FINANCIAL INSTRUMENTS

Demystified under Ind AS

VOLUME I

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Ind AS 32

FINANCIAL INSTRUMENTS: PRESENTATION

CHAPTER 1

Introduction **1**

Financial instrument **1.1**

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

Financial instruments can be traded or exchanged, and are represented by a legal agreement that involves monetary value.

A contractual right or obligation to receive, deliver or exchange financial instruments is itself a financial instrument. A chain of contractual rights or obligations meets the definition of a financial instrument if it will ultimately lead to the receipt or payment of cash or to the acquisition or issue of an equity instrument.

The ability to exercise a contractual right or the requirement to satisfy a contractual obligation may be absolute, or it may be contingent on the occurrence of a future event. A contingent right and obligation meet the definition of a financial asset and a financial liability respectively, even though such assets and liabilities are not always recognised in the financial statements, eg, a *financial guarantee contract*.

A financial guarantee contract requires the issuer to make specific payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

Contracts to buy or sell non-financial items do not meet the definition of a financial instrument because the contractual right of one party to receive a non-financial asset or service and the corresponding obligation of the other party **do not establish a present right or obligation of either party** to receive, delivery or exchange a financial asset, eg, commodity contracts.

However, some contracts to buy or sell non-financial items that can be settled net or by exchanging financial instruments, or in which the non-financial item is readily convertible to cash, are within the scope of the standard as if they were financial instruments.

Some contracts are commodity-linked, but do not involve settlement through the physical receipt or delivery of a commodity. They specify settlement through cash payments that are determined according to a formula in the contract, rather than through payment of fixed amounts.

EXAMPLE 1

The principal amount of a bond may be calculated by applying the market price of oil prevailing at the maturity of the bond to a fixed quantity of oil. The principal is indexed by reference to a commodity price, but is settled only in cash. Such a contract constitutes a financial instrument.

The following are the basic terms used in the definition of a financial instrument – **1.2**

Contract	Entity
•A ***contract*** is 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.	•An ***entity*** is defined as individuals, partnerships, incorporated bodies, trusts and government agencies.

The **four main Ind AS standards** dealing with financial instruments are the following – **1.3**

Ind AS 32: Financial Instruments – *Presentation*

This standard aims 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.

This standard deals with –

- Debt vs equity;
- Convertibles; and
- Treasury shares.

Ind AS 109 – Financial Instruments

This standard aims 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.

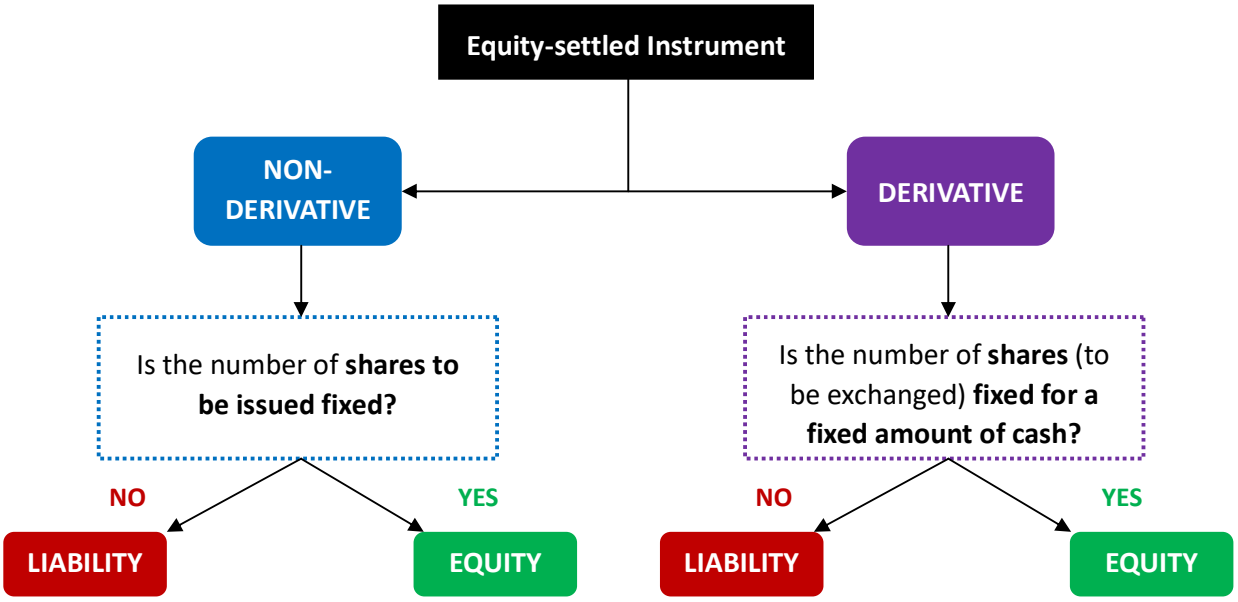
If one party has an obligation to transfer an economic resource, it follows that another party(s) has a right to receive that economic resource. Common examples of financial assets representing a contractual right to receive cash in the future and corresponding financial liabilities representing a contractual obligation to deliver cash in future are –

Trade receivable and payable	**Notes receivable and payable**	**Loans receivable and payable**	**Bonds receivable and payable**

In each case, one party's contractual right to receive (or obligation to pay) cash is matched by the other party's corresponding obligation to pay (or right to receive).

However, a requirement for one party to recognise a liability and measure it at a specified amount does not imply that the other party(s) must recognise an asset and measure it at the same amount. For example –

- The liability component of a convertible bond is measured at a discount to the amount convertible / repayable on maturity.
- A financial asset may be measured initially at fair value, but the corresponding liability at transaction price or *vice versa*.
- Financial assets like trade receivable or lease receivable may be recognised at *less* than its initial carrying amount, because of adjustment of loss allowance.



Primary (non-derivative) financial instruments 3

A non-derivative financial instrument is a financial asset or a financial liability, that has its own intrinsic value (ie, perceived or true value), and is not based on the value of another asset or variable. Some examples are:

Derivative financial instruments 3.1

A **derivative** is a financial instrument that derives its value from the price or rate of an underlying item.

