Seminar on Financial Instruments

AS 31 – Financial Instruments: Presentation

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Financial instruments – definition

Contract that gives rise to *both* a financial asset of one entity

&

A financial liability and /or an equity instrument of another entity

- Financial asset
- Financial liability
- Equity instrument

AS on Financial Instruments

- AS 30 → Financial Instruments: Recognition & Measurement
  - IAS 39, IFRS 9
- AS 31 → Financial Instruments: Presentation
  - IAS 32
- AS 32 → Financial Instruments: Disclosure
  - IFRS 7

Why AS for Financial Instruments ?

- Globalisation of Indian Economy;
- Increasing sophistication of financial products and markets;
- Increased use of derivatives for risk mitigation and trading;
- No Comprehensive standard until now and
- Presently, diverse practice has made comparability of performance difficult.

Key concepts

- The standard focuses on substance over form in accounting for financial instruments. The key concepts that come to fore are:

  - Fair valuation
  - Symmetry
  - Hedge accounting

- The standard is likely to have far reaching implications on accounting of most assets and liabilities with consequent PL implicaitons due to fair valuation, changes in various laws and challenging certain normally accepted principles

AS for financial instruments

- **AS 30**
  - Recognition and derecognition of financial instruments
  - Measurement of financial instruments
  - Derivatives and hedge accounting
- **AS 31**
  - Presentation
- **AS 32**
  - Disclosure

AS 31 – FIs Presentation

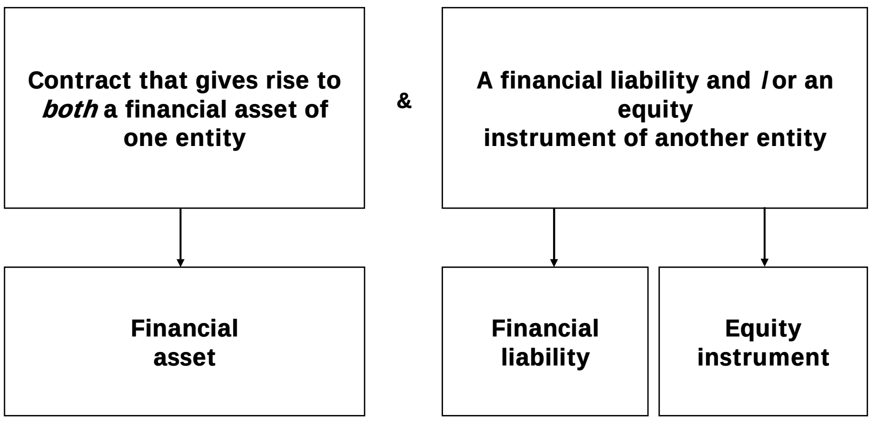
Objective and scope

- Establish principles for
  - Presenting financial instruments as liability or equity (and related classification of interest, dividends, losses and gains) by the issuer
  - Offsetting a financial asset and a financial liability
  - Presentation of transactions in own equity
  - Accounting for treasury stock

AS 31 – Objective and scope…

- This standard applies to all types of financial instruments and certain contracts for non financial items (within the scope of AS 30) except
  - ★ Interests in subsidiaries, associates and joint ventures
  - ★ Employer's rights and obligations under employee benefit schemes
  - ★ Contingent consideration in business combinations
  - ★ Insurance contacts (except embedded derivatives requiring separation under AS 30)

Financial instruments – definition



Financial instruments – definition…

- Financial asset
  - cash
  - equity instrument of another entity
  - a contractual right to receive cash or another financial asset from another entity or to exchange financial assets or liabilities with another entity under conditions that are potentially favourable to the entity
  - a contract that will or may be settled in the entity's own equity instrument 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 (does not include contracts for the future receipt or delivery of the entity's own equity instruments)

Financial instruments – definition…

- Financial liability
  - A contractual obligation to deliver cash or another financial asset to another entity or to exchange financial assets or liabilities with another entity under conditions that are potentially unfavourable to the entity
  - a contract that will or may be settled in the entity's own equity instrument 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 (does not include contracts for the future receipt or delivery of the entity's own equity instruments)

Financial instruments – definition…

- Equity instrument
  - A contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.
- Fair value
  - Fair value is the amount for which an asset could be exchanged, or a liability settled between knowledgeable, willing parties in an arm's length transaction.

