

# FINANCIAL INSTRUMENTS STANDARDS

A Guide on IAS 32, IAS 39 and IFRS 7

POOJA GUPTA

FINANZ  
MINI  
STICE  
ALGELD  
STICHO  
50

100

Financial Instruments Standards is welcomed by standard setters though the stakeholders and practitioners continue to grapple with interpretations and practices that are emerging in areas where the standards are not very explicit. These standards have been a moving target at the international scene. This document guides the reader through rules and supplements the application guidance with interpretation and analyses. It deals with aspects of embedded derivatives and de-recognition of financial instruments. It includes worked out example pertaining to complex calculations and disclosures. This study document will help practitioners, auditors and regulators of accounts in resolving myriad practical problems faced in applying financial instruments standards.

# FINANCIAL INSTRUMENTS

## AS 30, AS 31 & AS 32

### AS 31 Financial Instruments: *Presentation*

#### 1.1 Introduction

In recent years there has been huge growth worldwide in the variety and complexity of financial instruments in international financial markets. AS 31 deals with the relatively simple matters of presentation. The more complicated topic of the recognition and measurement of financial instruments in the balance sheet and income statement are dealt with in AS 30, while disclosure is now governed by AS 32. The new INDAS 109 (replacement of AS 30) deals with classification and measurement of financial assets.

#### 1.2 Definitions

A **financial instrument** is any contract that gives rise to both:

- a **financial asset** of one entity, and
- Either a **financial liability** or an **equity instrument** of another entity.

For example, a receivable of one entity (financial asset) will represent a payable (financial liability) of another entity. An equity instrument is a financial asset for an investor holding the instrument and is equity of the issuer of the instrument.

A **financial asset** is any asset that is:

- cash (examples include bank accounts)
- a contractual right to receive cash or another financial asset (examples include receivables or bonds held)
- equity shares in another entity
- a contractual right to exchange financial instruments under potentially favorable conditions (examples include purchased call and put options)
- 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 entity's own equity instruments or (ii) a derivative that will or may be settled other than by the exchange of fixed amount of cash or another financial

## STATUS OF FINANCIAL INSTRUMENTS STANDARDS

The financial instruments standards comes into effect in respect of accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years. These Standards will become mandatory in respect of accounting periods commencing on or after 1-4-2011 for all commercial, industrial and business entities except to a Small and Medium-sized Entity\*\*

\*\* The ICAI on its website specifies that AS 30, AS 31 and AS 32 are not mandatory as on July 1, 2012.

asset for fixed number of entity's own equity instruments.

A **financial liability** is any liability that is:

- a contractual obligation to deliver cash or another financial asset to another entity
- a contractual right to exchange financial instruments under potentially unfavorable conditions (examples include written call or written put options<sup>1</sup>)
- 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 entity's own equity instruments or (ii) a derivative that will or may be settled other than by the exchange of fixed amount of cash or another financial asset for fixed number of entity's own equity instruments.

In sum, a financial liability of the entity is an obligation of the entity that arises from a past event and expected to result in an outflow of economic benefits of the entity. Financial liabilities may take the form of bonds, loan notes, or mortgages to another person (s) required to be paid by a specified date (maturity).

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

The most common example of equity is ordinary share capital but equity instruments may also take the form of preference shares, other interests, or certain derivatives on those shares or interests.

### 1.3 Liability versus equity classification

Because investors rely on accounting information to make their investment decisions, it is important for accounting information to present items according to their substance, and not merely their legal form. Some financial instruments have the legal form of equity but are in substance, liabilities.

The issuer should classify the instrument, or its component parts, as a financial liability or equity in accordance with the 'substance' of contractual arrangement on initial recognition, and the definitions of **financial liability** and an **equity instrument**. The classification is made at the date of issue and is **not** revised later.

The critical feature in differentiating a financial liability from an equity instrument is the existence of a **contractual obligation** on one party to the financial instrument (the issuer) either to deliver cash or another financial asset to the other party (the holder) or to exchange another financial instrument with the holder under potentially unfavorable conditions.

Note that a restriction on the ability of the issuer to satisfy an obligation, such as lack of access to foreign currency to repay a foreign currency loan, does not negate the existence of liability.