A derivative has no value in itself, but it obtains its value from the right or obligation that transfers financial risks intrinsic in the underlying asset. On initiation, a derivative financial instrument gives one party a contractual right to exchange financial assets or financial liabilities with another party under conditions that are *potentially favourable*; or a contractual obligation to exchange financial assets or financial liabilities with another party under conditions that are *potentially unfavourable.*

It is a contract with **all three** of the following characteristics – 3.2

1. Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the *underlying*) ie, the main pricing-settlement variable.
2. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. In other words, a derivative could require a payment as a result of some future event that is unrelated to a notional amount.
3. It is settled at a future date.

Typical examples of derivatives are **forwards, futures, option** and **swap contracts**. 3.3

Forward	•An agreement to buy or sell an asset at a fixed price at a fixed future date.
Future	•It is similar to a forward contract except that it is standardised and traded on an exchange.
Option	•It is a right (but not an obligation) for the option holder to exercise at a pre-determined price; the option writer loses out if the option is exercised.
Swap	•It is an agreement to swap one set of cash flows for another (normally interest rate or currency swaps).

WORKED EXAMPLE 12

On 1 March 20x5, Entity A (year-end 31 March) sells a put option that gives it the obligation to buy (written put option) a fixed quantity of sugar at CU 250 on 30 April 20x5. Entity A receives CU 25 as option premium. The prices of sugar are on –

1 March 20x5: CU 250

31 March 20x5: CU 240

30 April 20x5: CU 255

JOURNAL

Entity A

20x4 – x5

1 March 20x5

• Cash		CU 25	
	Derivative liability		CU 25 [option premium]

31 March 20x5

• Fair value loss		CU 10	[CU 250 – CU 240]
	Derivative liability		CU 10
• Profit and loss		CU 10	
	Fair value loss		CU 10

20x5 – x6

30 April 20x5

• Derivative liability		CU 35	[CU 25 + CU 10]
	Profit and loss		CU 35

Forward 5

A forward contract is a private contract between two parties to buy or sell an asset at a predetermined price on a predetermined future date. The terms of a forward contract are such that a payment based on the difference between the price of the underlying and the forward price will occur at a specified date.

A forward contract is recognised as an asset or a liability on the commitment date, instead of on the date on which settlement takes place. When an entity becomes a party to a forward contract, the fair value of the right and obligation are often equal, so that the net fair value of the forward is zero. If the net fair value of the right and obligation is not zero, the contract is recognised as an asset or liability.

An example of a forward contract to be settled in three months' time in which one party (the purchaser) promises to pay CU 100 cash in exchange for CU 100 face value of fixed rate government bonds, and the other party (the seller) promises to deliver CU 100 face value of fixed rate government bonds in exchange for CU 100 cash. During the three months, both parties have a contractual right and a contractual obligation to exchange financial instruments.

On 15 July 20x4, Entity A (year-end 31 March) enters into a forward contract with Entity B to buy a fixed quantity of sugar for CU 100 on 31 May 20x5 (the date of settlement).

The market prices of sugar are –

15 July 20x4	**CU 95**
30 September 20x4	**CU 98**
31 December 20x4	**CU 102**
31 March 20x5	**CU 106**
31 May 20x5	**CU 104**

Since it is a forward contract for physical settlement, the party designated in the contract as the buyer (ie, Entity A) has to deliver the full stated amount of cash (ie, CU 100) to the seller (ie, Entity B) on 31 May 20x5 and the seller has to deliver the full stated quantity of sugar to the buyer on that date.

JOURNAL

Entity A

20x4 – x5

15 July 20x4

• Forward loss	CU 5 [CU 100 – CU 95]	
Forward liability *		CU 5

* When an entity becomes a party to a forward contract and if the net fair value (ie, the difference between the forward price and the market price on the commencement date) of the right and obligation is not zero, the contract is recognised as an asset or a liability.

30 September 20x4

• Forward liability	CU 3 [CU 98 – CU 95]	
Forward loss		CU 3

31 December 20x4

• Forward liability	CU 2 [CU 100 – CU 98]	
Forward asset	CU 2 [CU 102 – CU 100]	
Forward loss		CU 2 [CU 100 – CU 98]
Forward gain		CU 2

31 March 20x5

• Forward asset	CU 4 [CU 106 – CU 102]	
Forward gain		CU 4
• Forward gain	CU 6 [CU 2 + CU 4]	
Profit and loss		CU 6

20x5 – x6

31 May 20x5

• Purchase	CU 104	
Profit and loss	CU 2	
Forward asset		CU 6 [CU 2 + CU 4]
Cash		CU 100

NOTE

➢ This forward contract is favourable to Entity A, since it pays CU 100 for a fixed quantity of sugar, the market price of which is CU 104.

JOURNAL

Entity B

20x4 – x5

15 July 20x4

• Forward asset	CU 5 [CU 100 – CU 95]	
Forward gain		CU 5

30 September 20x4

• Forward gain	CU 3 [CU 98 – CU 95]	
Forward asset		CU 3

31 December 20x4

• Forward gain	CU 2 [CU 100 – CU 98]	
Forward loss	CU 2 [CU 5 – CU 3]	
Forward liability		CU 2
Forward asset		CU 2 [CU 5 – CU 3]

31 March 20x5

• Forward loss	CU 4 [CU 106 – CU 102]	
Forward liability		CU 4
• Profit and loss	CU 6	
Forward loss		CU 6 [CU 2 + CU 4]

20x5 – x6

31 May 20x5

• Cash	CU 100	
Forward liability	CU 6 [CU 2 + CU 4]	
Sales		CU 104
Profit and loss		CU 2

NOTE

➢ This forward contract is unfavourable to Entity B, since it delivers a fixed quantity of sugar for CU 100, the market price of which is CU 104.

WORKED EXAMPLE 38 **5.26**

On 1 October 20x4, Entity A (year-end 31 March) enters into a contract with Entity B that gives Entity B the right to sell and Equity A the obligation to buy 1,000 of Entity A's own equity shares (face value CU 10 per share) as of 31 July 20x5 at a price of CU 110 per share on 31 July 20x5, if Entity B exercises the right. The contract will be settled by physical delivery.