Financial instruments – examples

- Financial assets and liabilities
  - Trade receivables and payables
  - Loans receivable and payable
  - Deposits and advances
  - Perpetual debt instruments
  - Contractual rights arising on contingent assets – eg. Guarantees
  - Finance leases
- Following are not financial assets and instruments
  - Physical assets such as property, plant and equipment
  - Prepaid expenses (associated with the delivery of goods and services and not contractual obligation to pay cash or another financial asset).
  - Liabilities that are not of a contractual nature (such as income taxes)

Financial instruments – examples…

- Equity instruments
  - Equity shares
  - Irredeemable preference shares
  - Portion of preference shares having discretionary dividends after reducing liability component
  - Warrants / written call options that are settled by a fixed number of own instruments for a fixed amount of cash or another financial asset (equity option component of a convertible bond/debenture)
- Derivative financial instruments
  - Options, futures, forwards, interest rate swaps, currency swaps etc.

AS 31 – Liability and equity classification

- AS 31 adopts a substance based approach to equity and liability classification.
- However, the analysis of substance is not of intention but of the contractual arrangements.
- Liquidation preference is not a determinant to classify an instrument as equity or a liability

Liability or Equity?

- **Financial instrument is an equity instrument only if both criteria are met:**
  - ★ There is no obligation to deliver cash or another financial asset or to exchange financial assets or financial liability; and
  - ★ The issuer will exchange fixed amount of cash or another financial asset for a fixed number of its own equity instruments.

Does the entity have an unavoidable contractual obligation to deliver or exchange?

Yes → Liability

No → Equity

When there is a statutory requirement for classification as equity or liability, compliance with law = compliance with AS

Liability or Equity?...

- Redeemable preference share
- Mutual funds
- Partnership firms / co-operatives – entities with ownership shares which are puttable at 'fair value'
- Instruments which become redeemable by operation of law/statute

- Compound instrument = part equity and part debt
  e.g. convertible debt
- Split accounting required
- The liability portion is valued first and the equity portion is the residual amount

Liability or Equity?...

- Entity A issues a convertible bond on 1 January 2007 for 1,000,000.
- The interest rate on this bond is 10% per year payable annually, and the maturity is 10 years.
- The bond is convertible into the company's equity at each interest payment date after 5 years.
- The market rate for a comparable bond without the conversion features is 12% per year.

Present value of the principal:	$1\ 000\ 000 / (1 + 0.12)^{10} = 321\ 973$
Present value of the interest:	$\sum^{n}_{i=1} 100\ 000 / (1 + 0.12)^{i} = 565\ 022$
Total debt amount:	886 995
The equity is the residual	113 005

Liability or Equity?...

- Classification of liability and equity components of a convertible instrument is not revised as a result of a change in the likelihood that a conversion option will be exercised.
- The standard does not prescribe the specific line item in equity where a equity component of a compound instrument should be reflected in.
- No gain or loss arises from initially recognising the components of a compound instrument separately.
- Once allocation of equity and liability components are made and resulting gain or loss is made in accordance with the accounting principles applicable to the related component.
- Subsequent changes in the terms of an instrument are recognised (by comparing with the fair value of the new instrument) in the profit and loss account.

Transactions in own equity

A contract is not an equity instrument solely because it will result in the delivery of the entity's own equity instruments

Does the issuer potentially have an obligation to settle gross in cash or in a variable number of own shares? → Yes → **Liability**

↓ No

Will settlement be the exchange of fixed number of shares for fixed amount? → Yes → **Equity**

↓ No

Derivative

Contingent settlement provisions

- An instrument with a contingent settlement provision would be a financial liability for the issuer unless:

  - ★ The contingent settlement provision that could require settlement in cash or another financial asset is **not genuine**; or
  - ★ The issuer can be required to settle the obligation in cash or another financial asset **only in the event of liquidation of the issuer**.

Buyback of shares

- If an entity re-acquires (buys-back) its own shares, nominal value of those shares should be deducted from share capital

★ No gain or loss should be recognized in the profit and loss account;

★ Difference between the consideration paid and the nominal value of shares should be recognized in an appropriate equity account.

Interest, dividends, losses and gains

- Income statement classification of interest, dividends, losses and gains follows directly from the balance sheet classification as liability or equity.

