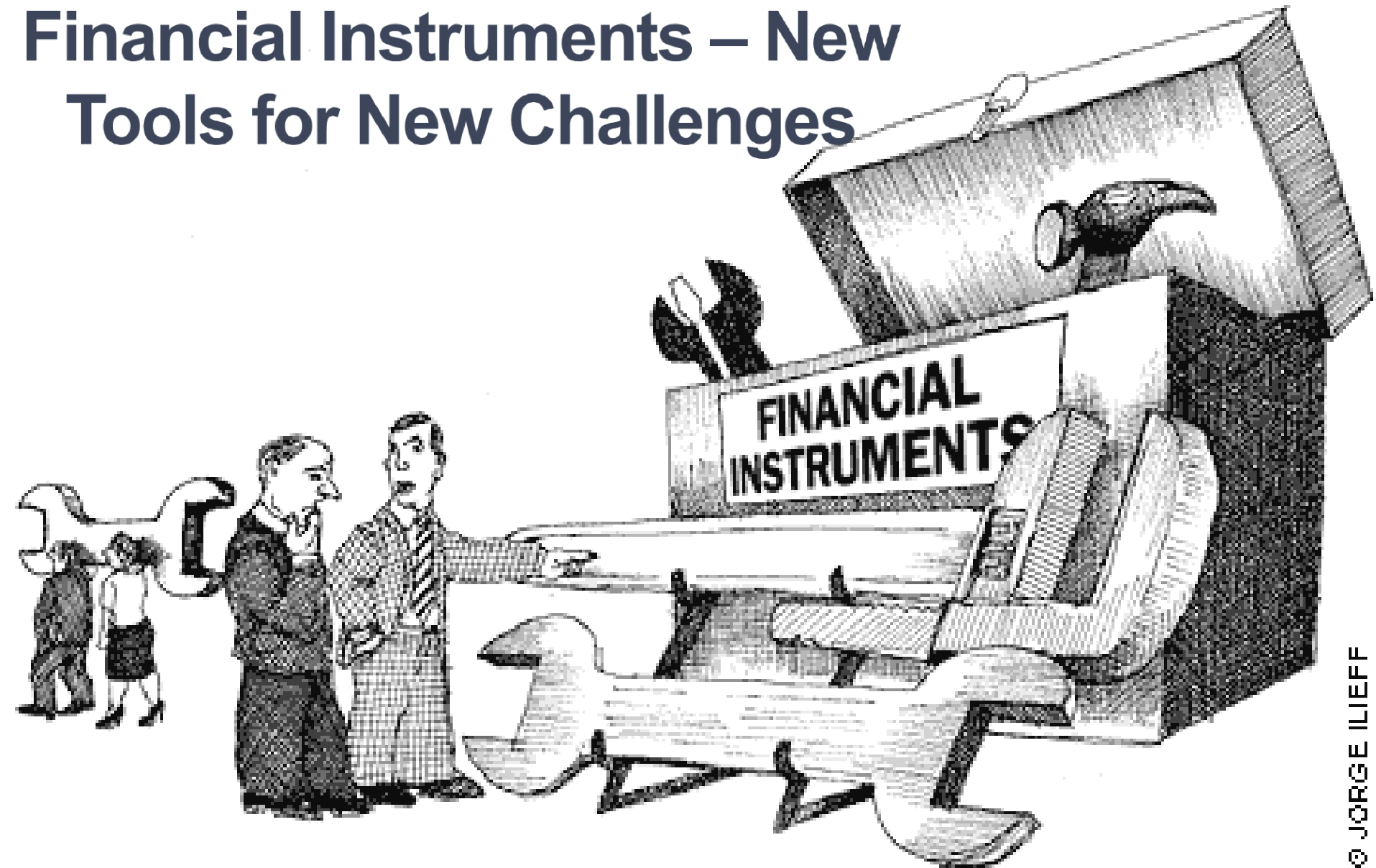


Financial Instruments – New Tools for New Challenges



CA POOJA GUPTA

Financial instruments – Definition

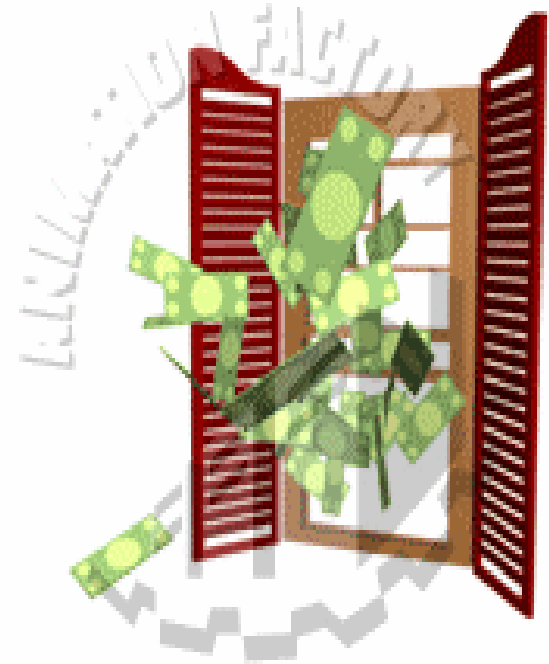
Presentation – Debt v/s Equity

Recognition and Initial Measurement

Subsequent Measurement