On 1 October 20x4, Entity B pays CU 5,000 to Entity A as option premium. The income tax rate is 30%. The current market interest rate is 12% p.a.

A put option seller speculates that the price of shares will rise above the specified price within the specified period, thus providing the seller with income related to the premium received for selling the option.

An option contract that contains an obligation for an entity to purchase its own equity instruments for cash that gives rise to a financial liability for the present value of the redemption amount (option exercise price, in this case). The financial liability is recognised initially at the present value of the redemption amount, and is reclassified from equity. Subsequently, the financial liability is measured at amortised cost. If the contract expires without delivery, the carrying amount of the financial liability is reclassified to equity. An entity's contractual obligation to purchase its own equity instruments gives rise to a financial liability for the present value of the redemption amount even if the obligation to purchase is conditional on the counterparty exercising a right to redeem (eg, a written put option) that gives the counterparty the right to sell an entity's own equity instruments to the entity for a fixed price.

Entity A

JOURNAL

20x4 – x5

1 October 20x4

- Cash CU 5,000
  Written put option premium CU 5,000

- Written put option premium CU 5,000
  Retained earnings CU 3,500
  Current tax liability [30%] CU 1,500

- Equity share capital CU 100,000 *
  Written put option liabilities CU 100,000 [Reclassification]

* CU [(1,000 x CU 110) ÷ 1.10]

31 March 20x5

- Interest expense [for 6 months] CU 6,000 [CU 100,000 x 12% x 6/12]
  Written put option liabilities CU 6,000

- Profit and loss CU 6,000
  Interest expense CU 6,000

- Deferred tax asset [30%] CU 1,800
  Deferred tax income CU 1,800

- Deferred tax income CU 1,800

Tax expense CU 1,800

20x5 – x6

31 July 20x5

- Interest expense [for 4 months] CU 4,000 [CU 100,000 x 12% x 4/12]
  Written put option liabilities CU 4,000

- Profit and loss CU 4,000
  Interest expense CU 4,000

- Deferred tax asset CU 1,200
  Deferred tax income [30%] CU 1,200

- Deferred tax income CU 1,200
  Tax expense CU 1,200

SCENARIO 1

On 31 July 20x5, the market price per share is CU 102. Therefore, Entity B exercises the option.

- Written put option liabilities CU 110,000 [CU 100,000 + CU 6,000 + CU 4,000]
  Cash CU 110,000

- Tax expense CU 3,000
  Deferred tax asset CU 3,000 [CU 1,800 + CU 1,200]

SCENARIO 2

On 31 July 20x5, the market price per share is CU 120. Therefore, Entity B leaves the option unexercised.

- Written put option liabilities CU 110,000
  Equity share capital CU 100,000
  Interest income CU 10,000

- Interest income CU 10,000
  Profit and loss CU 10,000

- Deferred tax expense [30%] CU 3,000
  Deferred tax liability CU 3,000

- Deferred tax liability CU 3,000
  Deferred tax asset CU 3,000 [CU 1,800 + CU 1,200]

EXAMPLE 18 **6.4 – 6.7**

Fixed-for-fixed currency swap

- Both counterparties exchange interest payments at fixed interest rates.

Fixed-for-floating currency swap

- One counterparty exchanges the interest cash flow of a fixed-rate loan for the interest cash flow of a floating-rate loan.

Floating-for-floating currency swap

- Both counterparties exchange interest payments at floating interest rates.

Principal only swap

- Two counterparties exchange only principal cash flows in two different currencies at maturity.

Puttable instruments 7

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.

EXAMPLE 19

Sometimes, puttable instruments are used as the reward in employee incentive schemes. It allows the employees to have a valuable interest in company results to have an extra incentive because they are able to put the shares back to the company.

An entity shall account for as follows for the reclassification of an instrument in accordance with the above paragraph:

- It shall reclassify an equity instrument as a financial liability from the date when the instrument ceases to have all the features or meet the conditions (as mentioned earlier). The financial liability shall be measured at the instrument's fair value at the date of reclassification. The entity shall recognise in equity (eg, retained earnings) any difference between the carrying value of the equity instrument and the fair value of the financial liability at the date of reclassification.
- It shall reclassify a financial liability as equity from the date when the instrument has all the features and meets the conditions (as mentioned earlier). An equity instrument shall be measured at the carrying value of the financial liability at the date of reclassification.

EXAMPLE 29 **7.3**

Financial Instrument	Normal classification	Exceptional classification
Shares puttable throughout its life at fair value, that is also the most subordinate, does not contain any other obligation, with discretionary dividends based on profits of the issuer	**Liability**	**Equity**
Shares puttable at fair value, that is not the most subordinate	**Liability**	**Liability**
Shares puttable at fair value only on liquidation, that is also the most subordinate, but contains a fixed non-discretionary dividend	**Liability**	**Compound (part equity and part liability)**
Share puttable at fair value only on liquidation, that is also the most subordinate, but contains a fixed discretionary dividend and does not contain any other obligation	**Liability**	**Equity**
Any of the instruments described above issued by a subsidiary held by non-controlling parties, in the consolidated financial statements	**Liability**	**Liability**