★ Any income statement effect on a financial liability will be recognized as an expense irrespective of the nomenclature of the item eg. dividends, distributions etc.

★ Distributions to holders of an equity instrument should be recognized in an appropriate equity account

★ Transaction costs, net of any income tax benefit, of an equity transaction should be recognized in an appropriate equity account

★ Unwinding of discount / redemption premiums form part of the recognized interest expense for a period on an effective interest rate basis.

★ Dividends classified as an expense are presented in the statement of profit and loss as a separate item.

Offsetting a financial asset and a financial liability

A ***currently legally enforceable*** right to set off
and an intention to settle net
or to realise the asset and settle the liability ***simultaneously***

but

Practical situations will cause implementation challenges

- **Master netting agreements**
- **Several instruments used to emulate a single instrument (synthetic instrument)**
- **Items with the same risk, but different counterparties**
- **Financial assets pledged as collateral for non-recourse liabilities**
- **Financial assets that did not qualify for de-recognition under AS 30**

In practice, netting will be difficult to achieve other than in very limited situations....because neither purely intention nor purely legal right is sufficient

Potential areas of impact

- As the classification of instruments changes, a number of parties will have to amend their current approach. For instance if all redeemable preference shares are now classified as liabilities:

- Management – Lower profits as dividends are now treated as interest costs; higher gearing
- Investors – Impairment treatment under AS 30 differs for debt and equity instruments
- Analysts and credit rating agencies – Adjust valuation and rating models
- Banks and lenders – expectations around debt covenants around debt equity ratios and debt service will need to change.

Classification of financial instruments

Category	Definition
Financial assets and financial liabilities at fair value through profit and loss	▣Classified as held for trading (intended to be actively traded) ▣All derivatives are classified as held for trading (except those used as hedging instruments on financial guarantee) ▣Financial asset or financial liability designated as such at inception (subject to certain conditions)
Held-to-maturity investments	▣Financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity
Loans and receivables	▣Non-derivatives financial assets with fixed or determinable payments, whether originated or acquired, quoted in an active market. (Does not need to have a fixed maturity)

Classification of financial instruments...

Category	Definition
Available-for-sale financial assets (AFS)	▣ **Non-derivative financial assets designated as AFS or that are not:** ◈ **Loans or receivables** ◈ **Held-to-maturity investments** ◈ **Financial assets at fair value through profit and loss**
Other financial liabilities	▣**Financial liabilities that are not classified as "fair value through PL", e.g. Warrants, obligations to deliver cash/cash equivalents/financial assets**

Classification of financial instruments: Held-to-Maturity Investments

Positive intent and ability to hold to maturity ?

Yes

Was any held-to-maturity instrument sold or reclassified in the current or two preceding years?

Yes

- Near maturity
- Isolated event beyond an entity's control
- Collected substantially all principal OR
- Insignificant amount in relation to the held-to-maturity portfolio

No

Reclassify all HTM instruments as available-for-sale

Yes

No

Classify as held-to-maturity and measure at amortised cost

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Classification of financial instruments: Available-for-sale financial assets

- **All available for sale assets are marked to market through a separate component of equity (Investment revaluation reserve account)**
- **Gains and losses on AFS assets are recognised in the profit and loss account on disposal or impairment of the asset. However, there are a number of other complications with available for sale gains and losses**

Gain or loss on available-for-sale asset

Change in value due to embedded derivative

Effective interest rate

Change in value due to spot FX change

Other changes in fair value

Profit and Loss Account

Equity

Recycled to the profit and loss account on disposal or impairment of the asset

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Amortised cost and effective interest method