---

<sup>1</sup> A **written call** option represents the obligation, if exercised, to sell an item at a specific price. A **written put** option represents the obligation, if exercised, to purchase an item at a specified price.

### Scenario 1: An obligation to pay dividends

White Ltd. Issues 100,000 preference shares with a fixed rate of dividend @ 7% at par for INR 1 million. According to the terms of the contract, the directors of White Ltd. have to compulsorily pay dividend following the date of issue.

#### **Solution:**

In substance, 'preference share' issue is a liability as White Ltd. has a contractual obligation to deliver cash to the holder of preference shares by way of dividends. In short, only if the distributions to the holders of preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, then the shares are equity instruments.

## 1.4 Compound Instruments

Some financial instruments, called compound financial instruments, have both liability and an equity element. In this case, AS 31 requires the component parts to be separated from each other with each part accounted for and presented separately according to its substance.

### Scenario 2: Convertible Debt

Red Ltd. issues 1000 bonds convertible into its own shares in 3 years. The bonds are issued at par with a face value of INR 100/- per bond. Interest is payable annually at nominal interest at 6% p.a. Each bond is convertible at any time up to maturity in 125 equity shares. When bonds are issued the prevailing market interest rate for similar debt without conversion options is 9% p.a.

#### **Solution:**

Under this approach, the liability element is valued first, and the difference between the proceeds of the bond issue and the fair value of the liability is assigned to the equity component. The present value of the liability component is calculated using a discount rate of 9%, the market rate for similar bonds with no conversion rights, as shown:

Particulars	Amount	Amount
Proceeds of the Bond		100,000
PV of the principal INR 100,000/- payable at the end	77,200	
PV of the interest INR 6,000/- payable annually for	15,186	
Total Liability Component		92,386
Equity component (balancing figure)		7,614

Discounting factor @ 9%

1 year      0.917

2 year      0.842

3 year      0.772

The equity component will be amortized over the term of the bond.

## 1.5 The income statement

The accounting treatment of interest, dividends, losses and gains relating to a financial instrument follows the accounting treatment of the instrument itself. In other words, interest, dividends, losses and gains attributable to financial liability must be reported in the income statement as expense, while distributions to holders of equity must be debited directly to equity.

## 1.6 Offsetting of a financial asset and a financial liability (Netting)

A financial asset and a financial liability may only be offset in very limited circumstances. The net amount may only be reported when an entity:

- ❖ 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.

## Derivatives

### 1.7 Definition

Derivative is an instrument with all the following characteristics:

- ↺ whose value changes in response to changes in an underlying price or index
- ↺ that requires little or no investment
- ↺ that is settled at a future date.

One can easily be overwhelmed by the apparently countless types of derivative instruments traded in market place. Do not be misled. Fundamentally, there are only two types of derivative contract – a forward and an option.

### 1.8 Accounting for derivatives

All derivatives are recognized on the balance sheet. They are initially measured at fair value. Subsequently also derivatives are measured at their fair value. Over time, market expectations of the price of the underlying at the settlement date will change. The amount that the market would pay or accept, to settle or 'close out' a derivative will change and this is its fair value. At settlement date the fair value of a derivative is the 'net settlement amount'. The carrying amount of a derivative will fluctuate over its life depending on changing market expectations; it could be positive or negative at various times.

