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# Financial instruments - An Introduction

The use of derivative contracts to manage risks arising from changes in foreign exchange rates or interest rates is a common practice these days, even for smaller companies. A variety of financial market products are accessible, mainly due to the integration of financial markets across the globe and the growth in international commerce. The use of these complex instruments including derivative contracts brought to the surface, the shortcomings of accounting models which rely mainly on historical costs. The term 'financial instruments' was coined to include basic instruments with contractual rights/obligations, for instance, trade receivables/payables; as well as contractual rights/obligations arising from derivative instruments.

The process to develop a comprehensive guidance on the accounting for and reporting of financial instruments which was started in 1988, has resulted in various standards being issued on the subject.

We will cover the accounting and reporting aspects of financial instruments over a series of issues. In this issue, we discuss:

- Overview of standards on financial instruments
- Introduction to financial instruments
- Financial assets
- Financial liability vs equity classification
- Compound financial instruments

## Overview of standards on financial instruments

| **IFRS/IAS** | **Description** | **Ind AS** |
|---|---|---|
| IAS 32: Financial Instruments - Presentation | This was the first standard issued on financial instruments. It deals with the classification of financial instruments into financial assets, financial liabilities and equity instruments. | Ind AS 32: Financial Instruments - Presentation |
| IFRS 9: Financial Instruments which will replace IAS 39: Financial Instruments - Recognition and Measurement | The revised standard exhaustively deals with the measurement, recognition and de-recognition principles for each class of financial assets as well as each class of financial liability. It also deals with the financial reporting aspects for embedded derivatives as well as hedge accounting. | Ind AS 109: Financial Instruments |
| IFRS 7: Financial Instruments - Disclosures | It lays down the disclosure requirements to enable users to evaluate the impact (in terms of significance and nature of risks) of financial instruments on the entity's financial position and performance. | Ind AS 107: Financial Instruments - Disclosures |

## Financial instruments

There are various standards that deal with the recognition and measurement principles of 'non financial assets'. These are assets which assist in creating an opportunity to generate an inflow of cash or other assets (for example: property, plant and equipment, inventories). On the other hand, there are assets and liabilities which represent a contractual right/obligation to receive/pay cash or other financial assets. Assets, liabilities or equity instruments resulting from contractual rights/obligations can be grouped as financial instruments. Cash, trade receivables and payables, loans receivables and payables are common examples of primary financial instruments. Forwards, options, swaps are some examples of derivative financial instruments.

Ind AS 32 requires that an issuer should classify a financial instrument (or its component parts) as a financial asset, a financial liability or equity instrument on initial recognition. Such classification should be based on the substance of the contractual agreement as well as the definition of financial asset, financial liability and equity instrument.

All financial instruments would be a result of contractual rights/obligations. In this context, 'contractual' refers to an agreement between two or more parties that have a clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. These agreements need not be in writing.

A chain of contractual rights or contractual obligations is also 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. Liabilities or assets that are not contractual (say statutory dues) are not financial instruments. Similarly, contractual right/obligation to acquire/sell a non-financial item (say gold bullion) is also not a financial instrument.

## Financial assets

A financial asset is any asset that is:

- Cash
- An equity instrument of another entity
- A contractual right -
  - To receive cash or another financial asset
  - To exchange financial assets or liabilities under conditions that are potentially favourable to the entity.
- Certain contracts which will or may be settled in entity's own equity instruments.

The following table gives a few examples:

| Asset | Is it a financial asset? |
|---|---|
| Currency (cash) | Yes |
| Deposit of cash with bank | Yes |
| Trade/loans receivable | Yes |
| Refundable lease deposits | Yes |
| Prepaid expenses | No |
| Physical assets (example: inventory, property, plant and equipment) | No |
| Advance taxes | No |

## Financial liability vs equity classification

### Financial liabilities

A financial liability is any liability that is:

- A contractual obligation
  - To deliver cash or another financial asset
  - To exchange financial assets or liabilities under conditions that are potentially unfavourable to the entity.
- Certain contracts which will or may be settled in entity's own equity instruments.

The existence of a contractual obligation is the key criterion for classification as a financial liability. The distinction between financial liability and equity instrument would be driven by substance rather than the legal form. Substance and legal form are mostly consistent, but not always. Some financial instruments take the legal form of equity but are liabilities in substance and others may combine features associated with equity instruments and features associated with financial liabilities. For instance, certain preference shares may exhibit all the characteristics of a financial liability. Careful consideration is required to classify an obligation, arising from a financial instrument, as a financial liability or an equity instrument.

If an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability. This is true, except for certain puttable instruments (A puttable instrument is a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder).

## Equity instruments

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

With respect to contracts where there is no option to settle the instrument into entity's own equity instruments, the instrument should satisfy the following conditions for being classified as equity instrument.