Derecognition

Disclosures



Financial Instruments - Definition

Financial instruments are defined as any contract that gives rise to:

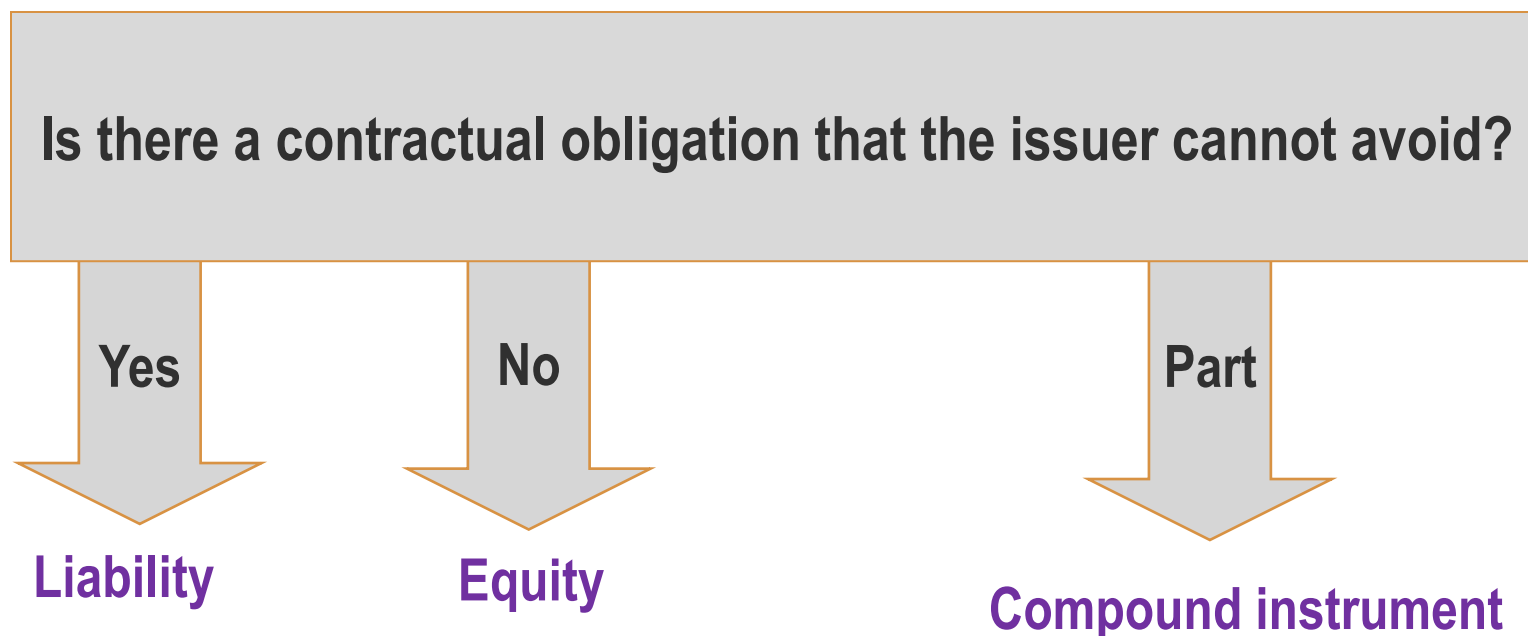
- financial asset of one entity and
- financial liability or equity instrument of another entity.



