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SLFRS 9, LKAS 32
Financial Instruments
Part 1

Chartered Accountancy
Strategic Level
Advanced Business Reporting (ABR)

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FCA, ACMA, MBA, ASA

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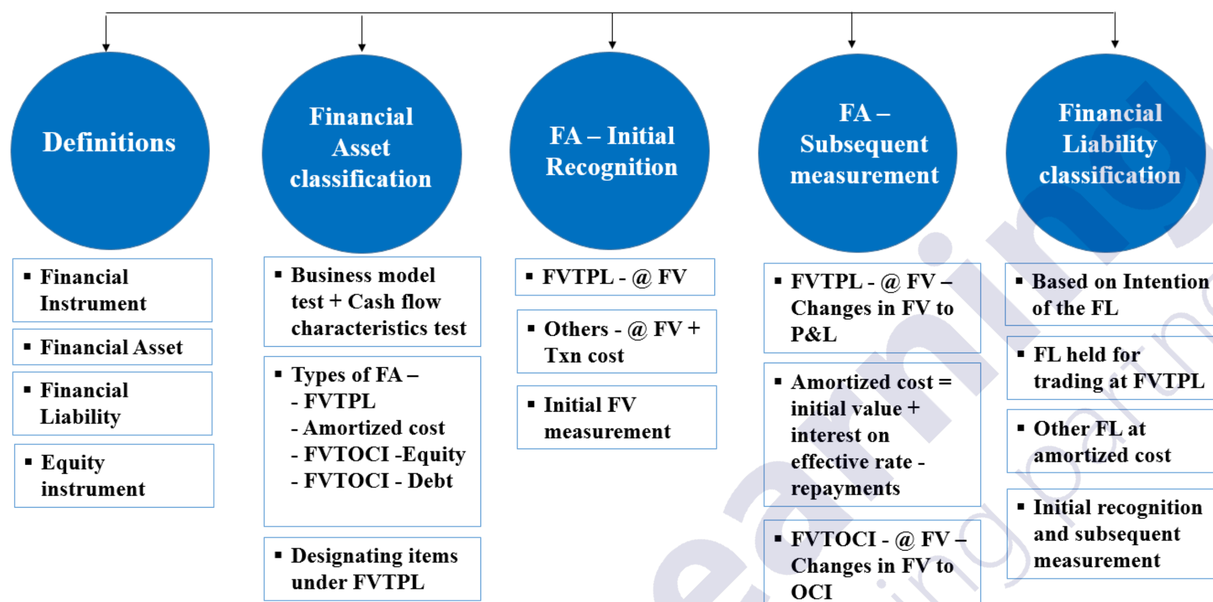
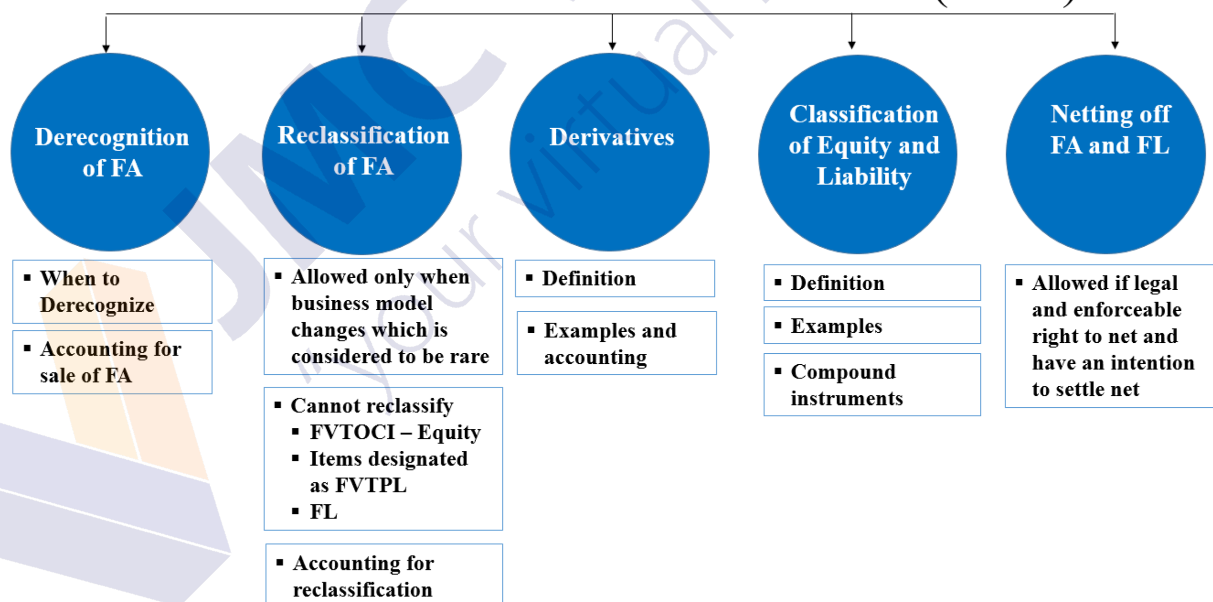
SLFRS 9, LKAS 32 - Financial Instruments





