
31/3/2017	No Entry			
2/4/2017	Financial Asset	Dr.	1,000	
	To Cash			1,000

Case (b) (i) Financial Asset at FVTPL – Trade Date Accounting

Dates	*Journal Entry*		*Amount*	*Amount*
			(₹)	*(₹)*
30/3/2017	Financial Asset	Dr.	1,000	
	To Payables			1,000
31/3/2017	Financial Asset	Dr.	20	
	To P&L			20
2/4/2017	Financial Asset	Dr.	10	
	To P&L			10
	Payables	Dr.	1,000	
	To Cash			1,000

(ii) Financial Asset at FVTPL– Settlement Date Accounting

Dates	*Journal Entry*		*Amount*	*Amount*
			(₹)	*(₹)*
30/3/2017	No Entry			
31/3/2017	Fair Value Change	Dr.	20	
	To P&L			20
2/4/2017	Fair Value Change	Dr.	10	
	To P&L			10
	Financial Asset	Dr.	1,030	
	To Cash			1,000
	To Fair Value Change			30

Case (c) (i) Financial Asset at FVTOCI – Trade Date Accounting

Dates	*Journal Entry*		*Amount*	*Amount*
			(₹)	*(₹)*
30/3/2017	Financial Asset	Dr.	1,000	
	To Payables			1,000
31/3/2017	Financial Asset	Dr.	20	
	To OCI			20
2/4/2017	Financial Asset	Dr.	10	
	To OCI			10
	Payables	Dr.	1,000	
	To Cash			1,000

(ii) Financial Asset at FVTOCI – Settlement Date Accounting

Dates	*Journal Entry*		*Amount*	*Amount*
			(₹)	*(₹)*
30/3/2017	No Entry			
31/3/2017	Fair Value Change	Dr.	20	
	To OCI			20
2/4/2017	Fair Value Change	Dr.	10	
	To OCI			10
	Financial Asset	Dr.	1,030	
	To Cash			1,000
	To Fair Value Change			30

Illustration 10

A Company invested in Equity shares of another entity on 15th March for ₹20,000. Transaction Cost = ₹400 (not included in ₹20,000)

Fair Value on Balance Sheet date i.e. 31st March 2017 = ₹24,000. Pass necessary Journal Entries when Financial Asset is accounted as FVTPL.

Solution

Date	**Particulars**		(₹)	(₹)
15/3/2017	Investment A/c	Dr.	20,000	
	Transaction Cost A/c	Dr.	400	
	To Bank			20,400
31/3/2017	Investment A/c	Dr.	4,000	
	To Fair Value Gain A/c			4,000
31/3/2017	P&L A/c	Dr.	400	
	To Transaction Cost A/c			400
31/3/2017	Fair Value Gain A/c	Dr.	4,000	
	To P&L A/c			4,000

Illustration 11

A Company invested in Equity shares of another entity on 15th March for ₹50,000. Transaction Cost = ₹1,000 (not included in ₹50,000). Fair Value on Balance Sheet date i.e. 31st March 2017 = ₹60,000. Pass necessary Journal entries when Financial Asset is accounted as FVTOCI.

Solution

Date	*Particulars*		*(₹)*	*(₹)*
15/3/2017	Investment A/c To Bank	Dr.	51,000	 51,000
31/3/2017	Investment A/c To Fair Value Gain A/c	Dr.	9,000	 9,000
31/3/2017	Fair Value Gain A/c To OCI A/c	Dr.	9,000	 9,000
31/3/2017	OCI A/c To Fair Value Reserve A/c	Dr.	9,000	 9,000

Illustration 12

A Company lends ₹ 10 lacs to another company @ 12% p.a. interest on 1/4/2017.

It incurs ₹ 4,000 incremental costs for documentation.

Loan tenure = 5 years with Interest charged annually.

Fair Value of Loan = ₹9,94,000. Pass necessary Journal entries when Financial Asset is accounted as Amortised Cost. Assume that interest rate is based on market rate of interest.

Solution

Date	*Particulars*		*(₹)*	*(₹)*
1/4/2017	Loan A/c To Bank A/c	Dr.	10,00,000	 10,00,000
1/4/2017	Loan Processing Expense A/c To Bank A/c	Dr.	4,000	 4,000
1/4/2017	Loan A/c To Loan Processing Expense A/c	Dr.	4,000	 4,000

Illustration 13

On 1st April, 2017, Alpha Ltd. issued ₹ 30,00,000, 6% convertible debentures of face value of ₹ 100 per debenture at par. The debentures are redeemable at a premium of 10% on 31.03.2021 or these may be converted into ordinary shares at the option of the holder, the interest rate for equivalent debentures without conversion rights would have been 10%.

Being compound financial instrument, you are required to separate equity and debt portion as on 01.04.2017.

Solution

Computation of Equity and Debt Component of Convertible Debentures as on 1.4.2017

	₹
Present value of the principal repayable after four years	22,44,000
[30,00,000 x 1.10 x .680 at 10% Discount factor]	
Present value of Interest	5,70,600
[1,80,000 x 3.17 (4 years cumulative 10% discount factor)]	
Value of debt component	28,14,600
Value of equity component	1,85,400
Proceeds of the issue	30,00,000

Illustration 14

A company borrowed a sum of ₹ 85 lakhs for its expansion. The terms of loan were as follows:

(i) Tenure of the loan will be 10 years.

(ii) Interest is payable @ 12% p.a. and the principal is repayable at the end of 10th year.

The company defaulted in the payment of interest for the year 4, 5 and 6.

A loan reschedule agreement took place at the end of 7th year. As per the agreement the company is required to pay ₹ 150 lakhs at the end of 8th year.

You are required to calculate the additional amount to be paid on account of rescheduling and also the book value of the loan at the end of 8th year when reschedule took place assuming that interest will be compounded in case of default.

Solution

Outstanding Amount at the end of 8th year = ₹ 85,00,000 x 1.12 x 1.12 x 1.12 x 1.12 x 1.12
= ₹ 1,49,79,904 (i.e. adding interest for 4th to 8th year)

Rescheduled amount to be paid at the end of the 8th year = ₹ 1,50,00,000

Additional amount to be paid on rescheduling = ₹ 1,50,00,000 - ₹ 1,49,79,904
= ₹ 20,096.

At the end of the 8th year, book value of loan will become Nil.

Note: In the above solution it is assumed that interest due for the 7th and 8th year have also not been paid.