Presentation of Financial Instruments

- **Presentation sets out principles for –**
 - **Debt v/s Equity;**
 - **Compound Financial Instruments;**
 - **Treasury shares;**
 - **Offsetting financial assets and financial liabilities**

Debt v/s Equity



(Para 15 of IAS 32)

- ◆ Assess at initial recognition
- ◆ Classification continues until disposal

- ◆ Determine liability component
- ◆ Equity is residual
- ◆ No gain or loss

Compound Financial Instruments

- IStaR 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 anytime 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.

• PV of the principal 100,000/- payable at the end of 3 yrs	(77,200)
PV of the interest 6,000/- payable annually for 3 years	(15,186)

Total Liability Component	(92,386)
• Proceeds of the Bond	100,000

• Equity component (bal. fig)	7,614
	=====
• Discounting factor @ 9%	
1 year 0.917	
2 year 0.842	
3 year 0.772	

Recognition & Initial Measurement of Financial Instruments

All financial assets and financial liabilities, including derivatives, should be recognised on the balance sheet at fair value when the entity becomes party to the contractual provisions of the instrument

Financial assets
@
“fair value of
consideration
given”



Financial liabilities
@
“fair value of
consideration
received”

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

Classification – Financial Assets

Category	Definition
Financial assets at fair value through profit or loss (FvPL)	<ul style="list-style-type: none">• Financial assets held for trading• Derivatives (unless accounted for as hedges)• Financial assets designated to this category under the fair value option
Loans and receivables (L&R)	Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market
Held-to-maturity (HTM)	Non-derivative financial assets with fixed or determinable payments and fixed maturity that the entity has the positive intent and ability to hold to maturity
Available-for-sale (AFS)	<ul style="list-style-type: none">• All financial assets that are not classified in another category. Called the 'residual' category

Classification – Financial Liabilities

Category	Definition
Financial liabilities at fair value through profit or loss (FvPL)	<ul style="list-style-type: none">• Financial liabilities held for trading• Derivatives (unless accounted for as hedges)• Financial liability designated to this category under the fair value option
Other financial liabilities	All financial liabilities that are not classified at fair value through profit or loss. 'Residual' category

Subsequent Measurement of Financial Instruments

Instrument	Measurement	Value Changes
Financial Assets at fair value through profit & loss	Fair Value	Profit & Loss
Loans & Receivables (L&R)	Amortized Cost	Not relevant (unless impaired)
Held to maturity (HTM)	Amortized Cost	Not relevant (unless impaired)
Available for sale (AFS)	Fair Value	Equity (unless impaired)
Financial Liabilities at fair value through profit & loss	Fair Value	Profit & Loss
Other Financial liabilities	Amortized Cost	Not relevant

Amortized Cost & Effective Interest Rate (EIR)



Amortisation is calculated using the **effective interest rate** method.

The **effective interest rate** is defined as “the rate that exactly discounts estimated future cash flows through the **expected life** of the financial instrument or, where appropriate, a shorter period to the net carrying amount of the financial asset or financial liability”.



Effective Interest Rate (EIR)

Product	Auto Loan
Tenor (Contractual Life)	5 years
Loan Amount	500,000/-
Processing charges (fees)	5,000/-
Interest rate	10% p.a.
EMI (Yearly)	131,899/-
EIR (calculated)	10.39%



EIR Accounting ...