1.) **Definition of financial instruments**

A ***financial instrument*** is a contract that gives rise to:

- a financial asset of one entity and
- a financial liability or equity instrument of another entity

Financial asset

- Cash
- Equity instrument of another entity
- Contractual right to receive cash or another financial asset (for example, loans and receivables) or to exchange financial assets or liabilities under potentially favourable conditions
- Certain contracts settled in the entity's own equity

Financial liability

- Contractual obligation to deliver cash (for example, accounts payable) or another financial asset or to exchange financial asset or liabilities under potentially unfavourable conditions
- Certain contracts settled in the entity's own equity
- Except for certain puttable financial instruments and obligations arising only upon an entity's liquidation

Equity instrument

- Contract evidencing a residual interest in the assets of an entity after deducting all of its liabilities

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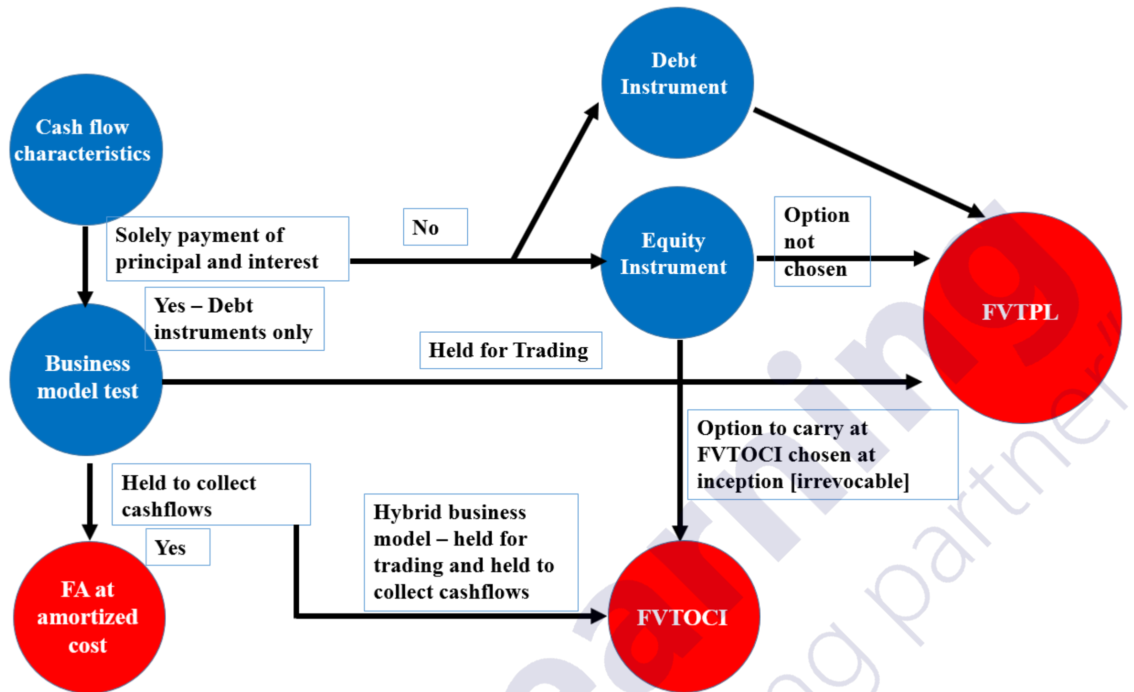
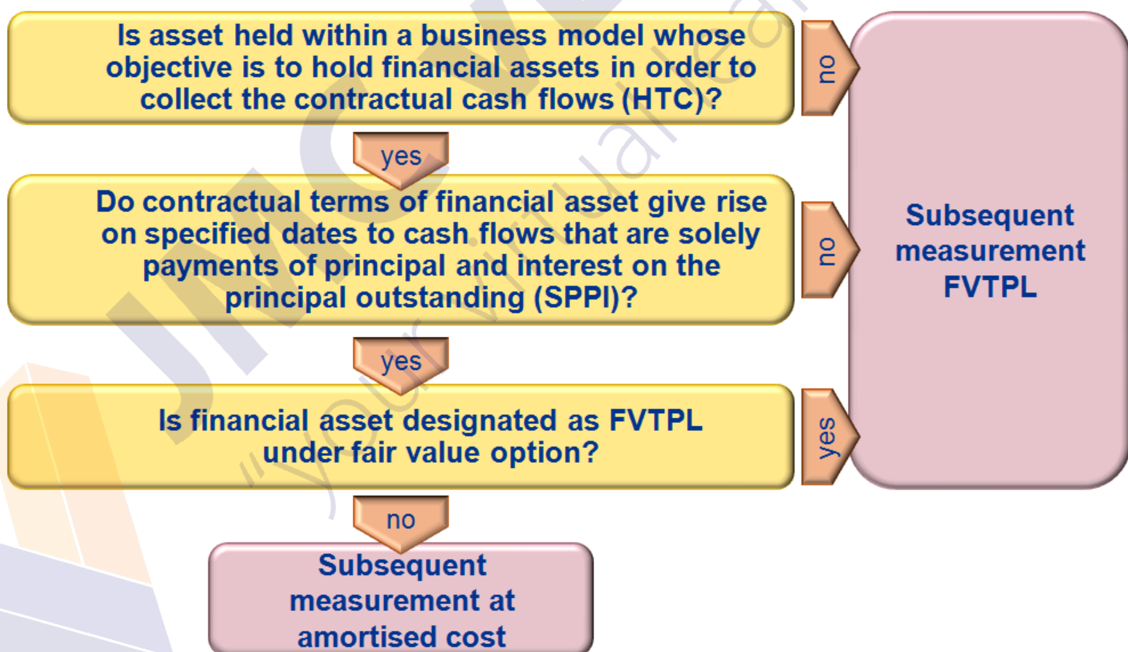
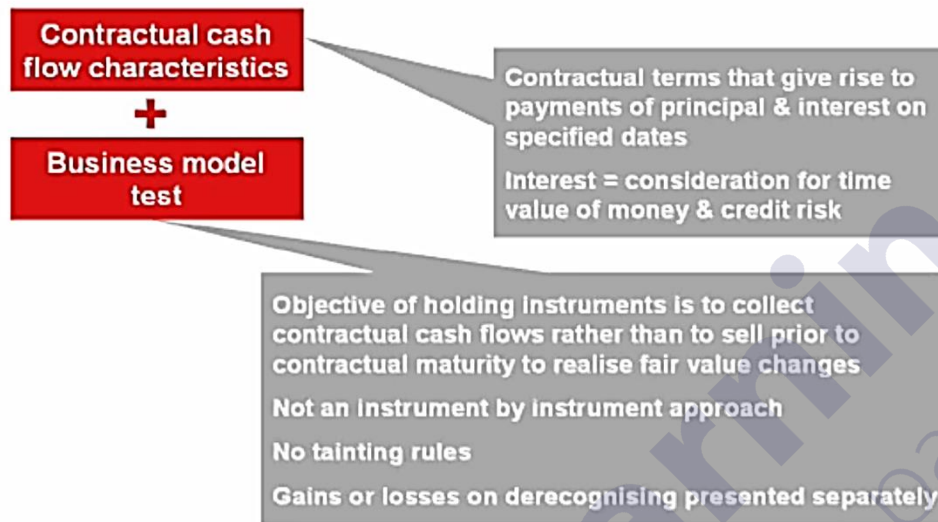
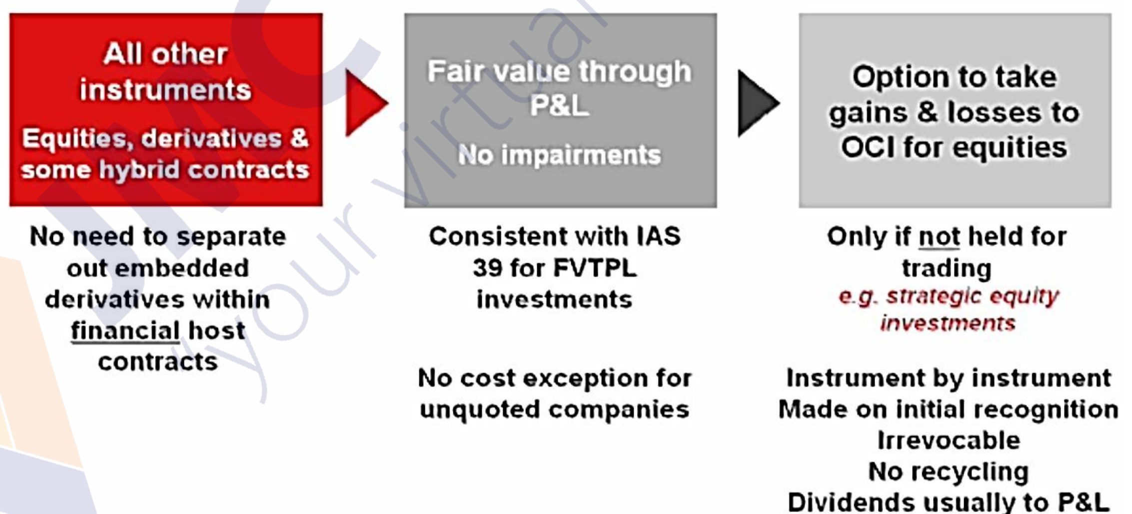
2.) **Classification of financial assets**









