Chapter 16

FINANCIAL INSTRUMENTS PRESENTATION (IAS -32)

Objective

The objective of this IAS is to enhance user's understanding of the significance of financial instruments to and entity's financial position, performance and cash flows. The main issues are: -

- Classification of financial instruments from the perspective of issuer;
- Classification of related interest, dividend, losses and gains; and
- The circumstances in which financial asset can be set off against the liability

Scope

This IAS is applicable to all entities to all types of financial instruments except: -

- Those interests in subsidiaries, associates and joint ventures accounted for under IASs 27, 28 & 31, however, where IAS-39 is applied for these instruments, the requirements of this IAS will be operative;
- Employer's rights and obligations where IAS-19 is applicable;
- Insurance contracts where IFRS-4 is applicable except embedded derivatives; and
- Contracts and obligations under share based payments under IFRS-2 except where this IAS or IAS-39 is applicable

This Standard shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts 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.

There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments. Examples are: -

(a) When the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;

(b) 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 (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);

(c) 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

(d) When the non-financial item that is the subject of the contract is readily convertible to cash.

Definitions

Financial instrument is any contract that gives rise to financial asset of one enterprise and financial liability or equity instrument of another enterprise.

Financial asset is any asset that is:

a) Cash;

b) An equity instrument of another entity;

c) A contractual right:

   i. to receive cash or another financial asset from another entity; or

   ii. to exchange financial assets or financial liability with another entity under conditions that are potentially favorable to the entity; or

d) a contract that will or may be settled in the entity's own 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.
   For this purpose the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

Examples of financial assets are cash, deposits in other companies, trade receivables, loan to other companies, investment in debt instruments, investment in shares, and other equity instruments.

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 liability with another entity under conditions that are potentially un-favorable to the entity; or

b) a contract that will or may be settled in the entity's own 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.
   For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.
   As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D.

Examples of financial liability are trade payables, loans from other companies and debt instruments issued by the entity.

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

A derivative is a financial instrument:

- Whose value changes in response to the change in an underlying variable such as an interest rate, commodity or security price, or index;
- That requires no initial investment, or one that is smaller than would be required for a contract with similar response to changes in market factors; and

- That is settled at a future date.

Contract and contractual refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.

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.

Presentation Financial Liability and Equity

The issuer of a financial instrument shall classify the instrument, or its components parts, on initial recognition as a financial liability, financial asset or an equity instrument in accordance with the substance of the contractual arrangement and definitions of a financial liability, a financial asset and equity instrument.

Classification

A financial instrument is an equity instrument only if: -

a) the instrument includes no contractual obligation to deliver cash or another financial asset to another entity or to exchange financial asset/liability with another entity under conditions which are potentially unfavorable to issuer; and

b) if the instrument will or may be settled in the issuer's own equity instruments, it is either:

- 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.

  For this purpose, rights, options or warrants to acquire a fixed number of the entity’s own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the issuer’s own equity instruments do not include instruments that have all the features and meet the conditions described in paragraphs 16A and 16B or paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the issuer’s own equity instruments.

Illustration - preference shares

If an enterprise issues preference (preferred) shares that pay a fixed rate of dividend and that have a mandatory redemption feature at a future date, the substance is that they are a contractual obligation to deliver cash and, therefore, should be recognized as a liability. In contrast, normal preference shares do not have a fixed maturity, and the issuer does not have a contractual obligation to make any payment. Therefore, they are equity.

Illustration – putt-able instruments

A financial instrument that gives the holder the right to return it to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability – even if the amount of cash or other financial assets is determined on the basis of an index or other variable that has the potential to increase or decrease, or when the legal form of the puttable instrument gives the holder a right to a residual interest in the assets of an issuer except when paragraph 16 A to 16 to 16 D of IAS 32 applied. (Mutual funds, unit trusts)

Illustration - issuance of fixed monetary amount of equity instruments

A contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instruments to be received or delivered equals the fixed monetary amount of the contractual right or obligation is a financial liability. (To deliver/receive shares equal to Rs. 100 or 10 ounces of gold)

Illustration - Fixed amount of cash and fixed number of shares

When a contract that will be settled by the entity receiving or delivering fixed number of shares for no future consideration or exchanging a fixed number of its own shares for a fixed amount of cash or another financial asset, is an equity instrument. Example is Forward contract to repurchase fixed number of own shares against fixed amount of cash.

c) 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, 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, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, or the issuer's future revenues, net income or debt-to-equity ratio. The issuer of such an instrument does not have the unconditional right 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 unless:

(a) The part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not genuine; or

(b) The issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer.

Illustration – contract settled in cash or another financial asset

A contract that will be settled in cash or another financial asset is a financial asset or liability even if the amount of cash or another financial asset that will be received or paid is based on changes in the market value of entity's own equity. Example is a net cash settled share option.

d) When a derivative financial instrument gives one party a choice over how it is settled (e.g. the issuer or the holder can choose settlement net in cash or by exchanging shares for cash), it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument.

e) **Compound Financial Instruments**

Some financial instruments - sometimes called compound instruments - have both a liability and an equity component from the issuer's perspective. In that case, IAS 32 requires that the component parts be accounted for and presented separately according to their substance based on the definitions of liability and equity. The split is made at issuance and not revised for subsequent changes in market interest rates, share prices, or other event that changes the likelihood that the conversion option will be exercised.