The instrument includes no contractual obligation:
(i) to deliver cash or another financial asset to another entity (the investor/holder); or
(ii) to exchange financial assets or financial liabilities with another entity (the investor/holder) under conditions that are potentially unfavourable to the issuer.

Thus, the aforementioned instruments will be classified as an equity instrument only where the issuer has an unconditional right to avoid delivering cash or another financial asset. This unconditional right to avoid delivering cash or another financial asset is not affected by factors like:

- Pressure on the company to declare dividends, so as to avoid any negative impact on the market price of ordinary shares.
- Availability of reserves or intention to declare dividends
- History of distribution of dividends.

**Example 1: Ordinary shares**
ABC Ltd. has issued ordinary shares (equity shares) which are not redeemable during the life time of the company. The payment of dividends on these shares is at the discretion of the company ABC Ltd.

Since there is no contractual obligation with respect to either the principal component or the dividend component, these ordinary shares exhibit characteristics of equity.

## Contractual obligation to deliver cash or another financial asset

A critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of one party to the financial instrument (the issuer) to deliver cash or another financial asset to the other party (the holder). Alternatively, it may also be a contractual obligation on the issuer to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer. It is pertinent to note that certain puttable instruments are an exception to the stated rule.

Let us consider a few examples, wherein we examine the contractual provisions relating to principal and return components.

**Example 2: Redeemable preference shares with mandatory dividends**
ABC Ltd. (Issuer) has issued 8% preference shares with mandatory fixed dividend obligation. These shares are to be mandatorily redeemed by the issuer for a fixed amount after the end of 10 years from the issue date.

Issuer has a contractual obligation to deliver cash for dividends as well as for redemption and hence these preference shares are to be classified as financial liability in its entirety.

**Example 3: Non redeemable preference shares**
ABC Ltd. (Issuer) has issued 8% non-redeemable preference shares with dividend payments linked to ordinary shares. The dividends on the preference shares are to be paid only if the issuer decides to pay dividend on its ordinary shares.

The dividend payments in the given case are discretionary and not contractual. This is because the issuer can opt to not pay any dividend on its ordinary shares (equity instruments). It must be noted that an issuer may wish to pay dividend on ordinary shares to meet the expectation of investors, however, there exists no contractual obligation for the issuer to do so.

Furthermore, the preference shares are non-redeemable. Thus, there is no contractual obligation to repay the principal.

These preference shares will thus, be classified as equity instruments.

In conclusion, if an issuer does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability. Certain puttable instruments are the only exception to this rule.

## Contractual obligations that are not explicit

Certain financial instruments may not provide an explicit obligation to deliver cash or another financial asset through its terms and conditions. Classification in such cases would be governed by the actual substance of the contractual terms.

**Example 4:**
A financial instrument provides that on settlement the issuer will deliver either: (i) cash or another financial asset; or (ii) its own shares whose value is determined to exceed substantially the value of the cash or other financial asset(s). Although, the entity does not have an

explicit contractual obligation to deliver cash or another financial asset(s), the value of the share settlement alternative is such that the entity will settle in cash. In any event, the holder has, in substance, been guaranteed a receipt of an amount that is at least equal to the cash settlement option.

## Contingent settlement provisions

A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability. Furthermore, such a settlement will be required only in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument. Instances of such uncertain future events are:

- Change in a stock market index
- Change in consumer price index
- Changes in law relating to taxation
- Requirements relating to issuer's future debt-equity ratio

The issuer of such an instrument does not have the unconditional right, in perpetuity, to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer.

**Example 5: Contingent settlement provisions**
ABC Ltd. (issuer) has issued 8% bonds. Under the current tax laws, the annual interest income earned on these bonds is exempt from tax. The bonds are redeemable in the event of tax exemption for interest income being withdrawn by the tax authorities.

As regards interest component, the issuer has a contractual obligation to pay interest.

As regards principal component, the issuer's liability to pay cash will arise only in case of a contingent event (changes in tax laws) which is beyond the control of both the issuer and holder of the instrument. It must also be noted that the issuer does not have an unconditional right to avoid delivering cash.

Hence, these 8% bonds are a financial liability for the issuer.

**Exceptions**
Under the following circumstances, the aforementioned contingent settlement provision will not lead to classification as a financial liability:

i. Contingent settlement event is considered to be 'not genuine'. An event that is extremely rare, highly abnormal and very unlikely to occur is considered to be 'not genuine'.
ii. The requirement to settle the obligation would arise only in the event of liquidation of the issuer.
iii. Puttable instruments which are classified as equity instruments pursuant to satisfying 'instrument specific conditions'.

## Settlement options

When a derivative financial instrument gives one party a choice over how it is settled, it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument.

