

Financial instruments-Recognition-IND AS107 and 109

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- Financial instrument is a document which has a monetary value, such as draft, cheques, bill of exchange and promissory notes
- For IAS financial instruments includes wide spectrum of assets and liabilities of entities and not limited to investments or merely capital market instruments and drafts , cheques bills of exchange and promissory notes.
- It includes with in its ambit receivables, loans, cash, deposits, investments, payables, debentures, bonds etc...
- **Definition of financial instruments:** “ a financial instrument is a legally enforceable agreement between tow or more parties expressing contractual rights to the payment of money.
- It is contractual right of one person to the agreement and contractual liability of another person to the agreement,
- consequently it will be the financial asset for the Peron who has right to receive the money and
- financial liability for the person who has obligation to pay money.
- Thus financial instruments included financial asset as well as financial liability”.

Financial assets

Meaning of Financial instruments: a financial instrument is any contract that give rise to a financial asset of one entity and a financial liability or equity instrument of another entity

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 form another entity or
 - To exchange financial assets or financial liabilities with another entity
- d) A contract that will or may be settled in the entity's won equity instruments that is :
 - A non-derivative entities equity instruments receivable in variable numbers
 - A derivative settled other than by exchange of fixed amount of cash or financial asset.

Common examples of financial assets

1. Cash is a financial asset - it represents the contractual right of the depositor to obtain cash from the institution or to draw cheque or similar instruments against the balance in favor of credit.
2. Trade accounts receivable
3. Notes receivable
4. Loans receivable and
5. Bonds receivable.

Lease : financial lease : amount received from the lessor is regarded as receivables and it is financial asset

Operating lease: the lease rent is not a financial asset for the lessor

Asset which are not a financial assets:

1. Financial assets such as inventories, property , plant and equipment
2. Leased assets
3. Intangible assets such as patents and trademarks are not financial assets;
4. Prepaid expenses
5. Income tax refund

Financial liability

Financial liability:

- a) Deliver cash or another financial asset to another entity; or
- b) Exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity.

Refer page no : 850 for case studies Dr.D.S.Rawat

Example of financial liability:

- 1. Trade payable-contractual obligation to pay cash
- 2. Bank loans- contractual obligation to pay cash
- 3. Finance lease obligation
- 4. Debenture and bonds payable
- 5. Financial guarantee
- 6. Financial derivatives
- 7. Redeemable preference share capital.

Examples of items which are not financial liability:

- 1. Income tax payable
- 2. provision for warranty obligation
- 3. Excise duty payable
- 4. advances from customers
- 5. Vat payable
- 6. interest
- 7. Non financial derivatives

Financial liability

Redeemable preference shares: financial liability gives the holder the right to require the issuer to redeem the instrument at or after a particular date.

Puttable instrument: financial liability

Exception to financial liability: the following puttable instruments are classified as **equity instruments if it has the following features**

Instrument specific features:

1. Holder is entitled for pro-rata shares of the entity's net assets on liquidation
2. Puttable instrument is subordinate to all other classes of instrument.
3. All instruments in the class have identical features.
4. Contractual obligation shall not be under potentially unfavorable conditions to an entity.
5. The expected cash flow based substantially on P&L or change in the recognized net assets or change in fair value or recognized and unrecognized net assets of the entity over the life of instruments.

Issuer specific features: issuer must have no other financial instrument or contract that has:

1. Total cash flows based substantially on P&L, change in recognized net assets or change in fair value of the recognized and unrecognized net assets of the entity.
2. The effect of substantially restricting or fixing the residual return to the puttable instrument holder.

Equity instruments

Equity instruments: an equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Ex: ordinary shares issued by a company or the partners' capital in a partnership

An instrument is classified as equity when it represents a residual interest in the net assets of the issuer.