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Financial assets: examples

Financial asset	Measurement
Equities – held for trading	Fair value through P&L
Equities – not held for trading	Fair value through either P&L or OCI – irrevocable choice
Debt instruments with contractual cash flow characteristics held with the objective of collecting contractual cash flows	Amortised cost
Debt instruments with contractual cash flow characteristics not held with the objective of collecting contractual cash flows	Fair value through P&L

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Financial assets: examples

Financial asset	Measurement
Hybrid debt instrument with contractual cash flow characteristics held with the objective of collecting contractual cash flows	Amortised cost
All other hybrid contracts with financial hosts	Fair value through P&L

Hybrid debt instrument (amortised cost): Includes assets with variable interest rates linked to market interest rates (e.g. LIBOR), caps, floors & collars

All other hybrid contracts (fair value through P&L):

- Includes assets with features such as equity or commodity linked interest rates
- Includes investments in convertible bonds or debentures

2.1) **Business model**

- Single entity may have more than one business model
- It will often be appropriate to assess business model at portfolio level
- No need to hold all assets to maturity in a held-to-collect model; sales may occur
- Business model is matter of fact and can be observed by way an entity is managed and information is provided to management

2.1.1) **Business model – Examples**

Discuss whether the business model's objective is to hold financial assets to collect the contractual cash flows

- ♦ A business model under which portfolio is actively managed in order to sell financial assets at a price higher than the purchase price
- ♦ A business model with objective of originating loans to customers and to realise the cash flows on the loans by selling them
- ♦ A business model under which distressed assets with incurred losses are acquired and debtors actively chased to make payments

2.2) **Contractual cash flow characteristics**

- Financial asset may be classified as amortised cost only if its contractual cash flows give rise to cash flows that are solely payments of principal and interest on the principal
  outstanding (SPPI)
- Interest is consideration for time value of money and credit risk associated with principal amount outstanding
- Assessment as to whether contractual cash flows are solely payments of principal and interest is made in currency in which financial asset is denominated

Discuss whether contractual cash flows of these financial assets are solely payments of principal or interest on the principal outstanding (SPPI) on specified dates

Assume assets do not contain any other features that would preclude satisfaction of SPPI criterion