## Contracts that will or may be settled in entity's own equity instruments

Various factors must be considered for the classification of these contracts as financial liability or equity instruments.

If the aforementioned contract is a non-derivative contract, it will be an equity instrument only if it does not include any contractual obligation for the issuer to deliver a variable number of its own equity instruments.

**Example 6: Contract to deliver variable number of entity's own equity instruments**
ABC Ltd. (Issuer) has entered into a contract to deliver as many of it's own ordinary shares as are equal in value to INR 100,000.

The number of ordinary shares required to be delivered at the time of settlement will vary depending upon the value of one ordinary share at that time. Thus, it is not an equity instrument because the entity uses a variable number of its own equity instruments as a means to settle the contract. Accordingly, the contract does not evidence a residual interest in the entity's assets after deducting all of its liabilities.

**Example 7: Convertible bonds**
ABC Ltd. has issued 10,000 8% convertible bonds of face value INR 100 each with a maturity of three years. On maturity, the holder of the bonds has an option to convert one bond into as many number of ordinary shares of ABC Ltd as are equal to an amount of INR 100.

As regards the interest component, there exists a contractual obligation and thus, has the characteristics of financial liability.

As regards the repayment of principal, the number of ordinary shares required to settle the contract will vary based on the fair value of ordinary shares prevailing at that time. Hence, the principal component, does not have characteristics of equity.

The convertible bonds as a whole are a financial liability.

Classification of derivative contracts that will or may be settled in an entity's own equity instruments, as well as classification of puttable instruments will be discussed in subsequent issues.

## Compound financial instrument

Certain non-derivative financial instruments may exhibit characteristics of both the financial liability as well as equity instrument.

In accordance with Ind AS 32, an entity recognises separately the components of a financial instrument that (a) creates a financial liability of the entity and (b) grants an option to the holder of the instrument to convert it into an equity instrument of the entity.

Take for instance, a 12% bond that can be converted on maturity into a fixed number of the issuer's own equity shares with the following contractual provisions relating to principal and return components:

- Issuer has a contractual obligation towards mandatory interest payments- the financial liability component.
- As regards principal component, there exists a call option granting the right to the holder, for a specified period of time, to convert the bonds into a fixed number of ordinary shares of the issuer.

The 12% bond in the given case is a compound financial instrument. The economic effect of issuing such an instrument is substantially the same as issuing simultaneously a debt instrument with an early settlement provision and warrants to purchase ordinary shares. Thus, going by the substance driven classification, (as required by Ind AS 32), the compound financial instrument is separated at the time of initial recognition into a financial liability and the equity component and this classification is not revised subsequently. This classification would be based on the respective definition for financial liabilities and equity instruments.

## Separating the liability and equity component

The initial carrying amount of the compound financial instrument (the 12% bond, in this case) measured in accordance with Ind AS 109 needs to be allocated to the financial liability and the equity component. This is done in a manner that no gain or loss arises from initially recognising the components of the instrument separately.

Fair value of compound financial instrument is equal to the issue price of the convertible bonds minus transaction costs.

Fair value of liability component is equal to the present value of the stream of interest payments and other amounts contractually payable during the life time of the instrument. While calculating this present value, the discounting rate to be used will be the rate of interest that the market will apply to instruments of comparable credit status and providing substantially the same cash flows, on the same terms, but without the conversion option (i.e. without the equity component).

Since equity represents residual interest in the net assets, the fair value of equity component is equal to the fair value of compound financial instrument minus the fair value of the liability component.

Examples on compound financial instruments follow.

**Example 8: Non-redeemable preference shares with mandatory dividends**
ABC Ltd. (Issuer) has issued 8% non-redeemable preference shares with mandatory fixed dividends.

For the principal component, the issuer does not have any contractual obligation and thus the principal component has equity characteristics.

For the dividend parts, the issuer has a mandatory obligation to pay dividends at a fixed rate. This obligation is not dependent upon the availability or non-availability of profits or on any other factor. The dividend strip, thus, has the characteristics of a financial liability.

Thus it appears the given financial instrument may be a compound instrument requiring each component to be accounted separately. The liability component will be measured as the present value of the dividend payments into perpetuity. Since equity represents residuary interest, the value of equity component will be determined as the fair value of compound instrument minus the fair value of the liability component. If, however, the fixed rate for dividend is set at the prevailing market rates, then, the fair value of a liability component would be equal to the fair value of the compound instrument. Hence, the fair value of equity component would be nil.