Examples of equity instruments:

1. Non puttable ordinary shares.
2. Puttable instruments(if not financial liabilities and specific conditions are met)
3. Instruments imposing obligation to deliver pro-rata shares in net assets only on liquidation
4. Preference shares (when distribution at the discretion of the issuer and not mandatory)
5. Warrants or written call options- that allows the holder to subscribe for or purchase a fixed number of non-puttable ordinary shares in the issuing entity in exchange for a fixed amount of cash or another financial asset is an equity instrument.

Derivative instruments

Derivatives instruments: the financial instrument or other contract with all Three of the following characteristics are called derivative

1. Value changes in response of underlying value changes in response to a changes in underlying items. Ex : changes in specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating, or credit index, or other variable.
2. No Initial Net Investment/Very Low Investment:
3. It is settled at a future date:

Some other type of derivatives :

1. Forward : are contracts to purchase or sell a specific quantity of a financial instrument with delivery or settlement on a pre-agreed future date.
2. Futures: are similar to forward contracts.
3. Options: are contracts that give the purchaser the right but not the obligation to buy or sell a specified quantity of a particular financial instruments.
4. Others: such as currency swaps and interest rate swaps- swaps are contracts to exchange cash flows as of specified dates based on a notional amount.

Examples of derivatives and underlying

Types of contract	Main pricing-settlement variable(underlying variables)
Interest Rate Swap	Interest rates
Currency swap (foreign exchange swap)	Currency rates
Commodity swap	Commodity prices
Equity Swap	Equity prices(Equity of another entity)
Credit swap	Credit rating, credit index or credit price)
Currency futures	Currency rates
Commodity futures	Commodity prices
Currency forward	Currency rates
Commodity forward	Commodity prices
Equity forward	Equity prices(equity of another entity)

Derivative instruments

- **Forward contracts** : is the simplest form of a derivatives contract.
- Basically forward contract is valid contract settled at some future point of time. **Ex:** one part promises to purchase Rs.10 lakhs face value of **fixed interest rate government bonds**, in exchange of Rs.10 lakhs cash and other party also agrees to do so with in 6 months both parties have a contractual right and contractual obligation to exchange financial instruments' thought the market price of the bonds rises above Rs.10 lakhs.
- **Option** : under option contract the option-holder has a right not an obligation to exchange the financial asset but the writer (seller) of the option has the obligation to exchange the financial asset upon exercise to the option
- Purchaser has a contractual right similar to the right under a call option held (a financial liability) similar to the obligation under a put option.
- **Other** : many other type of derivative instruments embody a right or obligation to make a future exchange, including interest rates and currency swaps, interest rates caps, collars and floors, loan commitments , note issuance facilities and letter of credit. An interest rate swap contract may be viewed as a variation of a forward contract in which the parties agree to make a series of future exchange of cash amounts,

Compound financial instrument

- Not all instruments are either debt or equity some known as compound instruments, contain elements of both in a single contract
- Ex: bonds that are convertible into equity shares either mandatory or at the option of the holder, must be split into **liability and equity** components.
- Each is then accounted for separately.
- The liability element is determined first by fair valuing the cash flows excluding any equity component, and the residual is assigned to equity.
- Financial instrument may include both liability and equity components.
- In such cases, the instrument should be classified into its components parts.
- These must be presented separately in balance sheet.

Process of determining whether an instatement is a liability or equity:

Process of determining whether an instrument is a liability or equity:

Instruments	Cash obligation for principal	Cash obligation coupon/dividends	Settlement in for fixed number of shares	Classification
Ordinary shares	No	NO	N.A	Equity
Redeemable preference shares with fixed dividend each year	YES	YES	NO	Liability
Redeemable preference shares with dividend and discretionary equity for dividends	Yes	Yes	Yes	Liquidity for principal and equity for dividends
Convertible bonds option to convert into fixed number of shares	Yes	Yes	Yes	Liability for bond and equity for conversion option
Convertible bond which converts into shares (variable number) to the value of the liability.	Yes	Yes	No	Liability