- ♦ An instrument with stated maturity and variable interest rate for which borrower can choose market interest at each reset date that corresponds to reset period
- ♦ A bond convertible into equity of the issuer
- ♦ A bond with a variable interest rate and an interest cap

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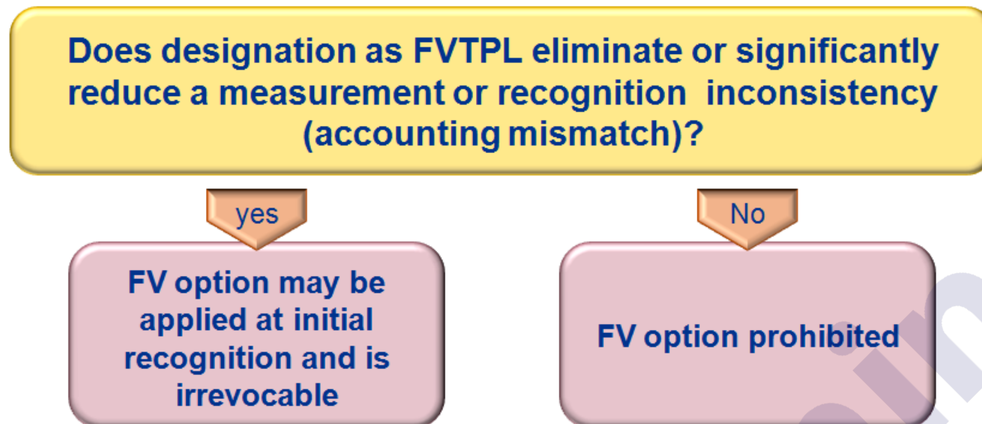
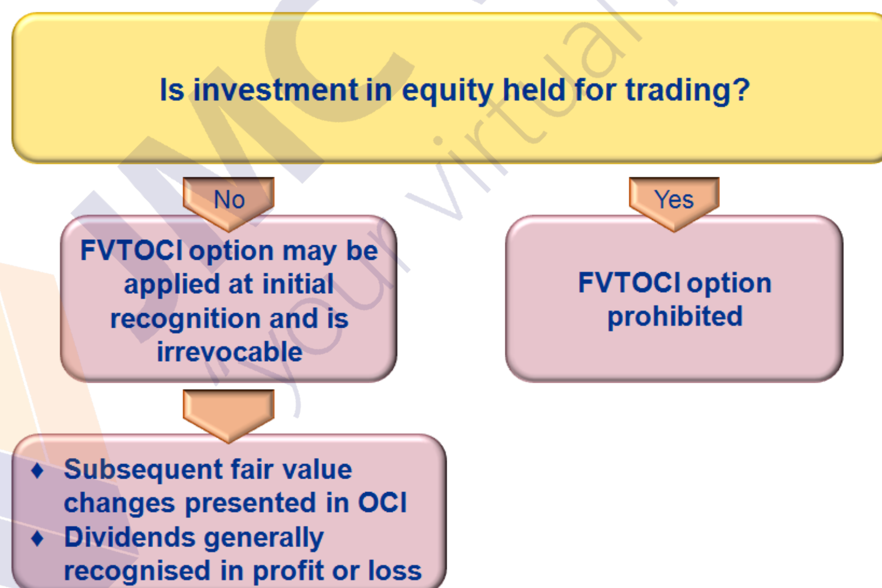
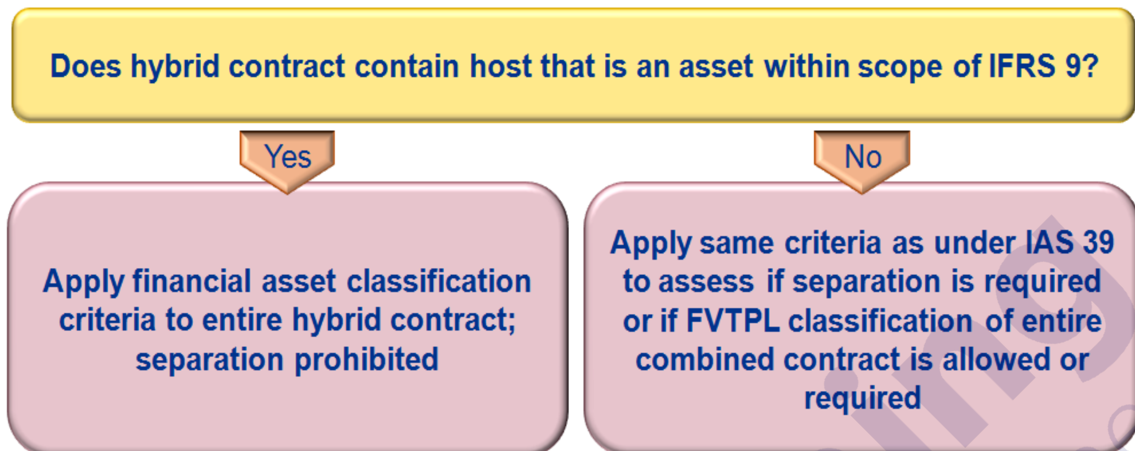
2.3) **Fair value option: Financial assets**



