Refresher Course on IND AS Practical aspects

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Topics To Be Covered

- IND AS 32 – Financial Instruments: Presentation
  - Compound Financial Instrument

Coverage

- What is Financial Instrument?
- Financial Assets
- Financial Liabilities
- Equity
- Classification of Financial Liabilities and Equity
- Compound Financial Instrument
- Treatment of Interest, Dividend, losses and Gains

Introduction

Ind AS 32, Financial Instruments: Presentation, addresses the presentation of financial instruments as financial liabilities or equity.

Ind AS 32 includes requirements for

- The presentation of financial instruments as either financial liabilities or equity, including
- When a financial instrument should be presented as a financial liability or equity instrument by the issuing entity
- How to separate and present the components of a compound financial instrument that contains both liability and equity elements
- The presentation of interest, dividends, losses, and gains related to financial instruments
- The circumstances in which financial assets and financial liabilities should be offset

Ind AS 32 complements the requirements for recognizing and measuring financial assets and financial liabilities in Ind AS 109, Financial Instruments: Recognition and Measurement, and the disclosure requirements for financial instruments in Ind AS 107, Financial Instruments: Disclosures.

Introduction

Ind AS 32 applies to all entities in the presentation of both

- Financial instruments
- Certain net settled contracts to purchase or sell nonfinancial items

Financial instrument. Any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

Equity instrument. Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Examples of equity instruments include

- Ordinary shares (that cannot be put back to the issuer by the holder)
- Preference shares (that cannot be redeemed by the holder or provide for nondiscretionary dividends)
- Warrants or written call options (that allow the holder to subscribe for—or purchase—a fixed number of non-puttable ordinary shares in exchange for a fixed amount of cash or another financial asset)

Financial Assets

Financial asset. Any asset that is:

(a) Cash;

(b) An equity instrument of another entity;

(c)A contractual right to receive cash or another financial asset from another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity; or

(d)A contract that may or will be settled in the entity's own equity instrument and is not classified as an equity instrument of the entity

Examples of assets that meet the definition of a financial asset are

1. Cash, see (a) above
2. Investment in shares or other equity instrument issued by other entities, see (b)
3. Receivables, see (c) above
4. Loans to other entities, see (c) above
5. Investments in bonds and other debt instruments issued by other entities, see (c)
6. Derivative financial assets, see (c) above
7. Some derivatives on own equity, see (d) above

Financial Liabilities

Financial liability. Any liabilitythat is:

(a)A contractual obligation to deliver cash or another financial asset to another entity; or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity; or

(b)A contract that will or may be settled in the entity's own equity instruments and is not classified as an equity instrument of the entity (discussed below).

Examples of liabilities that meet the definition of financial liabilities are

1. Payables (e.g., trade payables), see (a) above
2. Loans from other entities, see (a) above
3. Issued bonds and other debt instruments issued by the entity, see (a) above
4. Derivative financial liabilities, see (a) above
5. Obligations to deliver own shares worth a fixed amount of cash, see (b) above
6. Some derivatives on own equity, see (b) above

Exclusions

- Physical assets (e.g., inventories, property, plant, and equipment)
- Leased assets
- Intangible assets (e.g., patents and trademarks)
- Prepaid expenses. Such assets are associated with the receipt of goods or services. They do not give rise to a present right to receive cash or another financial asset.
- Deferred revenue. Such liabilities are associated with the future delivery of goods or services. They do not give rise to a contractual obligation to pay cash or another financial asset.
- Warranty obligations. Such liabilities are associated with the future delivery of goods or services. They do not give rise to a contractual obligation to pay cash or another financial asset.
- Income tax liabilities (or assets). Such liabilities (or assets) are not contractual but are imposed by statutory requirements.
- Constructive obligations

Scope Exemption

Scope Exception	Applicable Standard
Interests in subsidiaries	Ind AS 27, Consolidated and Separate Financial Statements
Interests in associates	Ind AS 28, Investments in Associates
Interests in joint ventures	Ind AS 111, Interests in Joint Ventures
Employee benefit plans	Ind AS 19, Employee Benefits
Share-based payment transactions	Ind AS 102, Share-Based Payment
Contracts for contingent consideration in business Combinations	Ind AS 103, Business Combinations
Insurance contracts	Ind AS 104, Insurance Contracts

Whether construction contract receivable or unbilled contract asset under IND AS 115 is a financial asset under IND AS 109 ?

Debt Vs Equity

Financial liabilities

Classification	Description
Financial liability	There is a contractual obligation to deliver cash which the entity cannot unconditionally avoid.