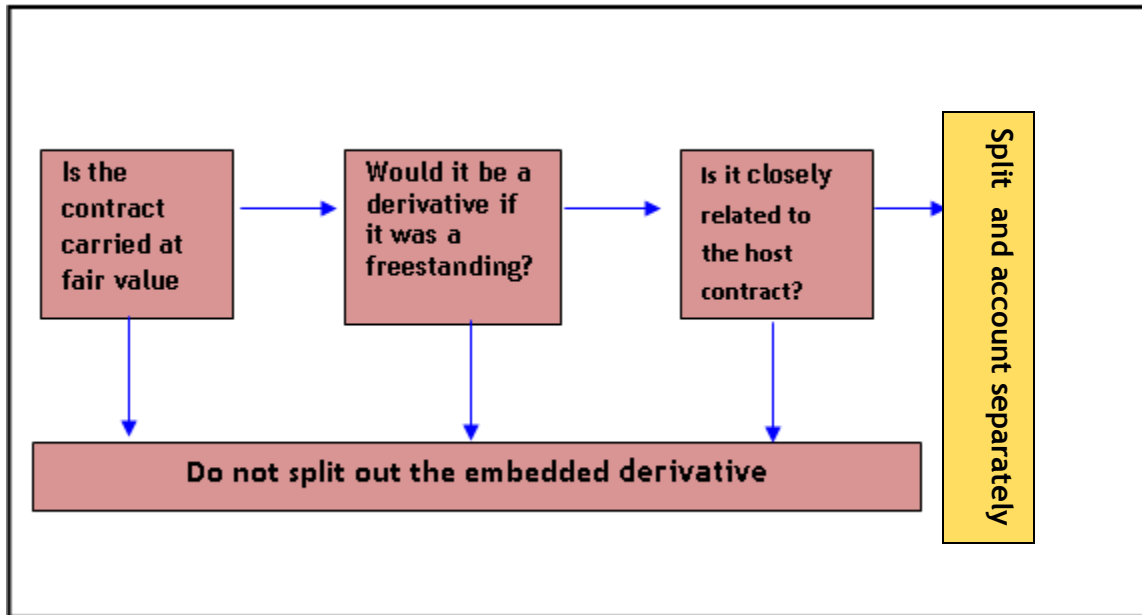
### 1.9 The 'Embedded Derivative' Issue

The financial instrument standard aims to ensure that the requirement for marking derivatives to market are not avoided by 'embedding' a derivative in a host contract that is accounted for differently.

## 1.10 Decision tree for an Embedded derivative

Determining whether an embedded derivative should be accounted for separately can be a complex process. The process of reviewing a range of contracts to identify those that might contain an embedded derivative is an important and time consuming aspect of AS 30.

### Decision tree for embedded derivatives



### Scenario 3: Embedded derivative in an indexed debt instrument

Blue Ltd. purchased an indexed debt instrument that has the following characteristics:

Principal amount of INR 10,000,000, which matures one year from the date of purchase. The return of the principal amount is guaranteed by the issuer. Interest is payable entirely at maturity. The coupon is linked to the USD: INR spot rate. The measurement spot rate is 46.924. Coupon is determined as follows:

- 8.0 percent if the spot rate at maturity is within + / - 7.5 percent of the measurement spot rate
- 3.0 percent if the spot rate at maturity exceeds the 7.5 percent threshold, but is within + / - 10.0 percent of the measurement spot rate
- 0.0 percent if the spot rate exceeds the 10.0 percent threshold at the date of maturity.

Blue Ltd. classifies this investment as held-to-maturity and thus measures it at amortized cost using the effective interest rate method.

The instrument can be viewed as a debt instrument with a zero rate of interest plus a series of three options. The economic risks and characteristics of the embedded derivative are not closely related to the host contract debt instrument, as the underlying reference is the USD: INR exchange rate and the host is not a dual currency debt instrument.

Blue Ltd. should therefore separate the embedded derivative and recognize it at fair value. The carrying

value of the option is then calculated by deducting the carrying value of the debt instrument from the consideration paid for the debt instrument. This should give the same value as considering the debt instrument to be a zero-coupon bond and calculating the carrying value based on market rates in order to give a market rate effective yield.

## AS 30 Financial Instruments: *Recognition and Measurement*

### 1.11 Introduction

AS 30 deals with the recognition and measurement issues. It contains rules which require significant changes to accounting practices like requiring nearly all derivative assets and liabilities to be included in the balance sheet at fair value. AS 30 remains the most controversial of all the IASB's<sup>2</sup> standards.

### 1.12 Scope and exclusions

AS 30 applies to all entities but not all financial instruments.

**Table 1.1 Items excluded from financial instruments standards**

	AS 31	AS 30	Applicable Standard
Interest in subsidiaries	X	X	IndAS 27
Interest in associates	X	X	IndAS 28
Interest in joint ventures	X	X	IndAS 31
Employee benefit plans	X	X	IndAS 19
Share based payments	X	X	IndAS 102
Insurance contracts	X	X	IndAS 104
Rights and obligations under leases	X	X	IndAS 17
Equity instruments issued by the entity, including warrants and options that meet the definition of an equity instrument (for the issuer)	-	X	AS 31
Loan commitments that cannot be settled net in cash or another financial instrument	-	X	IndAS 37

("X" indicates specific exclusion from the standard)

<sup>2</sup> IASB – International Accounting Standards Board



### 1.13 Initial recognition

An entity should recognize a financial asset or a financial liability on its balance sheet when, and only when, it becomes party to the contractual provisions of the instrument.