2.4) **Fair Value Through OCI (FVTOCI) option: Investments in equity instruments**



2.5) **Effect of embedded derivatives on classification of financial assets**



3.) **Classification of financial liabilities**

Category	Definition
Financial liabilities at fair value through profit or loss	• Financial liabilities held for trading • Financial liability designated as at fair value through profit or loss on initial recognition (fair value option) • Derivatives unless accounted for as hedging instruments in a cash flow hedge
Other financial liabilities – at amortised cost	All financial liabilities that are not classified at fair value through profit or loss

3.1) **Fair value option**

♦ Designation of financial instruments as at fair value through profit or loss is permitted, when

- The designation eliminates or significantly reduces "accounting mismatches"
- A group of financial assets and/or liabilities is managed on a fair value basis
- The financial instrument contains an embedded derivative that meets certain conditions

♦ Only available at initial recognition

♦ Designation is irrevocable

- No requirement for consistency, meaning that an entity can choose which, if any, of its financial instruments are to be designated under the fair value option

4.) **Initial measurement**

- Measured at *fair value* on initial recognition
- Transaction costs are included in the initial measurement of financial instruments that are not measured at fair value through profit or loss
- Transaction price is presumed to be the best evidence of fair value at initial recognition, unless another amount is determined by reference to observable current market transactions or by using valuation techniques that use only data from observable markets
- Applies to all financial instruments – whether or not negotiated on an arm's length basis (e.g., interest-free loans from a shareholder or government)

Example

Eg-1 Inter-company loans

- How should inter-company loans with zero or below market interest rates be accounted for?
- Key points
  - Recognise initially at fair value
  - Fair value equals face value if repayable on demand, otherwise discount expected cash flows over term at market rate
  - Discount from face value: distribution/capital contribution
  - Unwind discount (as finance income/expense) over term
  - Classify as non-current if at the end of the reporting period
    - Liability: have right to defer payment for more than 12 months
    - Asset: *expect* to demand repayment in more than 12 months

On 1-4-2011 P Ltd grants a loan of 1,000 to its subsidiary S Ltd repayable after 2 years without interest. Illustrate how this will be recorded in the books of P and S for the 2 financial years.

Eg- 2 Staff Loans

- How should staff loans with zero or below market interest rates be accounted for?
- Key Points
  - Recognise initially at fair value – present value of future cash payments discounted at market rates
  - Discount from face value: - Prepaid staff cost

