

Accounting of Financial Instruments

3

SLOB Mapped against the Module

To obtain in-depth knowledge on accounting and reporting of financial information for different types of corporate entities engaged in activities across certain sectors based on specified Ind ASs.

Module Learning Objectives

- ⦿ To provide reasonable knowledge in regard accounting and reporting of financial instruments in an Ind AS environment
- ⦿ To develop skill in application of reasonable knowledge in recognition, measurement, presentation and disclosure of financial instruments

Accounting of Financial Instruments

3

The following three Indian Accounting Standards are relevant for recognition, measurement and disclosure of financial instruments:

Financial instruments: Presentation (Ind AS 32)

Financial instruments: Disclosure (Ind AS 107)

Financial instruments (Ind AS 109)

Financial Instruments are classified as:

- (i) Financial assets,
- (ii) Financial liabilities and
- (iii) Equity instruments.

Ind AS 32 prescribes the requirements for presentation of financial instruments and Ind AS 107 prescribes about disclosure of financial instruments.

Ind As 109 deals with recognition and measurement of financial instruments and hedge accounting.

As per Ind AS 32 in financial statements financial instruments are presented as financial assets or as financial liabilities or equities.

Objectives of the standard:

The objective of this Standard is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset.

(I) Financial assets are:

- (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 liabilities with another entity under conditions that are potentially favourable to the entity; or
 - (a) a contract that will or may be settled in the entity's own equity instruments and is:
 - (iii) 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

- (iv) 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

(II) A 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 liabilities with another entity under conditions that are potentially unfavourable to the entity;

or

(b) 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 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.

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

The instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met.

(a) The instrument includes no contractual obligation:

- i. to deliver cash or another financial asset to another entity; or
- ii. to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.

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

- i. a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
- ii. 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.

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. Ordinarily it satisfies the conditions of being classified as financial liabilities. Where it entitles the holder a pro rata share of the entity's net assets on liquidation it is classified as equity.

Ind AS 109: Financial Instruments

Objective:

The objective of this Standard is to establish principles for the financial reporting of financial assets and financial liabilities that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of an entity's future cash flows.

It classifies the financial assets and financial liabilities into three categories for recognition and measurement:

(i) Measured at fair value through Other Comprehensive Income (OCI).

Conditions for being classified as (FV through OCI)--

- (a) Objectives of holding financial asset are both to collect contractual cash flows and to sell financial assets.
- (b) Contractual cash flows solely consists of payment of principal and interest on the principal amount outstanding on specified dates.

(ii) Measured at amortized cost.

If the objective of holding financial asset does not include collection of cash flows by selling of financial assets, such financial assets are classified as 'amortized cost.'

(iii) Measured at fair value through P & L

If a financial asset is not classified as amortised cost or an FV through OCI it is measured at fair value through P & L. Simple case **for example**, if investment in equity of any other company where there is no contractual cash flows for interest or principal.

Ind AS 107: Financial Instruments: Disclosures

Objective:

The objective of this Indian Accounting Standard (Ind AS) is to require entities to provide disclosures in their financial statements that enable users to evaluate: (a) the significance of financial instruments for the entity's financial position and performance; and (b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period, and how the entity manages those risks.

The principles in this Ind AS complement the principles for recognising, measuring and presenting financial assets and financial liabilities in Ind AS 32, Financial Instruments: Presentation, and Ind AS 109, Financial Instruments.

An entity shall disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance.

The carrying amounts of each of the following categories, as specified in Ind AS 109, shall be disclosed either in the balance sheet or in the notes:

- (a) financial assets measured at fair value through profit or loss,
- (b) financial liabilities at fair value through profit or loss
- (c) financial assets measured at amortised cost.
- (d) financial liabilities measured at amortised cost.
- (e) financial assets measured at fair value through other comprehensive income.

Illustration 1

G Ltd. issued 6% Debenture of total ₹ 10,00,000 on 01.04.2017 repayable on 31. 03.2022. The debenture holders have right to receive equity shares of face value of ₹ 4,00,000 at maturity as alternative to repayment in cash. The required rate of return is 10%. How the transaction will be recognised, measured and presented in 2017-2018?

Solution:

Debentures were issued with embedded derivative of option to convert them into shares. Equity is recognised and measured at the value of the embedded option. Liability is recognised at the present value of future cash flows.

Workings:**Present Value of Liability**

Year	Cash Flows (₹)	Discounting Rate	DCF (₹)
1	60,000	0.909	54,545
2	60,000	0.826	49,587
3	60,000	0.751	45,079
4	60,000	0.603	40,981
5	10,60,000		6,58,177
Total			8,48,369

Equity will be recognised and presented as Option to acquire shares under other equity in balance sheet measured at the difference between issue price and the present value of liability. Equity = ₹10,00,000 – ₹8,48,369 = ₹1,51,631.

Finance cost recognised and presented in statement of P & L = $10\% \times ₹8,48,369 = ₹84,837$.