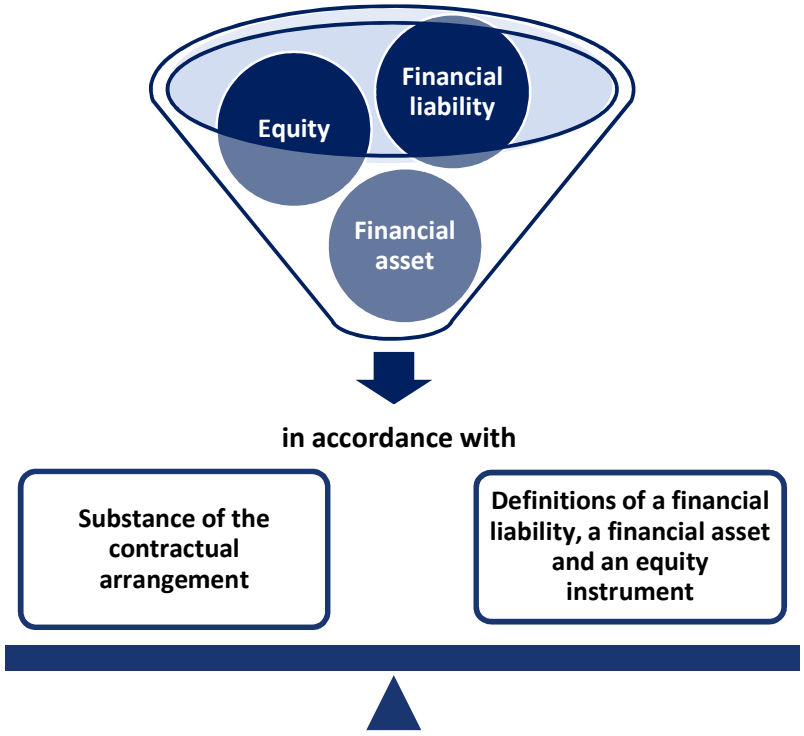
Puttable financial instruments classified as equity 7.4

For puttable financial instruments classified as equity instruments, an entity shall disclose (to the extent not disclosed elsewhere) –

- summary quantitative data about the amount classified as equity;
- its objectives, policies and processes for managing its obligation to repurchase or redeem the instruments when required to do so by the instrument holders, including any changes from the previous period;
- the expected cash outflow on redemption or repurchase of that class of financial instruments; and
- information about how the expected cash outflow on redemption or repurchase was determined.

Presentation 8

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



When the issuer applies the definitions to determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if, both conditions (a) and (b) are met:

(a) The instrument includes no contractual obligation –

(i) *to deliver cash and other financial asset to another entity*

A critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of the issuer either to deliver cash or another financial asset to the holder or to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer. Although the holder of an equity instrument may be entitled to receive a *pro-rata* share of any dividends or other distributions of equity, the issuer does not have a contractual obligation to make such distributions because it cannot be required to deliver or another financial asset to another party.

WORKED EXAMPLE 42 8.7

Entity A (year-end 31 march) issued a 3% CU 5,000 convertible loan on 1 April 20x1, repayable on 31 March 20X4 at an amount of CU 6,000. The interest is payable in arrears on 31 march each year. As an alternative to repayment, the holder may choose to receive 1,000 ordinary shares of a nominal value of CU 1 each. The effective interest is 10% p.a.

The initial carrying amount of the financial liability is the present value of the future cash outflows, discounted at 10%. This is measured using the amortised cost method. This is as under –

Year-end 31 March	Cash outflow (CU)	Discount factor @ 10%	Present value(CU)
20x2	**150**	**0.909**	**136**
20x3	**150**	**0.826**	**124**
20x4	**6,150**	**0.751**	**4,620**
		Fulfilment value *	**4,880**

**** It is the present value of the cash that an entity expects to be obliged to transfer as it fulfils a liability.***

The equity component is: CU 120 (CU 5,000 – CU 4,880).

Balance Sheet as at 31 March 20x2 (Extract)	**CU**
Equity	
Option to acquire shares	120
Non-current Financial Liability	
Financial liability [(CU 4,880 x 1.10) – CU 150]	5,218

Statement of Profit and Loss for the year ended 31 March 20x2 (Extract)	**CU**
Finance cost (CU 4,880 x 10%)	488

Contingent settlement provisions 9

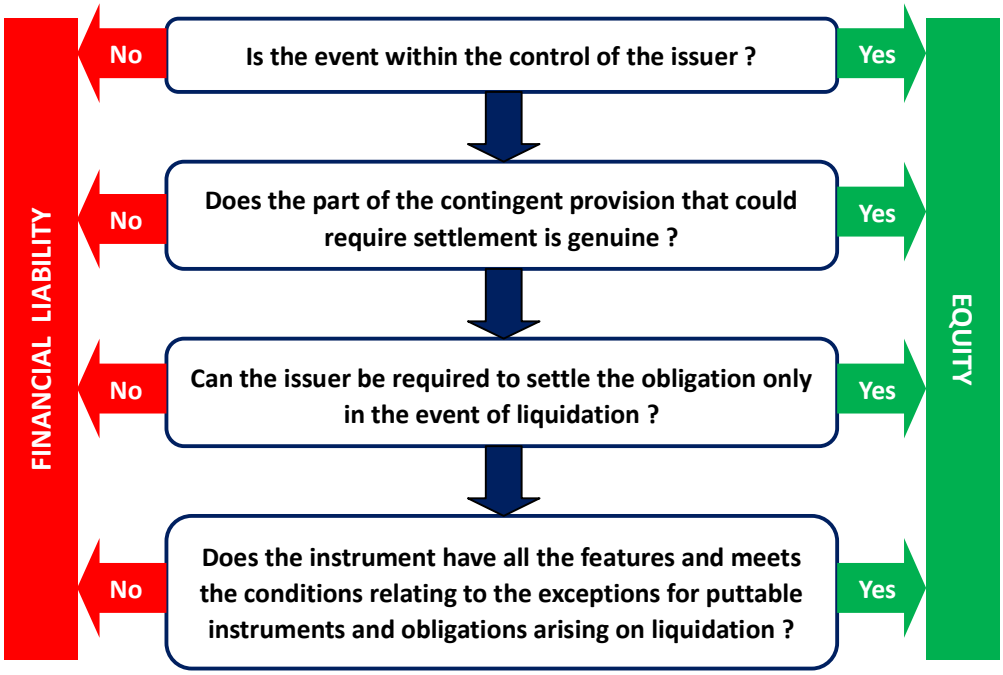
A financial instrument for which the manner of settlement depends on the occurrence or non-occurrence of uncertain future events, or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder (eg, stock market index, consumer price index etc.) is a **contingent settlement provision**.