- To illustrate, a convertible bond contains two components. One is a financial liability, namely the issuer's contractual obligation to pay cash, and the other is an equity instrument, namely the holder's option to convert into common shares. Another example is debt issued with detachable share purchase warrants.
- When the initial carrying amount of a compound financial instrument is required to be allocated to its equity and liability components, the equity component is assigned the residual amount after deducting from the fair value of the instrument as a whole the amount separately determined for the liability component.

- On conversion of a convertible instrument at maturity the entity de-recognizes the liability component and recognize it as equity. There is no gain/loss recognition on conversion at maturity.
- When an entity extinguishes a convertible instrument before maturity i.e. redemption or repurchase in which original conversion privileges are unchanged, the entity allocates the consideration paid and transaction cost to liability and equity component at the date of transaction. The method is same as used for original allocation of debt/equity.
- Interest, dividends, gains, and losses relating to an instrument classified, as a liability should be reported in the income statement. This means that dividend payments on preferred shares classified as liabilities are treated as expenses. On the other hand, distributions (such as dividends) to holders of a financial instrument classified as equity should be charged directly against equity, not against earnings.

f) Treasury shares

The cost of an entity's own equity instruments that it has reacquired ('treasury shares') is deducted from equity. Gain or loss is not recognized on the purchase, sale, issue, or cancellation of treasury shares. Treasury shares may be acquired and held by the entity or by other members of the consolidated group. Consideration paid or received is recognized directly in equity.

g) Off-setting

IAS 32 also prescribes rules for the offsetting of financial assets and financial liabilities. It specifies that a financial asset and a financial liability should be offset and the net amount reported when and only when, an enterprise:

- has a legally enforceable right to set off the amounts; and
- intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously.

Offsetting is usually inappropriate when:

- several different financial instruments are used to emulate the features of a single financial instrument (a ‘synthetic instrument’);
- financial assets and financial liabilities arise from financial instruments having the same primary risk exposure (for example, assets and liabilities within a portfolio of forward contracts or other derivative instruments) but involve different counterparties;
- financial or other assets are pledged as collateral for non-recourse financial liabilities;
- financial assets are set aside in trust by a debtor for the purpose of discharging an obligation without those assets having been accepted by the creditor in settlement of the obligation (for example, a sinking fund arrangement); or
- obligations incurred as a result of events giving rise to losses are expected to be recovered from a third party by virtue of a claim made under an insurance contract.

h) Costs of issuing and reacquiring equity instruments

Costs of issuing or reacquiring equity instruments (other than in a business combination) are accounted for as a deduction from equity, net of any related income tax benefit.

An entity typically incurs various costs in issuing or acquiring its own equity instruments. Those costs might include registration and other regulatory fees, amounts paid to legal, accounting and other professional advisers, printing costs and stamp duties. The transaction costs of an equity transaction are accounted for as a deduction from equity (net of any related income tax benefit) to the extent they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided. The costs of an equity transaction that is abandoned are recognized as an expense.

Transaction costs that relate to the issue of a compound financial instrument are allocated to the liability and equity components of the instrument in proportion to the allocation of proceeds. Transaction costs that relate jointly to more than one transaction (for example, costs of a concurrent offering of some shares and a stock exchange listing of other shares) are allocated to those transactions using a basis of allocation that is rational and consistent with similar transactions.

Examples-1

An enterprise issues 2,000 convertible bonds at the start of Year 1. The bonds have a three-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. Interest is payable annually in arrears at a nominal annual interest rate of 6%. Each bond is convertible at any time up to maturity into 250 common shares.

When the bonds are issued the prevailing market interest rate for similar debt without conversion options is 9%. The entity has incurred Rs. 100,000 as issuance cost of compound instrument. The effective rate considering the issuance cost of debt is 11% p.a.

Required: -

Determine the debt and equity component?

Pass necessary double entries for all the three years?

Pass necessary double entries at the maturity date if the investor exercises cash option or share option?

Example-2

On January 01, 1999 Entity A issued 10% convertible debentures with face value of Rs. 1,000,000 maturing at December 31, 2008. The debenture is convertible into ordinary shares of entity A at Rs. 25 per share. Interest is payable half yearly in cash. The market interest rate for non-convertible debenture at the issue date is 11%.

On January 01, 2004, the convertible debenture has a fair value of Rs. 1,700,000. Entity A makes a tender offer to the holders of the debentures for Rs. 1,700,000, which the holders accepted. At the date of repurchase entity could have issued non-convertible debt with a five-year term bearing a coupon rate of 8%.

Required: Determine the debt and equity component at the issue of loan and what accounting entries to be passed at the date conversion?

Past Papers

The following information pertains to Crow Textile Mills Limited (CTML) for the year ended 30 June 2012:

(b) On 1 July 2011, 2 million convertible debentures of Rs. 100 each were issued. Each debenture is convertible into 25 ordinary shares of Rs. 10 each on 30 June 2014. Interest is payable annually in arrears @ 8% per annum. On the date of issue, market interest rate for similar debt without conversion option was 11% per annum. However, on account of expenditure of Rs. 4 million, incurred on issuance of shares, the effective interest rate increased to 11.81%. (08)

Required:- Prepare Journal entries for the year ended 30 June 2012 to record the above transactions. ***(Show all necessary calculations)***