Example:

- ↳ receivable should be recognized as an asset when the entity becomes a party to the contract so that it has a legal right to receive cash
- ↳ a forward contract is recognized as an asset or liability on the commitment date, rather than waiting until the closing date when the exchange actually takes place.

### 1.14 Classification and Measurement

#### 1.14.1 Initial Measurement

A financial asset or liability should initially be recognized at fair value of the consideration given or received for it.

#### 1.14.2 Classification of financial asset

For the purpose of measuring a financial asset subsequent to initial recognition, AS 30 classifies financial assets into four categories:

- ❖ **Financial Assets at fair value through profit or loss** is either **held for trading (HFT)** or is specifically **designated** to be at fair value through profit or loss. AS 30 permits any financial asset to be so designated, as long as any of the three conditions are met. An entity may use this designation when doing so results in more relevant information because either:
  - it eliminates or significantly reduces an “accounting mismatch”
  - a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis in accordance with the entity’s documented risk management or investment strategy, and information is provided to key management personnel on this basis
  - in respect of an entire combined contract when such contract contains one or more embedded derivatives, unless those embedded derivatives either:
    - do not significantly modify the cash flows that otherwise would be required by the contract
    - are ones for which it is clear with little or no analysis when first considering a similar hybrid instrument that separation is prohibited.
- ❖ **Held to maturity (HTM) investments** are financial assets with fixed or determinable payments and fixed maturity that an entity has a positive intent and ability to hold to maturity.



- ❖ **Loans and receivables** are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market.
- ❖ **Available for sale (AFS)** financial assets are remaining financial assets that do not fall into any of the three categories above.

### 1.14.3 Subsequent measurement

After initial recognition, all financial assets should be measured at fair value except for:

- ↪ Loans and receivables (L&R)
- ↪ Held to maturity (HTM)
- ↪ Unquoted equity investments whose fair value cannot be reliably measured.

Those financial assets that are excluded from fair valuation and that have fixed maturity should be measured at amortized cost using effective interest rate method. Those that do not have fixed maturity are measured at cost.

### 1.15 Impairment

All financial assets should be reviewed for impairment at each balance sheet date. If there is objective evidence that financial asset is impaired, it should be written down to its estimated recoverable amount.

### 1.16 Measurement of Financial Liabilities

After initial recognition, an entity should measure all financial liabilities, other than liabilities held for trading (HFT) and derivatives that are liabilities at amortized cost using the effective interest rate method. HFT and derivative liabilities should be measured at fair value.

### 1.17 Gains and losses on remeasurement to fair value

A gain or loss on a financial asset or financial liabilities classified as 'at fair value through profit or loss' must be recognized in profit or loss. Other items are recognized as follows:

- Dividends receivable from an AFS equity instrument in profit or loss
- Interest charged or credited using effective interest rate method in profit or loss
- A gain or loss on AFS financial assets directly in equity (i.e. taken to reserve), until the asset is derecognized, when the cumulative gain or loss previously recognized in equity is recognized in profit or loss.

### 1.18 Gains or losses on instrument not remeasured to fair value

For those financial assets and liabilities carried at amortized cost, a gain or loss is recognized in net profit or loss when the financial asset or financial liability is derecognized or impaired, as well as through the amortization process.

### 1.19 Derecognition

AS 30 employs a mixed approach to derecognition, which starts by determining whether the

derecognition assessment should be applied to a financial asset as a whole or to parts of that financial asset. If the contractual rights to the cash flows of the financial asset (or identified part thereof) have expired, the asset or relevant part should be derecognized. However, if this is not the case the assessment continues. The derecognition assessment itself comprises an evaluation of the extent to which the risks and rewards of the financial asset are transferred, an analysis of whether the entity retains control of the financial asset and the consequent determination of the entity's continuing involvement in the financial asset, if any. Each of the steps to the flow chart is illustrated in AS 30.AG36.

