

Ind AS 32 Financial Instruments: Presentation

Agenda

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- ▶ Transactions in own equity – gross settled contracts
- ▶ Liabilities vs. equity – Preference shares and puttable instruments
- ▶ Compound instruments
- ▶ Treasury shares
- ▶ Reclassification from liability to equity
- ▶ Extinguishing financial liabilities with equity instruments

Objective and Scope



Objective and Scope

Objective

To establish principles for presenting financial instruments as liability or equity and for offsetting financial assets and liabilities

Scope

- ▶ Classification of financial instruments, by their issuer, into financial liabilities and equity instruments
- ▶ Settling a financial liability with an equity instrument
- ▶ Treasury shares – i.e. an entity's own equity instruments held by the entity
- ▶ Forward contracts or options for the receipt or delivery of the entity's own equity instruments
- ▶ The circumstances in which financial assets and financial liabilities should be offset

Financial instrument

- ▶ Any **contract** that gives rise to both
 - ▶ a **financial asset** of one entity, and
 - ▶ a **financial liability** or **equity instrument** of another entity

Liabilities vs equity



Definition – financial liability

Any liability that is

- ▶ A contractual obligation
 - ▶ to deliver cash or another financial asset to another entity;
 - ▶ to exchange financial assets/ liabilities with another entity under potentially unfavourable conditions

OR

- ▶ A contract that will or may be settled in the entity's own equity instruments and is
 - ▶ 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
 - ▶ 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
- ▶ Examples: Loans, bank overdrafts, mandatorily redeemable preference shares

Definition – equity instrument

Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Examples:

- Ø Ordinary shares
- Ø Share warrant
- Ø Mandatorily convertible preference shares

An instrument is an equity instrument if, and only if, **both** of the conditions below are met:

- ▶ Instrument includes no contractual obligation
 - ▶ to deliver cash or another financial asset to another entity;
 - ▶ to exchange financial assets/ liabilities with another entity under potentially unfavourable conditions
- ▶ If the instrument will or may be settled in the issuer's own equity instrument, it is
 - ▶ a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments or
 - ▶ a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments

Liabilities vs. equity – classification criteria

- ∅ An issuer of a financial instrument must classify the instrument or its component parts:
 - ∅ On initial recognition as financial liability/financial asset/equity
 - ∅ In accordance with the substance of the contractual arrangement, and
 - ∅ Based on definitions of financial liabilities/financial assets/equity
- ∅ The classification of an instrument as equity or a financial liability would not be impacted by, for example:
 - ∅ A history of making distributions
 - ∅ An intention to make distribution in the future
 - ∅ A possible negative impact on price of the issuer's ordinary shares if distributions are not made
 - ∅ The amount of the issuer's reserves
 - ∅ An issuer's expectations of a profit or loss for a period
 - ∅ An ability or inability of the issuer to influence the amount of its profit or loss for the period.

Liabilities vs. equity – key differentiators

- ▶ Critical feature differentiating a financial liability from equity:
 - ▶ Existence of a contractual obligation
 - ▶ To deliver cash/ another financial asset or
 - ▶ To exchange financial assets /financial liabilities under conditions that are potentially unfavourable to the issuer
- ▶ An issuer of an equity instrument does not have a contractual obligation to make distributions because it cannot be required to deliver cash or another financial asset to the holder
- ▶ Substance of financial instrument rather than its legal form, governs its classification
- ▶ Substance and legal form commonly consistent, but not always

Examples: whether financial liability?

Tax liability / deferred tax liability	>>	No	It is the obligation established from local law / statute and not because of contractual arrangement
Finance lease obligations	>>	Yes	However, accounting for financial lease obligations, except de-recognition, is not covered under Ind AS 109
Non refundable revenue received in advance	>>	No	There is no contractual obligation to pay cash / other financial assets
Non refundable advance received against <u>sale of government securities</u>	>>	Yes	Instrument contains contractual obligation to deliver other financial asset, viz., government securities
Liability for damages under a lawsuit	>>	No	Not arising because of contractual arrangement