Financial liabilities will be recognised and presented as debenture in balance sheet measured at present value of future cash flows discounted at 10% pa. plus accrued interest = ₹8,48,369 + ₹84,837 – ₹60,000 = ₹8,73,206.

[At maturity if conversion into shares are opted]

Particulars		Dr.	Cr.
		(₹)	(₹)
Debenture A/c	Dr.	10,00,000	
To, Equity Share Capital A/c			4,00,000
To, Security Premium A/c			6,00,000

Illustration 2

X Ltd. Granted a loan to Y Ltd amounting to ₹40 lakhs repayable in 2 years at ₹46 lakhs. However, due to economic recession after 1 year the repayable amount has been revised at ₹44 lakhs. Effective annual interest rate for such a loan is determined at 6% pa. The loan processing cost was ₹2 lakhs. X Ltd's accountant suggested to

- Charge processing cost to the first year profit and loss A/c.
- To credit ₹4 Lakhs as interest income in the second year profit and loss a/c.
- To carry loan a/c in the first year balance sheet at ₹40 lakhs. Your advice is solicited.

Solution:

- Processing cost should be added to the carrying value of the loan (i.e. ₹40 Lakhs + ₹2 Lakhs = ₹42 lakhs), and not be charged to P & L.
- In year 1 interest should be credited to P & L at 6% in ₹42 lakhs = ₹2.52 lakhs.
- The Carrying Amount of the loan at the end of year 1 = ₹42 lakhs + ₹2.52 lakhs = ₹44.52 lakhs. But since the Repayable Amount at the end of year 2 is revised at ₹44 lakhs, the recoverable amount at the end of year 1 is the present value = ₹44 lakh/1.06 = ₹41.51 (approx) lakhs.

Thus the carrying amount shall be brought down to ₹ 41.51 lakhs only, the difference being impairment loss under Ind AS 36 ₹(44.52 – 41.51) Lakhs = ₹ 3.01 Lakh to be charged to Profit and Loss Statement.

In year 2, interest shall be credited to Profit and Loss Statement ₹ (41.51 × 6) ÷ 2.49 lakh and the carrying amount of loan = ₹ 41.51 Lakhs + ₹ 2.49 Lakhs = ₹ 44 Lakhs that should be repaid at the end of year 2.

Solved Case Study(s)

Case 1

Dew Ltd. 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 ₹1,000 per bond, giving total proceeds of ₹20,00,000. Interest is payable annually at a nominal annual interest rate of 6 per cent. Each bond is convertible at any time up to maturity into 25000 ordinary shares of ₹ 10. When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is 9 per cent. The holders of the Debentures elected to convert the Debentures into Equity at maturity. Pass journal entries in the books of Dew Ltd.

Solution:

- ⊙ The liability component is measured first, and the difference between the proceeds of the debenture 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 per cent, the market interest rate for similar bonds having no conversion rights, as shown below.

Year	Interest and Principal (₹)	DCF at 9% (₹)
1	1,20,000	1,10,092
2	1,20,000	1,01,002
3	1,20,000	92,662
Present value of the interest		3,03,755
Present value of the principal		
4	20,00,000	15,44,367
Liability component		18,48,122
Proceeds of the Deb issue		20,00,000
Equity component		1,51,878

Date	Payment 6% coupon (₹)	Interest at 9% (₹)	Increase in liability (₹)	Total Debenture liability (₹)
01-04-2019				18,48,122
31-03-2020	1,20,000	1,66,331	46,331	18,94,453
31-04-2021	1,20,000	1,70,501	50,501	19,44,954
31-03-2022	1,20,000	1,75,046	55,046	20,00,000

Journal		Dr.	Cr.
Date	Particulars	(₹)	(₹)
01-04-2019	Bank To, Convertible Debenture (liability) To, Convertible Debenture (Equity component)	Dr. 20,00,000	 18,48,122 1,51,878
31-03-2020	Interest Expense To, Bank To, Convertible Debenture (liability)	Dr. 1,66,331	 1,20,000 46,331
31-04-2021	Interest Expense To, Bank To, Convertible Debenture (liability)	Dr. 1,70,501	 1,20,000 50,501
31-03-2022	Interest Expense To, Bank To, Convertible Debenture (liability)	Dr. 1,75,046	 1,20,000 55,046
31-03-2022	Convertible Debenture (liability) Convertible Debenture (Equity component) To, Equity Share Capital To, Securities Premium	Dr. Dr. 20,00,000 1,51,878	 2,50,000 19,01,878

Case 2

Hill Ltd. issues 4-year 2000 2% redeemable cumulative preference shares of ₹ 1000 at par to its parent Mountain Ltd. on 01-04-2018. Market rate of interest is 12%. Show journal entries in the books of Mountain Ltd. for all the years.

Solution:

Mountain Ltd. pays ₹ 1000 per preference share at issue and receives ₹ 20 dividend annually and ₹ 1000 at maturity, while market rate of interest is 12% amounting to ₹120 annually. The present value of dividends and maturity value of the preference shares at the discounting rate of 12% constitute the loan component of the investment and the excess consideration paid is accounted as equity component of the investment.