## 1.20 Hedge accounting

Most companies' hedge risk – that is, they take actions to mitigate or offset the risks that arise from their activities. For financial risk – such as interest rate risk, currency risk, equity price risk and commodity price risk – such hedging often involves the use of derivatives. Hedge accounting seeks to reflect the results of hedging activities, in particular hedging using derivatives, by reporting the effects of the derivative and the risk being hedged in the same period.

### 1.20.1 Accounting for hedges

Three types of hedge accounting are recognized by IFRS. These are fair value hedges, cash flow hedges and hedges of the net investment in a foreign operation. Each has specific requirements on accounting for the fair value changes.

↳ Fair value hedges: The risk being hedged in a fair value hedge is a change in the fair value of an asset or liability or unrecognized firm commitment, or an identified portion of an asset, liability or firm commitment that is attributable to a particular risk and could affect the income statement.

An example of a fair value hedge is a fixed-rate loan whose interest rate exposure is converted to floating rates with an interest-rate swap. Another example is mitigating a potential fall in the value of an available-for-sale equity investment with an equity forward or option.

↳ Cash flow hedges: The risk being hedged in a cash flow hedge is the exposure to variability in cash flows that:

- 1) is attributable to a particular risk associated with a recognized asset or liability, an unrecognized firm commitment (currency risk only), or a highly probable forecast transaction, and
- 2) could affect the income statement.

Examples of common cash flow hedges are an interest-rate swap converting a floating-rate loan to fixed-rate, and a forward foreign exchange contract hedging forecast future sales of inventory in a foreign currency or a forecast future purchase of inventory or equipment in a foreign currency.

- ↪ Hedges of Net investment in a foreign operation: An entity may have overseas subsidiaries, associates, joint ventures or branches ('foreign operations'). It may hedge the currency risk associated with the translation of the net assets of these foreign operations into the group's presentation currency. AS 30 permits hedge accounting for such a hedge of a net investment in a foreign operation.

## **AS 32 Financial Instrument: *Disclosures***

### **1.21 Introduction**

AS 32 was introduced to bring into a single IFRS disclosure requirements relating to financial instruments, these had previously been spread across several standards. As a result, all of the disclosure requirements previously located in AS 31 have been relocated in AS 32 and AS 31 renamed accordingly. The objective of IFRS is to require disclosures that enable users of financial statements to evaluate:

- The significance of financial instruments for an entity's financial position (balance sheet) and performance (income statement)
- The nature and extent of risk arising from financial instruments and how entity manages those risk.

AS 32 applies to all entities; manufacturers and retailers will normally find only few of its provisions apply to them such as those relating to bad debts. Banks and other financial institutions will find nearly all of it applies.

The key learning point is that AS 32 does not lay down how any amounts relating to financial instruments should be measured or displayed in financial statements; it merely sets out the amount of information reported to management for the purpose of running the business which must be made available to users.

### **1.22 Significance of financial instruments for financial position (balance sheet) and performance (income statement)**

An entity is permitted to present the required disclosures either on the face of the balance sheet or in the notes to financial statements. The standard requires disclosure by 'class' of financial instrument of the entity. A 'class' is not the same as 'category' of financial instrument. Financial assets and financial liabilities must be analyzed over different classes and:

- ↪ for each class the carrying amount must be disclosed
- ↪ for each class the net gains or losses must be disclosed
- ↪ in case of both loans and receivables and liabilities designated at fair value through profit or loss, there must be disclosure of maximum exposure at balance sheet date to credit risk (i.e. the risk of other party defaulting)

In addition there must be substantial disclosures in respect of accounting policies, hedge accounting and the basis of estimating fair values.

## 1.23 Nature and extent of risk and how they are managed

Two types of disclosures are required:

- ↳ Qualitative disclosures, i.e. the exposure to risk and how they arise and how this risk are measured and managed
- ↳ Quantitative disclosures which analyze risk between
  - Credit risk, with information about the age of assets where the other party has defaulted and about the collateral held
  - Liquidity risk in respect of financial liabilities, showing the remaining contractual maturity dates
  - Market risk, which itself is split between currency risk, interest rate risk and other price risk. Here, a sensitivity analysis must be provided.