This is a financial liability of the issuer **unless** –

- the part of the contingent settlement provision is not genuine, ie, extremely rare, highly abnormal and very unlikely to occur. A genuine provision is one that is authentic and has commercial substance.
- the issuer can be required to settle the obligation only in the event of liquidation of the issuer.
- the instrument has the following features:
  - it entitles the holder to a *pro-rata* share of the entity's net assets in the event of the entity's liquidation.
  - the instrument is in the class of instruments that is subordinate to all other classes of instruments.

NOTE

- ✓ The possibility of the entity being required to settle in cash or other financial asset is remote (ie, no genuine possibility of occurring) at the time the financial instrument is used.
- ✓ A contingent settlement provision that provides for payment in cash or another financial asset only on liquidation is similar to an equity instrument.



Settlement Options 9.2

When a derivate financial instrument gives one party a choice over how it is settled (eg, 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 equity classification.

An entity should not be able to circumvent the accounting requirements for financial assets or liabilities simply by including an option to settle a contract through the exchange of a fixed number of shares for a fixed amount.

EXAMPLE 41

A derivative financial instrument with a settlement option that is a financial liability is a share option that the issuer can decide to settle net in cash or by exchanging its own shares for cash. Similarly, some contract to buy or sell a non-financial item in exchange for the entity's own equity instruments can be settled either by delivery of the non-financial item or net in cash or another financial instrument. Such contracts are financial assets or liabilities and not equity instruments.

CASE STUDY 1

Accounting for Compound Financial Instruments: Deferred Tax implications and impact on EPS

Learning outcome

This case study aims to explain the key features of compound financial instruments. The accounting treatment revolves around the difference between debt and equity in an entity's financial statements, and the fact that these instruments have elements of both. Provision of deferred tax is necessary to prevent distorted presentation of results. These features have ramifications on a company's gearing ratio and on its EPS. For example, without the creation of a deferred tax liability (asset), the EPS will show higher (lower) than what it actually is. As a result, there is a risk that dividends might be higher (lower) than the entity should pay.

Prior to refinement from the cocktail of Ind AS listed below these debt instruments were accounted for as any other financial liability. As a result the 'true' cost of financing was not reflected and shareholders did not get a transparent picture of the extent to which their holdings were diluted.

Introduction

The most familiar type of compound financial instrument is a bond convertible into a fixed number of an entity's ordinary shares after a specified period of time. A transaction must be accounted for and presented in accordance with its substance and economic reality where this differs from its legal form, because recording the legal form of a transaction may be considered as reporting a more favourable performance than what it actually is. This is why, the substance of a convertible bond, rather than its legal form, governs its classification. Though a convertible bond takes the legal form of a financial liability, it combines features associated with both financial liability and equity instruments. The issuer's obligation to make scheduled payments of interest and principal is a financial liability that exists as long as the bond is not converted into equity. The point to note is that the contractual cash flows are not solely payments of principal and interest on the principal amount outstanding because the interest rate (which is generally lower than the prevailing market rate) does not reflect only consideration for the ***time value of money*** [1] and the ***credit risk*** [2]. The return is also linked to the value of the equity of the issuer. Therefore, an entity recognises separately the components of a convertible bond that –

- creates a financial liability of the issuer; and
- grants an option to convert it into an equity instrument (eg, a bond convertible into a fixed number of ordinary shares of the entity).

[1] The rate of interest is different from the entity's incremental borrowing rate, ie, it has a financing component which is significant to the issue.

[2] The risk that one party to a financial instrument (issuer) will cause a financial loss for the other party (holder) by failing to discharge the obligation (conversion).

This case study relates to **4 standards** namely:

1. **Ind AS 12** – Income Taxes;
2. **Ind AS 32** – Financial Instruments:Presentation;
3. **Ind AS 33** – Earnings per Share; and
4. **Ind AS 109** – Financial Instruments

Companies use convertible bonds as a source of raising finance at a lower coupon rate. The conversion feature is a delayed method of equity financing, which enables a company to share profit with the newly converted shareholders when it expects to do well.

How a compound financial instrument is segregated into debt and equity component

The issuer of a convertible bond analyses the instrument in its entirety and classifies [3] the convertible bond's liability component as a liability (a contractual agreement to deliver cash at regular intervals) and the equity component as equity (an option granting the holder the right, after a specified period of time,to convert the bond into a fixed number of ordinary shares of the entity in exchange for the principal amount). The liability component and the equity component are presented as follows – [3] ***See Para 15 and 28 of Ind AS 32***

- ***Measurement at recognition***
  - The issuer determines the carrying amount of the liability component by measuring the fair value of a similar liability (ie, instruments of comparable credit status and providing substantially the same cash flows, on the same terms) that does not have an associated equity component. The fair value (also known as amortised cost) of the liability component of the convertible bond is the present value of the contractually determined stream of future cash flows discounted using a market rate for a similar bond issued by the same issuer but without the conversion option.
  - The carrying amount of the equity component is then determined by deducting the fair value of the liability component from the fair value of the convertible bond as a whole. A taxable temporary difference may arise (eg, if the tax base of the bond is its nominal value). If so, this results in a deferred tax liability, because the carrying amount of the liability component is lower than the tax base of the convertible bond. The deferred tax liability is charged directly to the carrying amount of the equity component. [4] [4] ***See Para 61 A of Ind AS 12***
- ***On conversion at maturity***
  - The entity derecognises the liability component of the convertible bond and recognises it as equity, ie, ordinary shares.
  - A portion of the equity component of the convertible bond is transferred, at the end of each reporting period, to retained earnings which is the net of tax difference between the finance cost charged in profit and loss and the aggregate amount of interest paid and the amortised portion of transaction cost.

The original equity component remains as equity (although it may be transferred from one line item within equity to another). This Standard does not specify whether the equity component in respect of the convertible bonds should be transferred directly to retained earnings, when the conversion takes place or a portion of the equity component may be transferred to retained earnings at the end of each reporting period.

In each period the issuer charges a finance cost which is much more than the actual interest paid, thereby causing accounting profit to be lower than what it should be. Therefore, a portion of the equity component should be transferred to retained earnings at the end of each reporting period to avoid accounting mismatch.