Case study

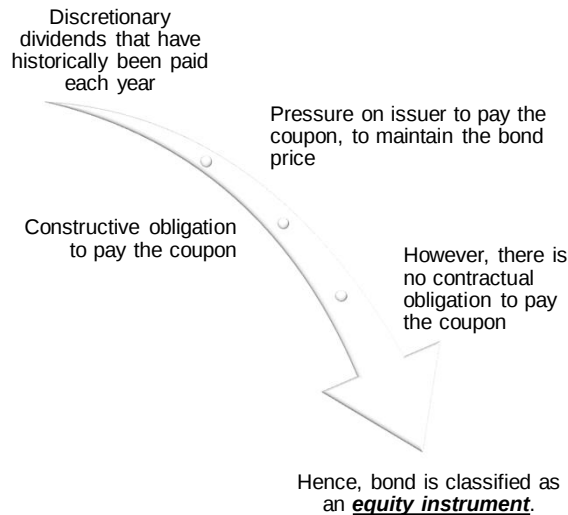


Company A issues a non-redeemable callable bond with a fixed 8% coupon.

- Ø Coupon can be deferred in perpetuity at the A's option
- Ø A has a history of paying the coupon each year and based on this trend current bond price is predictable on the holders expectation that the coupon will continue to be paid each year
- Ø Stated policy of A says that the coupon will be paid each year, which is available in public domain

Whether the bond should be classified as liability or equity?

Case study: Solution



Contingent settlement provisions

- ▶ A financial instrument may require delivery of cash depending on occurrence or non-occurrence of uncertain future events.
 - ▶ If the events are beyond the control of issuer and holder:
 - ▶ The issuer does not have the unconditional right to avoid delivering cash or another financial asset.
 - ▶ The instrument is a **liability**.
 - ▶ **Unless:**
 - (a) The part of the contingent settlement provision that could require settlement in cash or another financial asset is not genuine; or
 - (b) The issuer can be required to settle the obligation in cash or another financial asset only in the event of liquidation of the issuer.

Contingent settlement provisions (cont'd.)

- ▶ Not genuine = Provision that is extremely rare, highly abnormal and very unlikely to occur
- ▶ Not Genuine is generally understood to be spurious/ counterfeit/ without commercial substance.
- ▶ Not the same as 'remote' under Ind AS 37
- ▶ If an instrument provides for redemption on occurrence of events that are a likely precursor of liquidation (e.g. extreme insolvency, the financial statements not being prepared on a going concern basis) but falling short of formal liquidation, the instrument must be treated as a financial liability

Case study



Entity A issues undated preference shares with 6% dividend. Entity A is listed, has a credit rating of AA and operates in a stable economy.

The market rate interest is 5.5%.

The shareholders may not redeem the preference shares. However, Entity A may repay them after the 5th year.

After the fifth year (if not repaid by Entity A), the annual dividend on the preference shares will be stepped up to 20% (cumulative).

Entity A has full discretion on dividend distributions. However, it may not pay dividend on its ordinary shares before paying the dividend on the preference shares.

How should the shares be classified: equity or liability?

Case study: Solution

- ▶ In substance, Entity A has an obligation to redeem the shares in the fifth year as the entity can replace it with a cheaper finance.
- ▶ IFRIC discussed this situation and concluded that the preference shares should be classified as equity instruments since the entity has no contractual obligation to redeem or to pay dividends.
- ▶ The fact that not paying dividend may have serious effects on the entity's share price and on its reputation does not negate the equity classification.

Contingent settlement provisions (cont'd.)

Whether the event is within issuer's control or not?

Issuer makes a distribution on ordinary shares

Yes, dividends on ordinary shares are discretionary

Event of default under any of the issuer's debt facilities

No

Disposal of all or substantially all of the issuer's business undertaking or assets

Yes

Change in credit rating of the issuer

No

Upon suspension of listing of the issuer's shares from trading on the stock exchange for more than a certain number of days

Probably not, but it will depend on the jurisdiction and whether the reasons for suspension are always within the control of the entity

A change in accounting, taxation, or regulatory regime which is expected to adversely affect the financial position of the issuer

No

Issue of an IPO prospectus prior to the conversion date

Yes

Case study



An undated cumulative convertible bond, whose interest payments are at the discretion of the entity. However it contains a clause that states that instrument (including all unpaid cumulative interest) will become mandatorily payable if there is not an IPO by the end of 3 years from the instrument's issuance date.

How would the entity classify the instrument under Ind AS 32?