Obligation established through contractual terms

Economic compulsion not taken into account

Example:

Mandatorily redeemable preference shares

Debt Vs Equity

Equity

Classification	Description
Equity	The entity contractually has an unconditional right to avoid payment of cash.

Discretionary payments do not create an obligation to pay cash

History, intention, ability or liquidation rank are not relevant

Example:

Non-redeemable preference shares

Debt or equity

Financial instrument is an equity instrument only if **both** criteria are met:

- There is no obligation to deliver cash or another financial asset or to exchange financial assets or financial liability; **and**
- The issuer will exchange:

❑ fixed amount of cash; or

❑ another financial asset for a fixed number of its own equity instruments.

Does the entity have an unavoidable contractual obligation?

Yes → Liability

No → Equity

Convertible Options

Contract Settled in own Equity Shares	Monetary Value of consideration (Amountper share)	Number of shares	Classification
Scenario 1	Fixed	Variable	Financial Liability
Scenario 2	Variable	Variable	Financial Liability
Scenario 3	Variable	Fixed	Financial Liability
Scenario 4	Fixed in a currency other than entities functional currency	Fixed	Financial Liability
Scenario 5	Fixed	Fixed	Equity

Scenario 4 – There is a carve out in IND AS for FCCB which will be equity.

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Bringing it all together - the ultimate test

Evaluate the impact of contractual terms specific for each instrument to be an indicator of Debt or Equity?

Contract terms	Equity indicator	Debt Indicator
Stated maturity of 30 years		Debt
Mandatory coupon of 5%		Debt
Issuer option after 1 year to convert instrument into fixed number of own shares for a fixed amount.	Equity	
If the share price falls below the conversion price, the number of shares to be delivered will be adjusted		Debt
If not converted or redeemed previously, instrument will be repaid after 20 years at par + accrued and unpaid interest.		Debt
Perpectual debt Instrument with no definite terms and on which dividend is at the discretion of issuer	Equity	

Split Accounting for Compound Instruments

Compound Instruments are non-derivative financial instruments contain both liability and equity elements

Example

A bond that is convertible into a fixed number of ordinary shares of the issuer is a compound instrument. From the perspective of the issuer, a convertible bond has two components:

(1) An obligation to pay interest and principal payments on the bond as long as it is not converted.

This component meets the definition of a financial liability, because the issuer has an obligation to pay cash.

(2)A sold (written) call option that grants the holder the right to convert the bond into a fixed number of ordinary shares of the entity. This component meets the definition of an equity instrument.

Method of splitting the value

Fair value of compound instrument

– Fair value of liability component (= its initial carrying amount)

= Initial carrying amount of equity component

The accounting for the equity component is outside the scope of Ind AS 109. Equity is not re-measured subsequent to initial recognition.

Case Studies

Question 1

An entity issues a non-redeemable callable bond where the fixed dividend of 5% can be deferred at the issuer's option. The instrument includes a 'step-up' dividend clause that would increase the dividend to 25% at a pre-determined date in the future unless the instrument had previously been called by the issuer.
There is an economic compulsion for the issuer to call back the instrument on the date the dividend 'steps-up'

Answer - Equity

Question 2

An entity issues a non-redeemable callable subordinated bond with a fixed 6% coupon. The coupon can be deferred in perpetuity at the issuer's option. The issuer has a history of paying the coupon each year and the current bond price is based on the holders expectation that the coupon will continue to be paid each year. In addition the stated policy of the issuer is that the coupon will be paid each year, which has been publicly communicated i.e. a constructive obligation exists

Answer - Equity

Case Studies

Question 3

An entity issues a non redeemable capital note which provides the holder with the contractual right to receive payments on account of interest.

Scenario 1 – Interest is other than market rate
Scenario 2 – Interest is at market rate

Answer (Scenario 1) – Compound
Answer (Scenario 2) - Liability

Question 4

An entity issues zero coupon bond. Please classify whether equity or financial liability ?

Answer - Liability

Case Studies

Question 5

An entity issues mandatorily convertible debentures worth Rs. 1,00,00,000. The conversion will be into such no. of shares depending on the share price at the date of conversion which equals to Rs. 1,00,00,000. Please classify whether equity or liability.

Answer - Liability

Classify preference shares into equity, liability or compound financial instrument based on its terms.