The proportionate deferred tax liability is reversed through profit and loss in each reporting period.

CASE STUDY

On 1 April 20x1, A Ltd. has 200 ordinary shares of CU 5 each and issues 100, 5% convertible bonds of CU 10 each. Each bond is mandatorily convertible into 2 ordinary shares of CU 5 each on 31 March, 20x4. The prevailing market interest rate of similar bonds without the conversion feature is 10%. This means, at the date of issue, A Ltd. could have issued non-convertible bonds with a 3-year term bearing a coupon interest rate of 10%.

Additional information:

	20x1-x2	20x2-x3	20x3-x4
Profit before finance cost of A Ltd	**CU 250**	**CU 300**	**CU 400**
Transaction cost	**CU 50**		
Income tax rate	**40%**		

Interest paid and transaction costs are deductible in determining taxable profit in the period in which they are incurred.

JOURNAL (all figures are in CU)

Measurement at recognition

20x1

Apr 1

• Transaction cost	50	
Cash		50
• Cash	1,000 (100 x 10)	
5% Convertible bonds		1,000
• 5% Convertible bonds	175 (1,000 – 825) See Note 1	
Transaction cost		50
Equity component of 5% convertible bonds		75 [(950 – 825) x 60%]
Deferred tax liability		50 [(950 – 825) x 40%]

Subsequent measurement

20x2

Mar 31

• Finance cost	101 (12.2% of 825)	
5% Convertible bonds		101
• 5% Convertible bonds	50 (5% of 1,000)	
Cash		50
• Equity component of 5% convertible bonds	21 [(101 – 50 – 16) x 60%]	
Retained earnings		21

20x3

Mar 31

• Finance cost	108 (12.2% of 876)	
5% Convertible bonds		108
• 5% Convertible bonds	50 (5% of 1,000)	
Cash		50
• Deferred tax liability	23 [50 – {(1,000 – 934) x 40%}]	
Tax expense		23
• Equity component of 5% convertible bonds	25 [(108 – 50 – 16) x 60%]	
Retained earnings		25

5% Convertible Bonds (all figures are in CU)

Date	Heads of Account	NOTES	Carrying Amount (CA)			Tax Base (TB)		Deferred Tax Liability
			Dr	Cr	Balance		Balance	(TB – CA) x 40%
20x1								
Apr 1	Cash			1,000	1,000		1,000	
	Transaction cost		50		950	50	950	
	Equity component of convertible bonds		75[5]		875			
	Deferred tax liability	1	50[6]		825			(950 – 825) x 40% = 50
20x2								
Mar 31	Finance cost			101[7]	926			
	Cash		50		876			
	Transaction cost	2				50	1,000	(1,000 – 876) x 40% = 50
20x3								
Mar 31	Finance cost			108[8]	984			
	Cash		50		934			(1,000 – 934) x 40% = 27
20x4								
Mar 31	Finance cost			116[9]	1,050			
	Cash		50		1,000			
	Share capital		1,000		–		–	(50 – 23) = 27

[5] 60% of (950 – 825)

[6] 40% of (950 – 825)

[7] 12.2% of 825 (***See paragraph below on Impact of Effective Interest Rate***)

[8] 12.2% of 876

[9] 12.2% of 934

Impact of Effective Interest Rate

At initial recognition, transaction costs are to be deducted from the fair value of the bond. Since bonds are measured at amortised cost, transaction costs are subsequently included in the calculation of amortised cost using the effective interest method and, in effect, amortised through profit and loss over the life of the bond.

The effective interest rate including the impact of transaction costs is 12.2%. A Ltd. applies this rate to determine the finance cost of each period during the life of the bond. In effect, this will increase the carrying amount of the liability component of the bond to the fair value of the bond as a whole at the end of the term. This 12.2% is calculated in order to convert the amortised cost of CU 825 to the convertible amount of CU 1,000 at the end of 3 years, after considering periodic interest payment.

Amortisation of transaction cost

When applying the effective interest method, A Ltd. amortises the transaction cost in the calculation of the effective interest rate over the expected life of the bond. Here, transaction costs are amortised at an effective interest rate of 1.7%, which is calculated to convert CU 950 to CU 1,000 at the end of 3 years.

A Ltd
Balance Sheet as at 31 March (Extract)

	20x2	20x3	20x4
Equity and Liabilities			
Equity			
Share capital	1,000	1,000	2,000
Equity component of 5% convertible bond	54	29	–
Non-current liabilities			
5% Convertible bonds	876	934	–
Deferred tax liability	50	27	–

Statement of Profit and Loss for the year ended 31 March (Extract)

	NOTES	20x2	20x3	20x4
Profit before finance cost		250	300	400
Finance cost		(101)	(108)	(116)
Accounting profit		149	192	284
Tax expense	4	(60)	(77)	(113)
Profit for the period		**89**	**115**	**171**
Earnings per share –	5			
Basic		0.45	0.58	0.86
Diluted		0.38	0.45	0.60

Statement of Changes in Equity for the year ended 31 March (Extract)

	20x2	20x3	20x4
Equity			
Share capital			
Balance bf	1,000	1,000	1,000
5% Convertible bonds	–	–	1,000
Balance cf	**1,000**	**1,000**	**2,000**
Equity component of 5% convertible bonds (net of tax)			
Balance bf	75	54	29
Transferred to retained earnings [10]	(21)	(25)	(29)
Balance cf	**54**	**29**	**–**

[10] It is the difference between the finance cost that has been charged and the interest and transaction cost that should have been charged, both net of tax.

NOTES

(1) Amortised cost of 5% Convertible bonds

Date	Particulars	Cash outflow	Effective Interest Rate at 10%	Present value
20x1				
Apr 1	Transaction cost	(50)	–	(50)
20x2				
Mar 31	Interest	50	0.909	45
20x3				
Mar 31	Interest	50	0.826	41
20x4				
Mar 31	Interest and repayment	1,050	0.751	789
	Amortised cost (present value) of 5% Convertible bonds			**825**

The amortised cost of a convertible bond is the amount at which the financial liability is measured at initial recognition, *minus* principal repayments, *plus* the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount. The effective interest method is applied to calculate the amortised cost of a convertible bond and for allocating the interest expense over the period of the bond.