Case study: Solution

- ▶ Although it may be within the entity's control to determine whether IPO is attempted, market and regulatory forces determine whether any attempt is successful,
- ▶ These forces are beyond the control of the entity, therefore redemption upon an IPO event not occurring meets the definition of a contingent settlement event and results in the bond being classified as a financial liability from inception.

Scope inclusion



Scope inclusion

- ▶ Contracts to buy or sell non-financial items that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements are not in scope.
- ▶ However, following contracts are within the scope of Ind AS 32:
 - ▶ When the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments
 - ▶ When the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument, or by exchanging financial instruments
 - ▶ When, for similar contracts, the entity has a practice of taking delivery of the underlying 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; and
 - ▶ Contracts that give rise to a non-financial asset or non-financial liability in addition to a financial asset or financial liability
 - ▶ When the non-financial item that is the subject of the contract is readily convertible to cash.

Case study

- ▶ Company B borrows €1 million from its bank for five years .
- ▶ At the end of five years, the entity must deliver its head office building to the bank but may instead repay the loan at €1 million plus rolled-up interest at market rates.

How should B classify these borrowing under Ind AS 32?

Case study: Solution

- ▶ Repayment of loan is done by delivery of head office building to the bank But can also repay the loan at €1 million plus rolled-up interest at market rates.
- ▶ Non-financial obligation that can be avoided only by making a transfer of cash or another financial asset.

Hence, it is **financial liability**.

Transactions in own equity



Transactions in own equity

- ▶ An instrument would be a financial liability of the issuer, if it gave the holder right to obtain:
 - ▶ **Variable** number of non-puttable ordinary shares of the issuer for **fixed** amount of cash/ other financial asset; or
 - ▶ **Fixed** number of non-puttable ordinary shares of the issuer for **variable** amount of cash/ other financial asset
- ▶ Net-Settled contracts are contracts settled by payment of difference between the fair value, at the time of settlement, of the equity instrument and that of the consideration given

Case study



- ▶ C Ltd accepts Rs. 10 crores share application money from its holding company.
- ▶ Shares will be issued to holding company based on the future fair market value.

How should C classify this under Ind AS 32?

- ▶ The amount of application money is fixed, Rs.10 crores.
- ▶ However, number of shares are variable based on the future fair market value.

Therefore, entity C must treat this application balance as **financial liability** and measured at fair value.

Transaction in own equity (cont'd.)

Contract settled in entity's own shares	Monetary value of consideration*	Number of equity shares	Classification
Scenario 1	Fixed	Variable	Financial liability
Scenario 2	Variable	Variable	Financial liability
Scenario 3	Variable	Fixed	Financial liability
Scenario 4#	Fixed in a currency other than the entity's functional currency	Fixed	Equity
Scenario 5	Fixed	Fixed	Equity

* Value in the functional currency of the issuer.

ICAI has considered carve-out for FCCB.

Liabilities vs. equity – preference shares and puttable instruments



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Liabilities vs. equity – preference shares

- ▶ Preference shares are issued with various permutations and combinations of rights and/or obligations with regards to redemption, dividend payouts, participation in distributable profits, cumulating of dividends, convertibility, etc.
- ▶ Classification of preference shares should be done on the basis of the contractual obligations arising from the instrument and not the legal form (same as for any other financial instrument under Ind AS 32)

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Liabilities vs. equity – preference shares (cont'd.)

Mandatorily redeemable/ redeemable at the option of the <u>Holder</u>	Others - i.e. Non redeemable/ redeemable at the option of the <u>Issuer</u>
► Classified financial Liability	► Classified as Equity as there is no obligation for redemption
► If dividends are payable at the option of issuer, preference shares also contain as equity element and have to be treated as compound instrument and “split” accounted	► If there are contractual rights to dividends, preference shares also contain financial liability element and have to be treated as compound instrument and “split” accounted

Dividend blocker and dividend pusher

Dividend blocker:

- Issue of non-redeemable instruments with following terms:
 - ▶ Discretionary annual dividend upto a capped maximum amount
 - ▶ Unless a full discretionary dividend is paid to holders of the instrument, no dividend can be paid to ordinary shareholders.
- This restriction on dividend payments to ordinary shareholders is often referred to as a ‘dividend blocker’ clause.