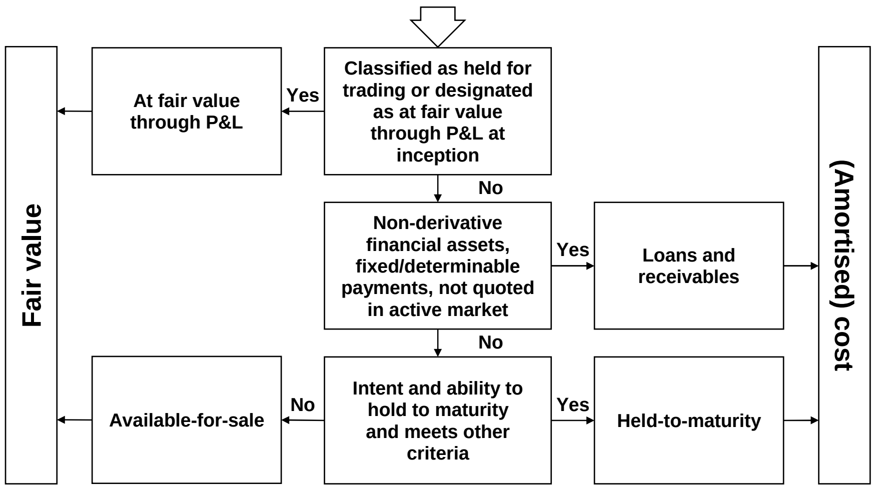
Amortised cost = Initial Recognition –/+ Cumulative amortisation using effective interest method – Impairment / uncollectibility – Principal Repayments

Effective Interest Method - Method of calculating amortisation cost and of allocating interest Income / Expenses over the relevant period

Effective Interest Rate – Rate that exactly discounts estimated future cash payments and receipts through the expected life of the financial instrument

At each reporting date apply the effective interest rate to carrying amount to determine interest income and interest expense

Classification determines subsequent measurement of financial assets



… similarly applies to financial liabilities

Improvements to IAS 39

- IAS 39 being rehashed by introducing 3 new IFRSs
- IFRS 9 Financial Instruments Classification & Measurement already introduced
  - Only two categories of FIs
    - FVTPL
    - Those with loan features and managed on contracted yield basis
- Exposure drafts on Impairment & Hedge Accounting expected in 2010

Freestanding derivatives – definition

Three characteristics

Fair value changes in response to the change in underlying	No initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors	Settled at a future date
• Interest rate • Financial instrument price • Commodity price • Foreign exchange rate • Credit rating/index • Index of prices or rates • Other variables (in the case of a non-financial variable - it is not specific to a party to the contract)		

Embedded Derivatives

- A component of a hybrid (combined) instrument that also includes a non-derivative host contract
  - Some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative
- A derivative attached to a financial instrument but contractually transferable independently of that instrument, or having a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument

Embedded derivatives…

Host contract

- FA / FL
- Normal purchase / sale contract
- Shares
- Leases
- Insurance

Embedded derivative

- Interest rate
- Foreign exchange rate
- Commodity price/index
- Security price
- Index rate

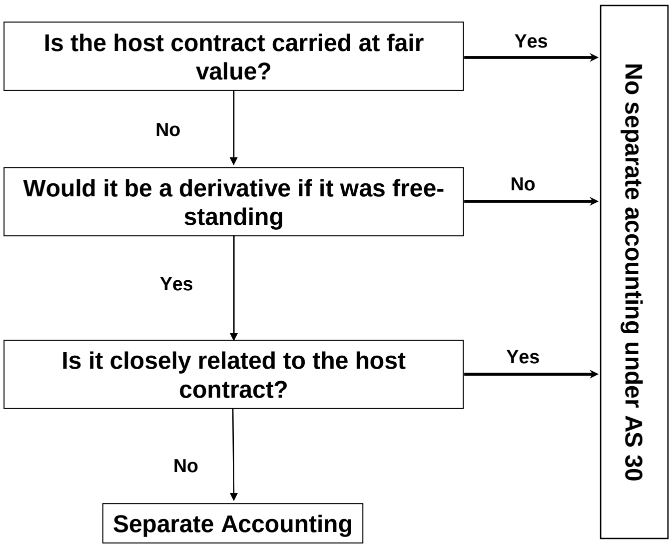
Embedded Derivatives…

- Should be separated from host contract for accounting, when
  - No close relationship pertaining to economic characteristics & risk between host and embedded
  - Can be traded as a derivative in isolation
  - Hybrid Instrument is not treated as FVTPL

Embedded Derivatives…

- May designate the entire hybrid contract at FVTPL, unless:
  - The embedded derivative does not significantly modify the cash flows
  - No past history that separation of embedded derivatives is prohibited
- Even though required by the AS to separate, but is unable to measure separately, then entire hybrid contract is designated as FVTPL

Embedded Derivatives…



Thank You

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