(2) Current Tax Expense

	20x2	20x3	20x4
Accounting profit	149	192	284
Add Finance cost	101	108	116
	250	300	400
Deduct Interest	50	50	50
Transaction cost	50 (100)	– (50)	– (50)
Taxable profit	150	250	350
Current tax expense at 40%	**60**	**100**	**140**

Effect of Deferred Tax Liability which is initially recognised in equity but subsequently reversed through Profit and Loss.

(3) Deferred Tax Liability

Date	Heads of Account	Dr	Cr	Balance
20x1				
Apr 1	Equity component of 5% Convertible Bonds		50	
20x2				
Mar 31		– [11]		50
20x3				
Mar 31	Tax expense	23 [12]		27
20x4				
Mar 31	Tax expense	27 [13]		–

Because of the classification of the convertible bond into debt and equity, the tax base of convertible bond, on initial recognition, becomes different from the carrying amount of the amortised cost of the convertible bond. Therefore, a deferred tax liability arises, which is charged directly to the carrying amount of the equity component of the bond. Subsequently this deferred tax liability is reversed through profit and loss.

(4) Tax expense

Date	Heads of Account	NOTES	Dr	Cr	Balance
20x2					
Mar 31	Current tax expense	2	60		60
	Profit and loss			60	–
20x3					
Mar 31	Current tax expense	2	100		100
	Deferred tax liability	3		23	77
	Profit and loss			77	–
20x4					
Mar 31	Current tax expense	2	140		140
	Deferred tax liability	3		27	113
	Profit and loss			113	–

(5) Earnings per Share

Basic	20x2	20x3	20x4
Profit for the period (A)	89	115	171
Number of ordinary shares (B)	200	200	200
Basic EPS (A ÷ B)	**0.45**	**0.58**	**0.86**

Diluted	20x2	20x3	20x4
Profit for the period	89	115	171
Add back Finance cost (net of tax)	61	65	69
Adjusted profit for the period (A)	**150**	**180**	**240**
Existing + Potential Shares (B)			
[200 + (100 x 2)]	400		
[200 + (100 x 2)]		400	
[200 + (100 x 2)]			400
Diluted EPS (A ÷ B)	**0.38**	**0.45**	**0.60**

Effect on Earnings per Share

Previously, a convertible bond used to appear as a liability in Balance Sheet, because there was no concept of debt-equity classification of a compound financial instrument. Now, with the advent of Ind AS, the liability component of a convertible bond is initially measured at a discount to the amount convertible on maturity. The discount is amortised to accounting profit as finance cost (unwinding of discount) over the life of the convertible bond.

CASE STUDY 2

Accounting for Deep-Discount Bonds under Ind AS

Introduction

A deep-discount bond is a bond that sells at a significantly lesser value than its par value. For example, a deep-discount bond is issued at CU 750 – par value of which is CU 1,000. This means an investor will pay CU 750 to acquire a deep-discount bond but will get CU 1,000 at the end of a specified period (ie, the life of the bond, eg, 3 years). The difference between the redemption value and the issue price is the interest for the bond, ie, CU 250 (CU 1,000 – CU 750), in this case. Therefore, CU 750 is the present value of the cash flows needed (ie, CU 1,000) to fulfil the liability, applying a specified *effective interest rat*e (ie, a rate that exactly discounts estimated future cash payments through the expected life of the financial liability).

Essence of Deep-discount Bonds

Deep-discount means a larger or greater than usual reduction in price. In particular, these bonds generally are sold at a substantial discount to par value and have a yield that is significantly higher than the prevailing rates of fixed-income bearing securities with a similar profile. A zero-coupon bond is an example, where total interest is paid at the end of the life of the bond. A company may issue such bonds when its credit rating is suddenly downgraded.

Application

The *Conceptual Framework for Financial Reporting under Ind AS* requires entities to prepare financial statements applying accrual accounting (ie, expenses that **should have been paid** and income that **should have been received** are to be recognised). Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period.

Ind AS 12 *Income Taxes* requires an entity to account for the tax consequences of transactions and other events in the same way that it accounts for the transactions and other events themselves.

Standards Reference

12	**Income Taxes**
32	**Financial Instruments: Presentation**
33	**Earnings per Share**
109	**Financial Instruments**

20x2–x3

Mar 31 20x3

- Finance cost — CU 83 (10% of CU 825)
  - Deep-discount bonds — CU 83
- Profit and loss — CU 83
  - Finance cost — CU 83
- Current tax expense — CU 120 **(Note 1)**
  - Cash — CU 120
- Tax expense — CU 120
  - Current tax expense — CU 120
- Deferred tax asset — CU 33
  - Deferred tax income — CU 33 **(Note 2)**
- Deferred tax income — CU 33
  - Tax expense — CU 33
- Profit and loss — CU 87
  - Tax expense — CU 87 (CU 120 – CU 33)

20x3–x4

Mar 31 20x4

- Finance cost — CU 92 (10% of CU 908 – balancing figure)
  - Deep-discount bonds — CU 92
- Profit and loss — CU 92
  - Finance cost — CU 92
- Current tax expense — CU 120 **(Note 1)**
  - Cash — CU 120
- Tax expense — CU 120
  - Current tax expense — CU 120
- Deferred tax asset — CU 37
  - Deferred tax income — CU 37 **(Note 2)**
- Deferred tax income — CU 37
  - Tax expense — CU 37
- Profit and loss — CU 83
  - Tax expense — CU 83 (CU 120 – CU 37)

20x4–x5

Apr 1 20x4

- Deep-discount bonds — CU 1,000
  - Cash — CU 1,000

Mar 31, 20x5

- Current tax expense — CU 20 **(Note 1)**
  - Cash — CU 20
- Profit and loss — CU 120
  - Current tax expense — CU 20
  - Deferred tax asset — CU 100 **(Note 3)**

