

Financial Instruments Crux

Meaning of FI

Not Statutory
→ Not Constructive

Contract between two parties

Financial Asset (Cash, Inv in shares, debentures, TR, Loan given)

Financial Liability or Equity

Trade Payables, loans taken, Bonds issued

Ordinary shares or Pref. shares classified as Equity.

FA

- i) Contractual **right** to receive cash on another FA
- ii) Exchange FA on FL under conditions potentially Favourable (Derivative Financial Asset)
- (iii) Contract may be settled in Entity's own Eq. Inst.
 - a) Non Derivative - obliged to receive variable no. of shares. (if fixed no. of shares - Equity)
 - b) Derivative - other than Fixed Amount but fixed no. of shares (if fixed Amt & fixed shares - Equity)

FL

- i) Contractual **obligation** to deliver cash on another FA
- ii) Exchange FA on FL under conditions potentially Unfavourable (Derivative Financial Liabilities)
- (iii) Contract may be settled in Entity's own Eq. Inst.
 - a) Non Derivative - obliged to deliver variable no. of shares. (if fixed no. of shares - Equity)
 - b) Derivative - other than Fixed Amount but fixed no. of shares (if fixed Amt & fixed shares - Equity)

Note: In case of **own Eq. Inst.**, if **Fixed** but **Fixed** test passes - classified as **Equity**.

Following items are not FA or FL

Prepaid asset, Advance from customers, warranty obligations, income taxes, Deferred Revenue, Advance paid to supplier but goods or services, Contract assets.

Classification as Equity or FL

- Redeemable Pref. Sh / Debentures with mandatory dividend / interest → Financial Liability.
- Irredeemable Pref. Sh / Debentures with Discretionary dividend / interest → Equity.
- Irredeemable Pref. Sh / Debentures with mandatory dividend / interest → Compound F.I.
- Redeemable Pref. Sh / Debentures with Discretionary dividend / interest → Compound F.I.

Meaning of Equity \langle Contract that evidence residual interest after deducting all liabilities \rangle

No contractual obligation to deliver cash or another FA & No contractual obligation to Exchange FA or FL under conditions potentially Unfavourable.

FL or Equity classification

Instruments convertible into fixed no. of shares \langle Assume interest payment mandatory \rangle

Compulsory convertible \div Only Interest Component discounted to P.V. and shown as FL \langle Dibt. in Equity \rangle

Convertible at option of Holder \div Both Interest & Principal discounted to P.V. \langle Dibt. in Equity \rangle

Instruments convertible into variable no. of shares

Compulsory convertible \div Both Interest & Principal discounted to P.V. \langle Dibt. shown as other liabilities \rangle

Convertible at option of Holder \div Both Interest & Principal discounted to P.V. \langle Dibt. shown as other liab. \rangle

<u>Consideration</u>	<u>No. of shares</u>	<u>Classification</u>
Fixed	Variable	FL
Variable	Fixed	FL
Variable	Fixed	FL
Fixed	Fixed	Equity.

Financial Assets \langle Initial measurement \rangle

(i) Transaction at market terms \rightarrow FA measured at Transaction price

(ii) Transaction at off market terms \rightarrow Determine Fair value of FA

a) if fair value based on level 1 Input - Difference recognised in P/L.

b) Other cases \div Recognise as an asset \langle if FEB \rangle , otherwise in P/L.

\downarrow
Investment in Subsidiary, Prepaid staff cost, ROU Asset

Measurement of Financial Assets

FA initially measured at fair value.

FA subsequently measured at \div

Strategic Debt Restructuring (Modification)

1. Measure C.A. of old liability at Modification Date.
2. Check if 10% test passes \leftarrow Revised terms of cash flows discounted using old EIR which is compared with C.A. of old liability to check if difference more than 10%. \rightarrow
3. If 10% test passed, Apply Extinguishment A/cing. - If 10% test fails, Apply Modification A/cing.

Extinguishment A/c \div :

CA of old liability derecognised, Fair value of New liab recognised, Difference in P/L.
Fees or cost incurred charged to P/L

Modification A/c \div :

Any payments made reduced from CA of old liab.
Calculate New EIR.
Any fees or cost paid reduce CA of old liab.

Debt on Equity Swaps

When Eq. Instt. issued to creditor to settle liability, measure them at Fair value of Eq. Instt. issued. If not reliably measurable, then measure them at Fair value of liability extinguished.

\Rightarrow DFA, DFL

Derivatives \leftarrow Options, Futures, Forward contract, Swapping \div Following conditions need to satisfy

- 1) Its value changes in response to change in underlying.
- 2) No initial or very less investment than reqd. in normal course
- 3) Settled at a Future period.

For Derivatives Contract, FVTPL accounting is applied & remeasured at each R.P. end.

Embedded Derivatives \leftarrow Eg. issue of Bonds where Payment of Interest & Principal Comp. linked with Gold Price \rightarrow

it is one Component of a Hybrid Instt that also includes Non Derivative Host Contract

with effect that some cash flows vary in a way similar to stand alone Derivatives

Separation of Embedded Derivative from Non Derivative Host \rightarrow closely related NOT REQUIRED in below situations \div

(i) Hybrid contract measured at FVTPL.

(ii) Economic characteristic & risk of E.D. closely related to Host.

In below cases, An **Embedded Foreign Currency derivative** considered closely related to Host and separation is not required: (Refer comp. & Tyk Illustration 4)

- (i) Payment denominated in F.C. of any Party to the contract
- (ii) Currency routinely denominated in commercial trans. around the world (& for crude oil)
- (iii) stable and liquid currency commonly used in local business transaction.