**Example 9: Convertible bonds**
ABC Ltd. (Issuer) has issued 10,000 8% convertible bonds of face value INR 100 each with a maturity of three years. On maturity, the holder of the bonds has an option to convert one bond into three ordinary shares of ABC Ltd. At the time of the issue, the rate of interest prevailing in the market on similar bonds without the equity conversion option is 10%. Assuming that the transaction costs are nil, the proceeds from the issue of bonds are INR 1,000,000, which is also the fair value of the convertible bonds (i.e. compound instrument as a whole). The accounting should be carried out in the following manner.

**Ascertaining the value of liability component**
Contractual cash flows would be interest payable annually at the rate of 8% on the principal i.e. INR 80,000 and repayment of principal at the end of third year i.e.

INR 1,000,000. The present value of stream of contractual cash flows, using 10% as the discounting rate is given in the table below:

| Present value of: | Calculation | Present value amount (INR) |
|---|---|---|
| Interest payable at the end of Y1 | 80,000/(1.10) | 72,727 |
| Interest payable at the end of Y2 | $80,000/(1.10)^2$ | 66,116 |
| Interest payable at the end of Y3 | $80,000/(1.10)^3$ | 60,105 |
| Principal repayable at the end of Y3 | $1,000,000/(1.10)^3$ | 751,315 |
| **Total** | | **950,263** |

**Ascertaining the value of equity component**
Equity component representing the residuary amount is calculated as follows:

| Particulars | Amount (INR) |
|---|---|
| Fair value of compound instrument as a whole | 1,000,000 |
| Less: | |
| Fair value of liability component | 950,263 |
| Value of equity component | 49,737 |

The following journal entry would be appropriate:

| Particulars | Debit Amount (INR) | Credit Amount (INR) |
|---|---|---|
| Bank A/c_ Dr. | 1,000,000 | |
| To financial liability component of 8% convertible bonds | | 950,263 |
| To equity component of 8% convertible bonds | | 49,737 |

**Example 10: Considering transactions costs in example 9**
Assuming that in Example 4 above, ABC Ltd. incurs INR 15,000 as transaction costs towards issue of bonds. The fair value of bonds will be calculated as follows:

| Particulars | Amount (INR) |
|---|---|
| Proceeds received from issue of bonds | 1,000,000 |
| Less: | |
| Transaction costs | 15,000 |
| Fair value of compound instrument as a whole | 985,000 |

The transaction costs of INR 15,000 will be allocated to the financial liability and equity component in the proportion of amounts determined above i.e. 950,263:49,737.

| Transaction costs allocated to | Calculation | Amount (INR) |
|---|---|---|
| Financial liability component | 15,000* (950,263/1,000,000) | 14,254 |
| Equity component | 15,000* (49,737/1,000,000) | 746 |
| **Total** | | **15,000** |

The amounts to be initially recognised will thus be:

| Particulars | Proceeds | Transaction cost | Amount (INR) |
|---|---|---|---|
| Financial liability component | 950,263 | 14,254 | 936,009 |
| Equity component | 49,737 | 746 | 48,991 |
| **Total.** | **1,000,000** | **15,000** | **985,000** |

## Conversion of compound financial instrument.

On conversion of a convertible instrument at maturity, the entity derecognises the liability component and recognises it as equity. The original equity component remains as equity (although it may be transferred from one line item within equity to another). There is no gain or loss on conversion at maturity.

**Example 11: Conversion at the end of year three - of bonds described in Example 9**
Using the effective interest rate method, the financial liability component at the end of each year would show the following balance:

| Year | Opening liability | Add: Interest accrued @ 10% | Less: Interest paid | Closing liability |
|---|---|---|---|---|
| 1 | 950,263 | 95,026 | 80,000 | 965,289 |
| 2 | 965,289 | 96,529 | 80,000 | 981,818 |
| 3 | 981,818 | 98,182 | 80,000 | 1,000,000 |

The equity component will remain INR 49,737.

At the end of three years, when the conversion option is exercised, the liability component (having a balance of INR 1,000,000) will be derecognised by giving a corresponding credit to equity. The journal entry would be:

| Particulars | Debit Amount (INR) | Credit Amount (INR) |
|---|---|---|
| Financial liability component of 8% convertible bonds A/c_ Dr. | 1,000,000 | |
| To ordinary shares | | 1,000,000 |

The original equity component of INR 49,737 may be transferred to another line item within equity.

## In retrospect

The principles discussed above are laid down in Ind AS 32. In 2009, the Institute of Chartered Accountants of India came out with Accounting Standards 30, 31 and 32 relating to recognition, measurement and presentation and disclosures of financial instruments. With this, the need to have a comprehensive accounting guidance on the subject matter was emphasised. These standards were largely in line with the IFRS/IAS counterparts. The standards were however not notified by the Ministry of Corporate Affairs (MCA).

Even at that time, it was a consensus that the application of standards relating to financial instruments would require businesses to prepare on various fronts. Now is the time to capitalise on the preparation and ensure a smother application of these standards.

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