Deep-discount bonds CU

Date	Heads of Account	Carrying amount		
		Dr.	Cr.	Balance
20x1				
Apr 1	Cash		750	750
20x2				
Mar 31	Finance cost		75	825
20x3				
Mar 31	Finance cost		83	908
20x4				
Mar 31	Finance cost		92	1,000
20x5				
Apr 1	Cash	1,000	–	–

Balance Sheet as at 31 March (Extract) CU

	20x2	20x3	20x4	20x5
Equity and Liabilities				
Equity				
Share capital	1,000	1,000	1,000	1,000
Non-current liabilities				
Deep-discount bonds	825	908	–	–
Current liabilities				
Deep-discount bonds	–	–	1,000	–

Statement of Profit and Loss for the year ended 31 March (Extract)

CU

	Note	20x2		20x3		20x4		20x5	
Profit before finance cost		300		300		300		300	
Finance cost		(75)		(83)		(92)		(–)	
Accounting profit		**225**		**217**		**208**		**300**	
Tax expense –									
Current tax expense	**1**	120		120		120		20	
(Deferred tax income)	**2**	(30)		(33)		(37)		–	
Deferred tax asset	**3**	–	(90)	–	(87)	–	(83)	100	(120)
Profit for the year (A)			**135**		**130**		**125**		**180**
Basic earnings per share (A ÷ number of shares)			1.35		1.30		1.25		1.80

WORKED EXAMPLE 43 10.3

A Ltd. has 100 ordinary shares in its books having a face value of CU 100 per share. Thus, the equity part of the Balance Sheet shows the following details:

Equity part of Balance Sheet	CU
Share Capital	10,000
Share Premium	1,500
Other Reserves	4,500
Retained Earnings	2,500
Total	**18,500**

The entity decides to reacquire 30 shares for each CU 145, totalling to an amount of CU 4,350.

Now, there are two ways of accounting for these treasury or reacquired shares. In both methods, these are deducted from equity.

Method 1

The consideration paid to acquire the treasury shares is broken into two parts: nominal face value for 30 shares = CU 100 X 30 = CU 3,000 and the share premium = CU 4,350 - CU 3,000 = CU 1,350.

Therefore, under this method, the consideration paid for treasury shares are deducted from share capital and share premium.

Equity part of Balance Sheet	CU	Deduction (CU)	CU
Share Capital	10,000	3,000	7,000
Share Premium	1,500	1,350	150
Other Reserves	4,500	–	4,500
Retained Earnings	2,500	–	2,500
Total	**18,500**		**14,150**

In the Balance Sheet, equity (from liabilities side) and cash (from the asset side) are reduced by CU 4,350.

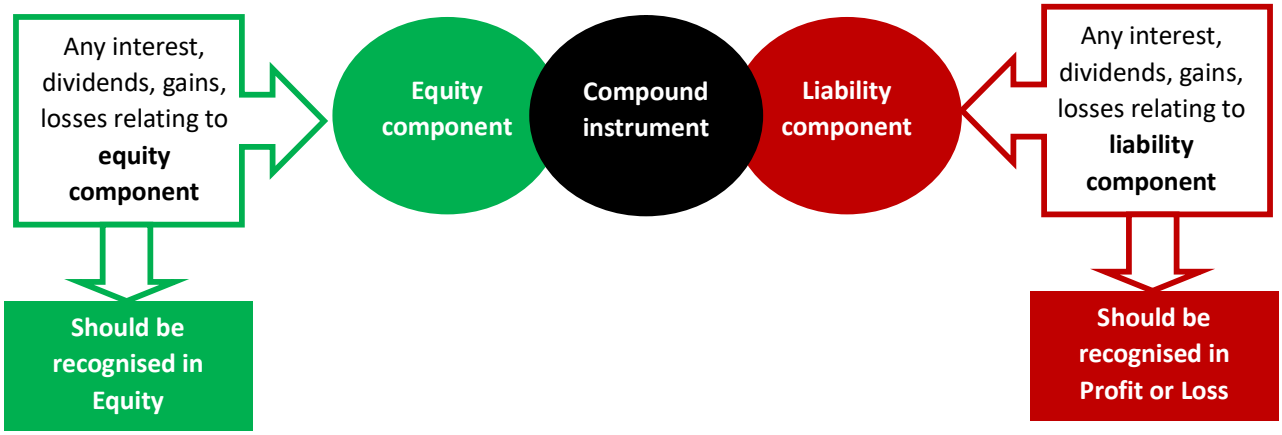
Method 2

In this method, the share capital and the share premium are left untouched and the consideration paid for treasury shares is listed under equity as a negative figure.

Equity part of Balance Sheet	CU
Share Capital	10,000
Share Premium	1,500
Treasury Shares	(4,350)
Other Reserves	4,500
Retained Earnings	2,500
Total	**14,150**

This method is preferred because it shows both the actual share capital and share premium before acquiring the treasury shares as well as the negative figure of the treasury shares (clearly shown in the Balance Sheet).

In case of compound instruments, the basic rule applies:



EXAMPLE 45

A Ltd. issued non-cumulative preference shares which are mandatorily redeemable for cash in five years, but that dividends are payable at the discretion of the entity before redemption date. Such an instrument is a compound financial instrument, with the liability component being the present value of the redemption amount.

The unwinding of the discount on this component is recognised in Statement of Profit and Loss and classified as interest expense. Any dividends paid relate to the equity component, and accordingly, are recognised as a distribution of profit or loss.

Offsetting a Financial Asset and a Financial Liability 12

A financial asset and a financial liability shall be offset and the net amount presented in the Balance Sheet when, and only when, an entity –

- **currently has a legally enforceable right to set off the recognised amounts; and**

  A right to set-off may be currently available or it may be contingent on a future event (eg, the right may be triggered or exercisable only on the occurrence of some future events, such as a default, insolvency or bankruptcy of one of the counterparties). Even if the right to set off is not contingent on a future event, it may only be legally enforceable in the normal course of business, or in the event of default, or in the event of insolvency or bankruptcy, of one or all of the counterparties.

  The following points are to be noted –

  The right to set off:

  - must not be contingent on a future event; and
  - must be legally enforceable in all of the following circumstances :
    - the normal course of business;