Year	No EIR				EIR				Txn Costs
	Interest	Prin	EMI	O/s	Interest	Prin	EMI	O/s	
1	50,000	81,899	131,899	418,101	51,454	80,445	131,899	414,555	1,454
2	41,810	90,089	131,899	328,013	43,092	88,807	131,899	325,747	1,282
3	32,801	99,097	131,899	228,915	33,860	98,039	131,899	227,809	1,059
4	22,892	109,007	131,899	119,908	23,670	108,229	131,899	119,479	778
5	11,992	119,908	131,899	0	12,420	119,479	131,899	0	428
	159,495	500,000			164,495	495,000			5000



Zero Coupon Bond

Modi & Kejriwal Ltd. issued a zero coupon bond of par value ₹ 100 at ₹68 ; maturity 5 years

Years	Cash flows	Interest	Amortized Cost	Journal Entry
0	68		68	Bank A/c Dr 68 Zero Coupon Bond A/c 68
1	0	5.453	73.4526	
2	0	5.89	79.3424	
3	0	6.362	85.7045	
4	0	6.872	92.5767	
5	-100	7.423	100	
IRR	8.02%			



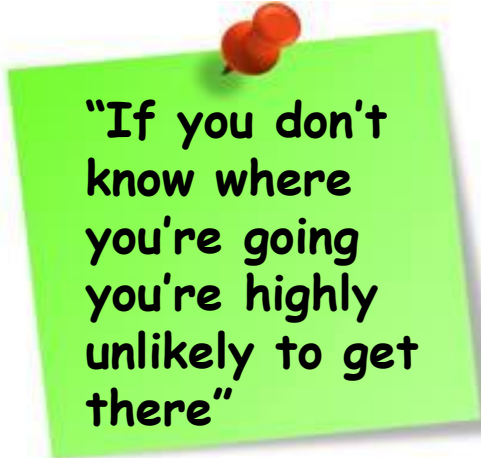
Derivatives

Derivatives are instruments with all three of the following characteristics

- Value changes in response to changes in specified underlying price/ index (e.g. interest rate, FX rate, share price)
- Requires no or little net investment
- Settled at a future date

Examples of derivatives:

- Forward FX contract
- Interest rate swap
- Collar and Caps



"If you don't know where you're going you're highly unlikely to get there"



Forward Contract Accounting

Purchase of Buy USD - Sell INR forward contract (Assume Incremental Borrowing rate @ 6% or alternatively use WACC)