Initial recognition:

Year	Dividend and Principal	DCF at 12% (₹)
1	40,000	35,714
2	40,000	31,888
3	40,000	28,471

Year	Dividend and Principal	DCF at 12% (₹)
4	40,000	25,421
Present value of the Dividend		1,21,494
Present value of the maturity value		
5	20,00,000	12,71,036
	Loan component	13,92,530
	Investment	20,00,000
	Equity component	6,07,470

Subsequently, loan component of the investment will be carried at amortised cost as follows:

Year	Receipts @ 2% (₹)	Interest@12% (₹)	Increase in Loan (₹)	Carrying amount (₹)
0				13,92,530
1	40,000	1,67,104	1,27,104	15,19,634
2	40,000	1,82,356	1,42,356	16,61,990
3	40,000	1,99,439	1,59,439	18,21,429
4	40,000	2,18,571	1,78,571	20,00,000

Journal		Dr.	Cr.
Date	Particulars	(₹)	(₹)
01-04-2018	Investment (Equity portion)	Dr. 6,07,470	
	Loan Receivable	Dr. 13,92,530	
	To, Bank		20,00,000
31-03-2019	Loan Receivable	Dr. 1,27,104	
	Bank	Dr. 40,000	
	To, Interest Income		1,67,104
31-04-2020	Loan Receivable	Dr. 1,42,356	
	Bank	Dr. 40,000	
	To, Interest Income		1,82,356
31-03-2021	Loan Receivable	Dr. 1,59,439	
	Bank	Dr. 40,000	
	To, Interest Income		1,99,439

Date	Particulars		(₹)	(₹)
31-03-2022	Loan Receivable	Dr.	1,78,571	
	Bank	Dr.	40,000	
	To, Interest Income			2,18,571
31-03-2022	Bank	Dr.	20,00,000	
	To, Loan Receivable			20,00,000

Exercise

A. Theoretical Questions:

⊙ Multiple Choice Questions

1. The Indian Accounting Standards relevant for recognition, measurement and disclosure of financial instruments are
 - a. Financial instruments: Presentation (Ind AS 32)
 - b. Financial instruments: Disclosure (Ind AS 107)
 - c. Financial instruments: (Ind AS 109)
 - d. All of the above
2. Financial assets are
 - a. cash
 - b. an equity instrument of another entity
 - c. a contractual right
 - d. All of the above
3. Ind AS 109: Financial Instruments classifies the financial assets and financial liabilities into the following categories for recognition and measurement
 - a. Measured at fair value through OCI
 - b. Measured at amortized cost
 - c. Measured at fair value through P & L
 - d. All of the above
4. Ind As 109 deals with
 - a. recognition and measurement of financial instruments and hedge accounting
 - b. presentation of financial instruments
 - c. disclosure of financial instruments
 - d. None of the above

5. An _____ is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities
- equity instrument
 - puttable instrument
 - financial instrument
 - None of the above

Answer:

1.	2.	3.	4.	5.
D	D	D	A	A

⊙ **Fill in the Blanks**

- A _____ 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.
- As per _____ in financial statements financial instruments are presented as financial assets or as financial liabilities or equities.
- If the objective of holding financial asset does not include collection of cash flows by selling of financial assets, such financial assets are classified as _____.
- If a financial asset is not classified as amortised cost or an FV through OCI it is measured at _____ through P & L.
- Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an _____.

Answer:

1.	puttable instrument	2.	Ind AS 32
3.	amortized cost	4.	fair value
5.	arm's length transaction		

⊙ Short Essay Type Questions

1. Define Financial Asset as per Ind AS 32.
2. Briefly explain Puttable Instrument.
3. Classify the financial assets and financial liabilities into three categories for recognition and measurement under Ind AS 109.
4. Mention the categories whose carrying amount shall be disclosed either in the balance sheet or in the notes as per Ind AS 107.
5. Define Equity Instrument. Mention the conditions to be met to be classified as Equity Instrument.

B. Numerical Questions:

⊙ Comprehensive Numerical Problems

1. G Ltd. issued 8% Debenture of total ₹ 20,00,000 on 01.04.2020 repayable on 31.03.2025. The debenture holders have right to receive equity shares of face value of ₹ 12,00,000 at maturity as alternative to repayment in cash. The required rate of return is 10%. How the transaction will be recognised, measured and presented in 2020-2021?
2. X Ltd. Granted a loan to Y Ltd. amounting to ₹ 60 lakhs repayable in 2 years at ₹70 lakhs. However, due to economic recession after 1 year the repayable amount has been revised at ₹ 68 lakhs. Effective annual interest rate for such a loan is determined at 6% pa. The loan processing cost was ₹ 3 lakhs. X Ltd.'s accountant suggested to
 - (i) Charge processing cost to the first-year Profit and Loss A/c.
 - (ii) To credit ₹ 8 Lakhs as interest income in the second-year Profit and Loss A/c.
 - (iii) To carry Loan A/c in the first year balance sheet at ₹ 60 lakhs.

Your advice is solicited.