Dividend pusher:

- Non redeemable preference shares on which dividends are payable only if the entity also pays a dividend on its ordinary shares.

Case study



Company H issues non-redeemable preference shares on which dividends are payable only if the entity also pays a dividend on its ordinary shares ('dividend pusher').

How should these preference shares be classified as?

Case study: Solution

- ▶ The dividend payments on the preference shares are discretionary and not contractual, because no dividends can be paid if no dividends are paid on the ordinary shares, which are an equity instruments.
- ▶ As the perpetual preference shares contain no contractual obligation ever to pay dividends and there is no obligation to repay the principal, they should be classified as equity in their entirety.
- ▶ Where the dividend payments are also cumulative, the perpetual shares will be classified as equity only if the dividends can be deferred indefinitely and the entity does not have any contractual obligations whatsoever to pay those dividends.
- ▶ A liability for the dividend payable would be recognised once the dividend is declared.

Compound instruments



Compound instruments

- ▶ The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity instrument.
- ▶ Such components shall be classified separately as financial liabilities, financial assets or equity instruments.
- ▶ Example:

Instrument	Liability component	Equity component
Preference shares with discretionary dividends	Principal redemption liability	Discretionary dividend
Convertible bonds	Principal redemption and interest payment liability	<u>Convertibility option to the holder</u>

Separation



The liability component is determined by fair value of expected cash flows (for future interest payments and for principal payments)

The residual value is allocated to the equity component.

Transaction costs are allocated to the liability and equity components in the same proportion as above.

Case study



- Ø Company J issues 2000 optionally convertible bonds.
- Ø The bonds have a 3 year term, and are issued at par with a face value of Rs.1,000 per bond, giving total proceeds of Rs. 2,000,000.
- Ø Interest is payable annually in arrears at a nominal annual interest rate of 6% (i.e. Rs.120,000 per annum).
- Ø Each bond is convertible at any time up to maturity into 250 ordinary shares. When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is 9% per annum.
- Ø The entity incurs issue costs of Rs.100,000.

Accounting implications?

Case study: Solution

- ▶ The economic components of this instrument are:
 - ▶ a liability component - discounted fixed rate debt, and
 - ▶ an equity component - holder's right to convert at any time before maturity (a written call option)
- ▶ The liability component is measured at the NPV of the maximum potential cash payments and the difference between the proceeds of the bond issue and this calculated fair value of the liability is assigned to the equity component.
- ▶ The NPV of the liability component is calculated as Rs.1,848,122, using a discount rate of 9%.

Solution

Year		Cash Flow INR	Discount Factor (@9%)	NPV of cash flow
1	Interest	120,000	1/1.09	110,092
2	Interest	120,000	1/1.092	101,001
3	Interest & principal	2,120,000	1/1.093	<u>1,637,029</u>
	Total liability component			1,848,122
	Total equity component (balance)			<u>151,878</u>
	Total proceeds			<u>2,000,000</u>

Case study: Solution

- ▶ The issue cost Rs.100,000 would be allocated on a pro-rata basis i.e. Rs.92,406 ($100,000 \times 1,848,122 / 2,000,000$) towards debt and balance Rs.7,594 towards equity.
- ▶ The Rs.144,284 (151,878 minus 7,594) credited to equity is not subsequently re-measured.
- ▶ On the assumption that the liability is not classified as at fair value through profit or loss, Rs.1,755,716 (1,848,122 minus 92,406) liability component would be accounted for under the effective interest rate method i.e. 10.998%



Working

Solution (contd. ...)

	Liability component	Equity component	Total
Gross proceeds	1,848,122	151,878	2,000,000
Issue costs (pro-rata)	(92,406)	(7,594)	(100,000)
Net proceeds	1,755,716	144,284	1,900,000

Solution (contd. ...)

Year	Opening liability	Interest @ 10.98%	Cash paid	Closing liability
1	1,755,716	193,094	(120,000)	1,828,810
2	1,828,810	201,134	(120,000)	1,909,944
3	1,909,944	210,056	(2,120,000)	–
Total finance cost		604,284		

The INR144,284 (151,878 minus 7,594) credited to equity is not subsequently re-measured.