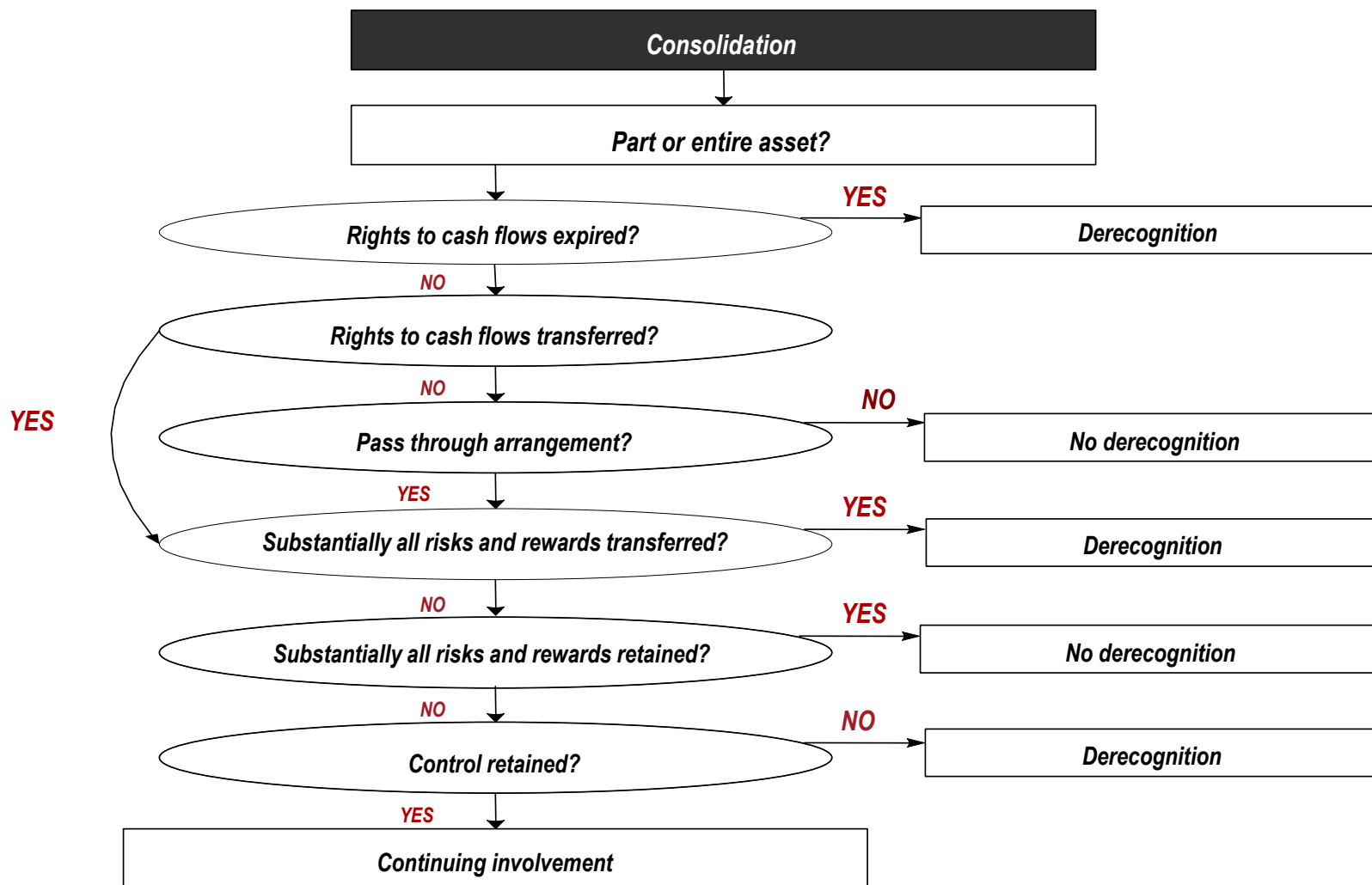
			Forward	Spot	
Forecast purchase \$ 10000					
1.10.2010			45.6	45.20	6 month
31.12.2010			45.5	45.10	3 month
31.3.2011				45.00	0 month
<u>Journal Entries</u>					
1.10.2010	Entry with zero amount			Discounted	Undiscounted
31.12.2010	Unrealized P & L A/c	Dr	985.22	-985.22	-1,000
	Forward Liability	Cr	985.22		
31.3.2011	Unrealized P & L A/c	Dr	5,014.78	-	-6,000
	Forward Liability		5,014.78		
31.3.2011	Purchases	Dr	4,50,000		
	To Bank		4,50,000		
	Forward Liability	Dr	6,000.00		
	To Bank		6,000.00	4,56,000	

**"Jack be nimble
Jack be quick"**

Derecognition

- De-recognition rules were developed to deal with '*off balance sheet financing*'
- The standard combines the 'risk and rewards approach' and 'control approach'
- IAS 39 details principles for:
 - Complete de-recognition
 - Partial de-recognition (e.g. servicing rights retained)
 - De-recognition combined with recognition of a new liability (e.g. credit risk guaranteed)

Derecognition flowchart – Financial Assets



Derecognition – Financial Liabilities



- Financial liability (or part thereof) is removed from the balance sheet when it is extinguished, i.e. when the obligation is discharged or cancelled or expires



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