Regular way purchase and sell of FA

Purchase or sell of FA whose terms require delivery of asset within time frame established by negotiation or convention. (NO Derivatives Accounting)

Trade Date Accounting

AcM	FVOCI	FVTPL
FA To Payables	FA To Payables	FA To Payables
X	FA To OCI reserve	FA To P/L.
Payables TO Bank	Payables TO Bank	Payables TO Bank

Settlement Date Accounting

AcM	FVOCI	FVTPL
No Entry	No Entry	No Entry
	Fair Value change To OCI reserve	Fair Value change To P/L.
FA TO Bank	FA TO Bank To Fair value change TO OCI reserve	FA TO Bank To Fair value change TO P/L.

Reclassification of FA (if change in Business model)

AcM to FVTPL → Inv in Bonds (FVTPL)
TO Inv in Bonds (AcM)
TO P/L

AcM to FVOCI → Inv in Bonds (FVOCI)
TO Inv in Bonds (AcM)
TO OCI reserve

FVTPL to AcM → Bonds at AcM
P/L (Profit or loss)
TO Bonds at FVTPL

FVTPL to FVOCI → Bonds at FVOCI
P/L (Profit or loss)
TO Bonds at FVTPL

FVOCI to AcM → Bonds at AcM
TO Bonds at FVOCI
Bonds at AcM
TO OCI

FVOCI to FVTPL → Bonds at FVTPL
TO Bonds at FVOCI
P/L (Recycling)
TO OCI

Impairment of FA $\left\langle \text{Impairment loss always recognised in P/L even if FVOCI Accounting} \right\rangle$

Recognise loss Allowance from Expected credit loss on \div

FA measured at ACM/FVOCI, TR, Loan commitment on Financial Guarantee Contract.

Impairment loss not recognised if \div :

1) FL on Equity Instt. 2) Inv in Equity Instt. 3) FA measured at FVTPL.

also called loss given default

Loss Allowance provided are of two types \div :

Lifetime ECL \rightarrow TR on lease receivable, Short term FA, Credit risk ^{if 30 days past due} increased significantly.

\hookrightarrow P.V. at original EIR of Difference betⁿ Cash Flows due to Entity and Cash Flows expected to receive.

if Credit risk increased significantly \div Interest on Gross C.A.

if Credit risk impaired - Interest on Amortised cost $\left\langle \text{i.e. After adjusting loss allowance} \right\rangle$

12m ECL \rightarrow Other FA whose credit risk not increased significantly.

\hookrightarrow Lifetime ECL $\left\langle \text{on loss given default} \right\rangle \times 12 \text{ months Probability of Default.}$

An Entity may use practical expedient when measuring Lifetime ECL or 12m ECL from TR by using provision matrix. $\left\langle \text{i.e. using its historical credit experience} \right\rangle$ refer Unit 2 911 44

Derecognition of FA $\left\langle \text{Refer illustration 12A, 12B, 12C of unit 5} \right\rangle$

- i) Right to Cash Flow from Asset Expires.
- ii) Entity transfers right to receive cash flows and transfers substantially all risk and reward.
- iii) Entity neither retained nor transferred subs. all risk and reward and not retained control of Asset.

Example on Efd. Subs. All risk & reward

- 1) Unconditional sale
- 2) Sale and Repurchase at Fair value.
- 3) Sale + Put/call option Deeply out of money

Example retained Subs. All risk & reward

- 1) Sale and Repurchase at Fixed Price on Sale price Plus lender's return.
- 2) Sale + Put/call option Deeply in the money
- 3) Securities lending Arrangement
- 4) Sale of short term FA with guarantee from Credit losses.
- 5) Sale with return Swap Efd. risk Exposure back to Entity.

If transferee has practical ability to sell asset entirely and is able to exercise that ability unilaterally and without needing to impose additional restriction on transfer, entity has not retained control. If transfer does not qualify for derecognition, continue to recognise the asset and recognise financial liability from the consideration received.

An entity derecognises part of FA if: i) Part comprises only specifically identified cash flows
 ii) Part comprises fully proportionate cash flows iii) Part comprises fully proportionate interest on principal strip.

Payment to creditor on legally released.

Derecognition of FL (Remove from B/Sheet when extinguished i.e. obligation discharge or expires)

Difference between CA of liability and consideration paid recognised in P/L.

Securitisation: In some situation, entity retains right to receive C/F but simultaneously it assumes contractual obligation to pay C/F to other entities (Pass through Arrangements).

To qualify transfer, all conditions met:

- i) No obligation to pay unless collects.
- ii) Obligation to remit C/F if collects without material delay.
- iii) Prohibited from selling or pledging
- iv) No reinvestment except in cash or cash eq. and interest earned is passed to recipients.

Illustration 12A, 12B, 12C: Continuing Involvement Asset.

Bank	90cm	} ⇒ Single Entry →	C.I.A.	5.5cm
Loss on Derecog. (P/L)	5cm		Bank	90cm
TO S.F.R. (FA)	9.5cm		Loss on Der.	5cm
C.I.A.	5.5cm		TO S.F.R. (FA)	9.5cm
TO Guarantee Liab.	5.5cm		TO Guarantee Liab.	5.5cm

Refer → Hedge Accounting Question, Financial Guarantee B., Foreign Currency E.D. B.

* If loan repayable on demand - No Interest Exp. on Interest income recognised.