Financial Instruments

By: CA. Kapileshwar Bhalla

Quiz….

Identify the nature of instrument?

1. Equity share capital
2. Debentures
3. Bonds

Moral of the story………..

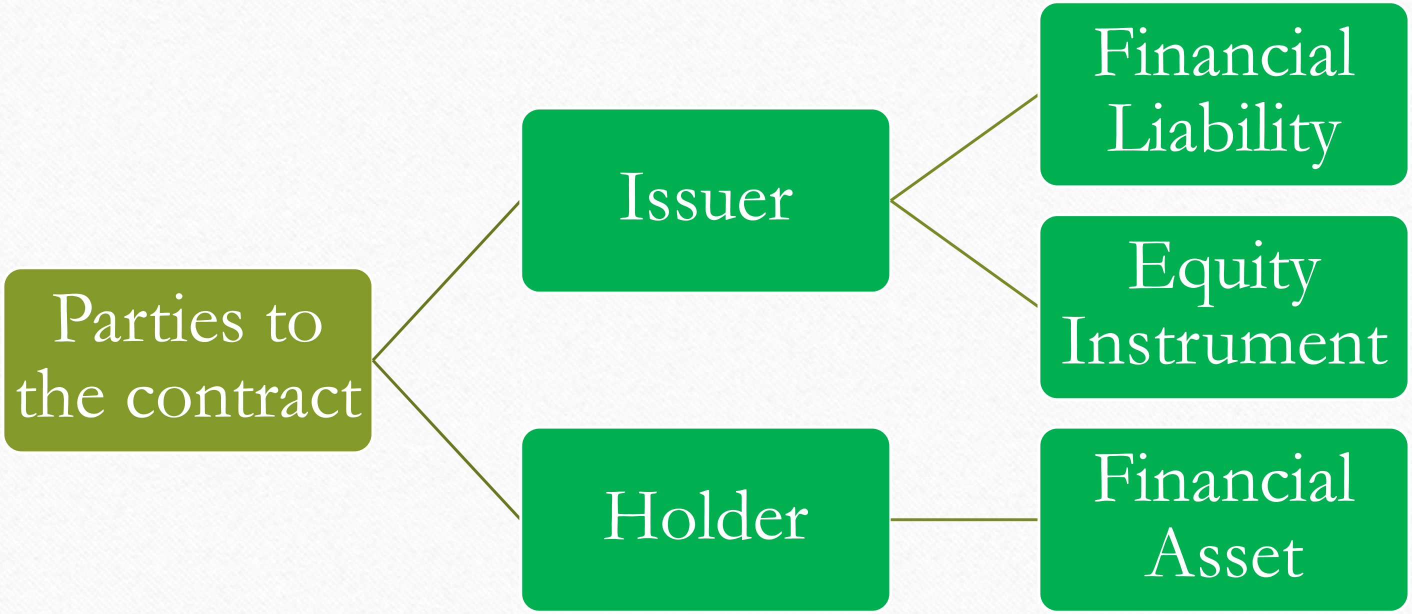
What's in a name….

Financial Instruments:

Financial Instruments

- Ind AS 32
- Ind AS 109
- Ind AS 107

Parties to the contract ….



Basic Example:

Mr. A borrows Rs. 1,00,000 from Mr. B

Interest ignored for convenience

Evaluate the possibilities?

Possibilities offered by Mr. A to Mr. B

- Cash/Cheque
- Fixed no. of equity shares
- Variable no. of equity shares

3 Step Procedure:

Step I:
Is there a contractual obligation?

- No – Ind AS 32 N.A.
- Yes – Go to Step II

What is the mode of payment?

- Cash - FL
- Equity Shares

What is the nature of the contract?

- Non-derivative – Fixed Test
- Derivative - Fixed for Fixed Test

Example:

C Ltd. issues convertible debentures to R Ltd. for a subscription amount of ₹100 crores. Those debentures are convertible after 5 years into equity shares of C Ltd. using a pre-determined formula. The formula is:

$$\frac{100 \text{ crores} \times (1 + 10\%)^{\wedge}5}{\text{Fair value on date of conversion}}$$

Examine the nature of the financial instrument.

Example:

Target Ltd. took a borrowing from Z Ltd. for ₹10,00,000. Z Ltd. enters into an arrangement with Target Ltd. for settlement of the loan against issue of a certain number of equity shares of Target Ltd. whose value equals ₹10,00,000. For this purpose, fair value per share (to determine total number of equity shares to be issued) shall be determined based on the market price of the shares of Target Ltd. at a future date, upon settlement of the contract.

Evaluate this under definition of financial instrument.

Example:

D Ltd. issues convertible debentures to J Ltd. for a subscription amount of ₹100 crores. Those debentures are convertible after 5 years into 15 crore equity shares of ₹10 each.

Examine the nature of the financial instrument.

Example:

A Ltd. issues warrants to all existing shareholders entitling them to purchase additional equity shares of A Ltd. (with face value of ₹100 per share) at an issue price of ₹150 per share.

Evaluate whether this constitutes an equity instrument or a financial liability?

Compound Financial Instruments:

Redemption Terms

Distribution Terms

Criteria …………..

FL + FL = FL

Example:

A Ltd. (issuer) issues preference shares to B Ltd. (holder). Those preference shares are redeemable at the end of 10 years from the date of issue and entitle the holder to a cumulative dividend of 15% p.a. The rate of dividend is commensurate with the credit risk profile of the issuer.

Examine the nature of the financial instrument.

Criteria …………..

FL + EI = CFI

Criteria ……………..

EI + EI = EI

Example:

Silver Ltd. issued irredeemable preference shares with face value of ₹10 each and premium of ₹90. These shares carry dividend @ 8% per annum; however, dividend is paid only when Silver Ltd declares dividend on equity shares.

Analyze the nature of this instrument.

Test:

A Ltd. issued compulsorily convertible preference shares (CCPS) at ₹100 each (₹10 face value + ₹90 premium per share) for ₹10,00,000. These are convertible into equity shares at the end of 10 years, where the number of equity shares to be issued shall be determined based on fair value per equity share to be determined at the time of conversion.

Evaluate if this is financial liability or equity?

What if the conversion ratio was fixed at the time of issue of such preference shares?

Questions and Answers:

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