Terms	Terms	Classification
Redemption of principal	Payment of dividend (assume at market rates)	Type of instrument
1. Non-redeemable	Discretionary	Equity
2. Non-redeemable	Non-discretionary	Liability
3. Redeemable at issuer's option	Discretionary	Equity
4. Redeemable at issuer's option	Non-discretionary	Liability
5. Mandatorily redeemable at fixed amount	Discretionary	Compound
6. Mandatorily redeemable at fixed amount	Non-discretionary	Liability

Classify preference shares into equity, liability or compound financial instrument based on its terms.

7. Redeemable at the holder’s option at some future date	Discretionary	Compound
8. Redeemable at the holder’s option at some future date	Non-discretionary	Liability

Case Studies

Question 6

An entity issues 1,00,000 convertible bonds at the start of year 1. The bonds have a 3-year term and they are issued at par with a face value of INR 100 per bond resulting in total proceeds of INR 1 crore. Interest is payable annually in arrears at a nominal annual interest rate of 6 %. Each bond is convertible at any time up to maturity into 25 ordinary shares at the face value of INR 1 per share. At the time of issue of bonds, the market rate of interest for similar debt without conversion option is 10%.

Issue – Please classify the instrument into proper classification as per IND AS 32 and prepare a table for the answer.

Solution to Case Study 6

Year	Cash Outflow @ 6%	Discounted at market rate of 10%	Net Present Value (NPV)
Year 1	6,00,000	0.90909	545454
Year 2	6,00,000	0.82645	495870
Year 3	1,06,00,000	0.75131	7963886
Liability Component			**9005210**
Equity Component (residual)			**994790**
Total proceeds			**10000000**

The amount credited to equity is not subsequently remeasured. The liability component will accrete to its final redemption amount of 1 crore by unwinding of interest at EIR of 10% .

If it is converted at the end, the liability component will be de-recognized and transferred to equity. (Share capital INR 25,00,000 and reserves INR 75,00,000)

Case Studies

Question 7

An entity issues 1,00,000 convertible bonds at the start of year 1. The bonds have a 3-year term and they are issued at par with a face value of INR 100 per bond resulting in total proceeds of INR 1 crore. Interest is payable annually in arrears at a nominal annual interest rate of 6 %. Each bond is mandatorily convertible at the end of 3-year term into 25 ordinary shares at face value of INR 1 per share. At the time of issue of bonds, the market rate of interest for similar debt without conversion option is 10%.

Issue – Please classify the instrument into proper classification as per IND AS 32 and prepare a table for the answer.

Solution for Case Study 7

Year	Cash Outflow @ 6%	Discounted at market rate of 10%	Net Present Value (NPV)
Year 1	6,00,000	0.90909	545454
Year 2	6,00,000	0.82645	495870
Year 3	6,00,000	0.75131	450786
Liability Component			**1492110**
Equity Component (residual)			**8507890**
Total proceeds			**10000000**

The amount credited to equity is not subsequently remeasured. The liability component will be measured subsequently at amortised cost using the EIR method. The interest payments will reduce the liability component to zero.
When it is converted at the end, the original equity component of INR 8507890 will become the consideration for these shares. (Share capital INR 25,00,000 , share premium INR 60,70,890)

Case Studies

Question 8

OMPL has allotted 1000 CCDs of 1 crore each with quarterly interest at the rate of 8.75% per annum. CCDs are backed by undertaking from parents for interest payment in case OMPL fails to do so. Tenure of CCD is 36 months with mandatory put/call option at the end of 35th month. The parent to mandatorily acquire all the CCDs at the end of 35th month. The parent can also buy out the CCDs at any time prior to expiry of 35 months. Investors have put option on parent in the event of default. Company's obligation under option agreement is limited only to the extent of servicing of interest. Upon conversion of the CCDs, OMPL would be required to issue equity shares to the parent. The segregation of CCDs into debt and equity component is in accordance with IND AS 32 regarding compound financial instruments.

Issue – Please give your views whether the classification done by OMPL is correct or not.

Presentation of interest, dividends, losses, and gains

The classification of an issued financial instrument as either a financial liability or an equity instrument determines whether interest, dividends, gains, and losses relating to that instrument are recognized in profit or loss or directly in equity.

- Dividends to holders of outstanding shares that are classified as equity - directly to equity.
- Dividends to holders of outstanding shares that are classified as financial liabilities - same way as interest expense on a bond.
- Gains and losses associated with redemptions of financial liabilities – profit or loss.
- Changes in the fair value of equity instruments of the entity - not recognized in the financial statements.
- costs incurred in issuing or acquiring own equity instruments are not expensed but accounted for as a deduction from equity. Such costs include regulatory fees, legal fees, advisory fees, and other transaction costs.

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