Separation – Subsequent measurement

- ▶ The liability component is subsequently measured as per Ind AS 109- either at amortised cost or at fair value.
- ▶ The equity component is carried at the amount initially measured. It is not subsequently re-measured.
- ▶ Any premium or discount on redemption of compound instrument is factored in working out the liability component on initial recognition.
- ▶ In subsequent measurement, effective interest rates worked out considering premium or discount on redemption.

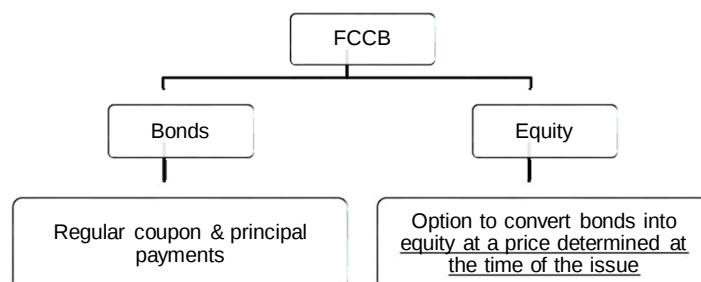
Conversion

- ▶ On conversion of a compound instrument at maturity, the entity should de-recognize the liability component and recognize it as equity.
- ▶ Equity issued on conversion is measured at the carrying amount of the liability component at the date of conversion.
- ▶ There is no gain or loss on conversion at maturity.
- ▶ The equity component of the instrument recognised initially is transferred to share capital. Other components of equity (like share premium) are recognised depending on the legal requirements.

Foreign Currency Convertible Bonds

Features of FCCB in India:

- ▶ Issued in a currency different than the issuer's domestic currency
- ▶ A mix between debt and equity instrument

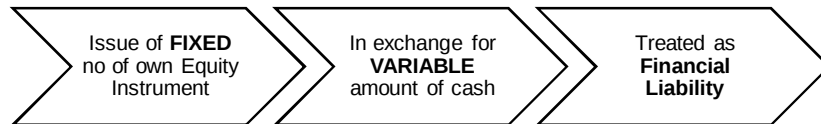


- ▶ Unless converted, redeemed, purchased and cancelled, the Bonds are to be redeemed on maturity.

Foreign Currency Convertible Bonds

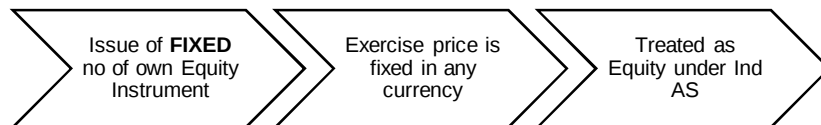
Para 24 of Ind AS 32: Fixed to Fixed principle

- ▶ A contract that will be settled by the entity delivering or receiving a fixed number of its own equity instruments in exchange for a variable amount of cash or another financial asset is a financial asset or financial liability.



Para 11 of Ind AS 32: Carve out for FCCB

- ▶ The equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of the entity's own equity instruments is an equity instrument if the exercise price is fixed in any currency.



Case study



- Ø On 1 January 2014, L Ltd* issued 10,000 FCCB at par with face value of USD 1,000 per bond, giving total proceeds of USD 10 million.
- Ø FCCBs carry coupon of 4% p.a.
- Ø Each USD 1,000 bond is convertible at the holder's discretion, at any time prior to maturity on 31 December 2018, at a conversion price of INR 90 per share**.

* Functional currency of L Ltd is Indian Rupees (INR).

** At present, entity's share is trading at INR 65.

- Notes:
1. Conversion rate at the time of issue of bond is INR 60 per USD.
 2. Current interest rate for comparable bond without conversion option is 7% (Indian market)

How would the FCCBs be accounted for under Ind AS 32?

Case study: Solution

- ▶ Amount of liability in local currency = INR 600 mn (considering the exchange rate at inception)
- ▶ Current interest rate for the comparable bond is 7%.
- ▶ Fair value of the bond at inception is approx INR 527 mn
- ▶ Hence INR 73 mn difference between the Fair value of the bond at its inception and the host liability would have be accounted as derivative under IFRS. But under Ind-AS it would be accounted as equity.
- ▶ The host financial liability will be subsequently measured at amortised cost using effective interest rates under Ind-AS 109 and translated at the closing foreign exchange rate as per Ind-AS 21



Example

- ▶ On 1 April, ABC issued 10,000 FCCB at par with face value of GBP1,000 per bond, giving total proceeds of GBP10 million. Redeemable in 3 years
- ▶ FCCBs carry coupon of 2% p.a.
- ▶ Premium on redemption: 10%
- ▶ Each bond is convertible into 5 equity shares of ABC.
- ▶ On the date of issue, prevailing market rate of interest for similar bond without conversion option is 11% p.a.