## INDAS 109 Financial Instruments: *Classification and Measurement of Financial Assets*

### 1.24 Introduction

The new INDAS 109 issued by the IASB on 12 November 2009 impacts banks and insurance companies most significantly, but all entities that hold financial assets will be affected. The degree of the impact will depend on the type and significance of financial assets held by the entity and the entity's business model(s) for managing financial assets.

The effective date of the new classification and measurement guidance is 1 January 2013; early application is permitted. INDAS 109 should be applied retrospectively; however, if adopted before 1 January 2012, comparative periods do not need to be restated. In addition, entities adopting before 1 January 2011 are allowed to designate any date between then and the date of issuance of INDAS 109, as the date of initial application that will be the date upon which the classification of financial assets will be determined.

### 1.25 The 'new' norms

The major changes to existing guidance in AS 30 are outlined below. INDAS 109 replaces the multiple classification and measurement models in AS 30 with a single model that has only two classification categories: amortized cost and fair value. Classification under INDAS 109 is driven by the entity's business model for managing the financial assets and the contractual characteristics of the financial assets. A financial asset is measured at amortized cost if two criteria are met: a) the objective of the business model is to hold the financial asset for the collection of the contractual cash flows, and b) the contractual cash flows under the instrument solely represent payments of principal and interest.

The new standard removes the requirement to separate embedded derivatives from financial asset hosts. It requires a hybrid contract to be classified in its entirety at either amortized cost or fair value. Most embedded derivatives introduce variability to cash flows. This is not consistent

with the notion that the instrument's contractual cash flows solely represent the payment of principal and interest. Most hybrid contracts with financial asset hosts will therefore be measured at fair value in their entirety. Two of the existing three fair value option criteria become obsolete under INDAS 109, as a fair value driven business model requires fair value accounting, and hybrid contracts are classified in their entirety. The remaining fair value option condition in AS 30 is carried forward to the new standard – that is, management may still designate a financial asset as at fair value through profit or loss on initial recognition if this significantly reduces an accounting mismatch. The designation at fair value through profit or loss will continue to be irrevocable.

INDAS 109 prohibits reclassifications except in rare circumstances when the entity's business model changes; in this case, the entity is required to reclassify affected financial assets prospectively.

There is specific guidance for contractually linked instruments that create concentrations of credit risk, which is often the case with investment tranches in a securitization. In addition to assessing the instrument itself against the INDAS 109 classification criteria, management should also 'look through' to the underlying pool of instruments that generate cash flows to assess their characteristics. To qualify for amortized cost, the investment must have equal or lower credit risk than the weighted average credit risk in the underlying pool of instruments, and those instruments must meet certain criteria. If 'a look through' is impracticable, the tranche must be classified at fair value through profit or loss.

INDAS 109 classification principles indicate that all equity investments should be measured at fair value. However, management has an option to present in other comprehensive income unrealized and realized fair value gains and losses on equity investments that are not held for trading. Such designation is available on initial recognition on an instrument-by-instrument basis and is irrevocable. There is no subsequent recycling of fair value gains and losses to profit or loss; however, dividends from such investments will continue to be recognized in profit or loss.

INDAS 109 removes the cost exemption for unquoted equities and derivatives on unquoted equities but provides guidance on when cost may be an appropriate estimate of fair value.

INDAS 109 represents the first milestone in the IASB's planned replacement of AS 30. The next steps involve reconsideration and re-exposure of the classification and measurement requirements for financial liabilities, further exploration and field testing of the proposed impairment approach for financial assets, and development of enhanced guidance on hedge accounting. The IASB aims to fully replace AS 30 by the end of 2010.

## **1.26 Need of the hour**

The standard is available for early adoption immediately. Management should familiarize themselves with the detailed requirements of INDAS 109 and evaluate the effects of the new standard on the classification and measurement of financial assets held by the entity. Management should consider the potential benefits of early adoption of the new guidance in

light of the provided relief from restatement of comparative information and the relaxed requirements for the determination of the date of initial application for early adopters. However, management should bear in mind that the financial instruments project is evolving. There may be changes in the financial statements presentation for financial assets to enable investors to more easily reconcile the IASB and FASB models. Management and other interested parties should monitor the AS 30 replacement project and consider the impact of further decisions in the context of requirements already established by INDAS 109.

**~~ All the Luck ~~**