	1 April 2014	31 March 2015	31 March 2016	31 March 2017
Exchange rate as on the date	80	85	83	90
Average rate for the year	NA	82	84	88

Solution – Computation of liability and equity components

Year	Cash outflow GBP	Discount factor @ 11% p.a.	Present value GBP
Year 1	200,000	0.900901	180,180
Year 2	200,000	0.811622	162,324
Year 3	11,200,000	0.731191	8,189,343
Fair value of liability component			8,531,848
FV of equity component			1,468,152
		Total	10,000,000
Fair value of liability component (INR)			682,547,851
FV of equity component (INR)			117,452,149

Solution – Determination of GBP interest

Year	Opening balance	Accrued interest @11%	Principal / Interest paid	Closing balance
Year 1	85,31,848	938,503	200,000	9,270,351
Year 2	92,70,351	1,019,739	200,000	10,090,090
Year 3	1,00,90,090	1,109,910	11,200,000	-

Solution – Determination of INR interest

Year	Opening balance	Interest	Exchange differences	Payment at closing rate	Closing balance
Rate used	PY end rate	Average date	Difference	Closing rate	Closing rate
Year 1	682,547,851	76,957,270	45,474,751	(17,000,000)	787,979,872
Year 2	787,979,872	85,658,047	(19,560,442)	(16,600,000)	837,477,477
Year 3	837,477,477	97,672,072	72,850,450	(1,008,000,000)	-

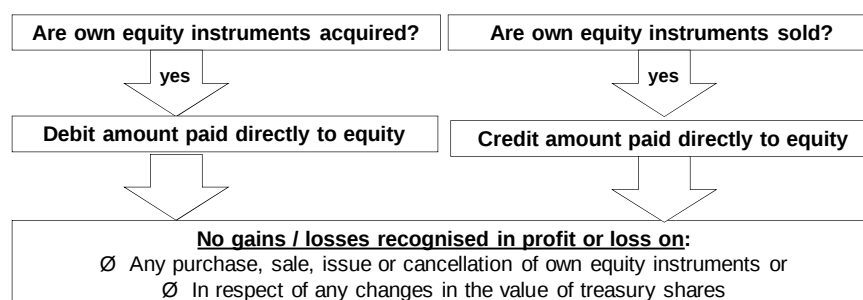
Treasury shares



Treasury Shares

- ▶ Treasury shares are shares issued by an entity that are held by the entity.
- ▶ Holdings of treasury shares may arise in a number of ways.
 - For example:
 - ▶ The entity holds the shares as the result of a direct transaction, such as a market purchase, or a buy-back of shares from shareholders as a whole, or a particular group of shareholders
 - ▶ The entity is in the financial services sector with a market-making operation that buys and sells its own shares along with those of other listed entities in the normal course of business, or holds them in order to 'hedge' issued derivatives
 - ▶ In consolidated financial statements:
 - ▶ the shares were purchased by another entity which subsequently became a subsidiary of the reporting entity, either through acquisition or changes in financial reporting requirements;
 - ▶ the shares have been purchased by an entity that is a consolidated SPE of the reporting entity.
- ▶ The circumstances in which an entity is permitted to hold treasury shares are a matter for legislation in the jurisdiction concerned.

Treasury shares



Reclassification from liability to equity



Reclassification from liability to equity

Has debt been swapped for equity as a result of renegotiation of terms of a financial liability?

yes

- Ø **Derecognise carrying amount of financial liability**
- Ø **Recognise equity instruments (consideration paid) at fair value if reliably measurable, or if not reliably measurable then at fair value of derecognised liability**
- Ø **Recognise difference in profit or loss**

Example:

- MNO Limited exchanges debt (carrying amount CU 100) for equity (fair value CU 120)
- Derecognise liability and recognise equity instruments and a loss of CU 20 in profit or loss

Thank you