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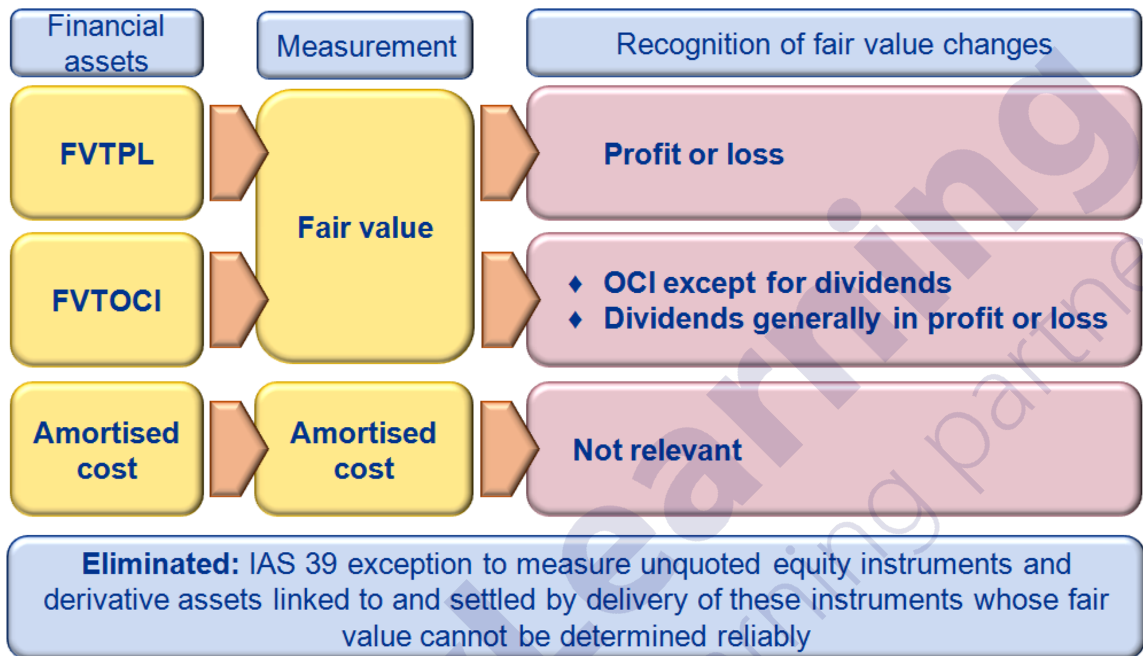
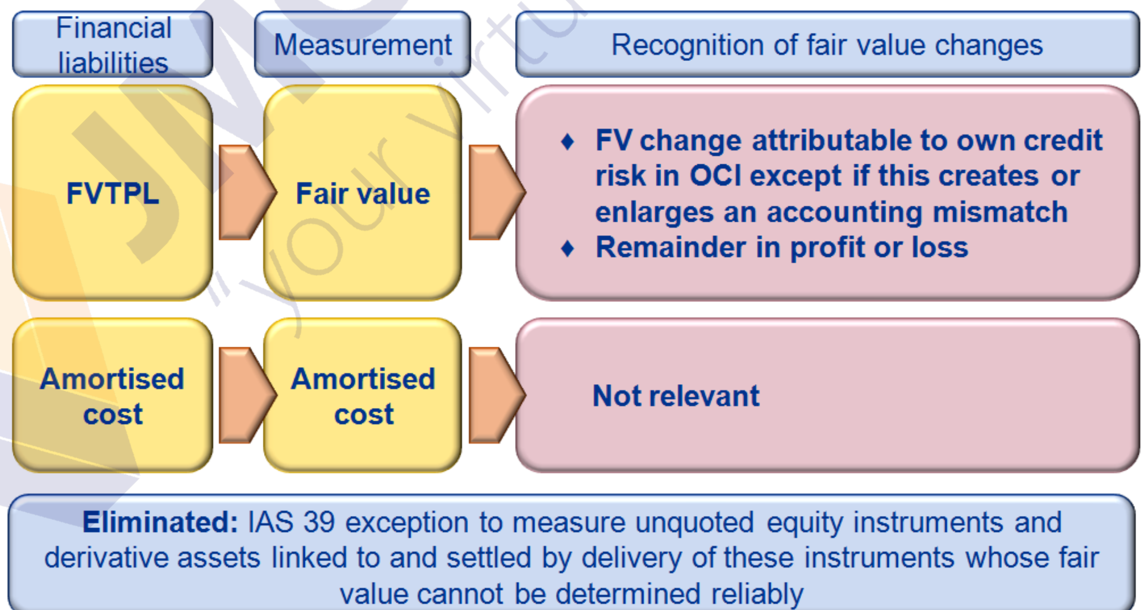
- Unwind discount as interest income based on market rate
- Amortize staff cost over the period on a straight line basis.

5.) **Subsequent measurement: Financial assets**



5.1) **Subsequent measurement: Financial liabilities**



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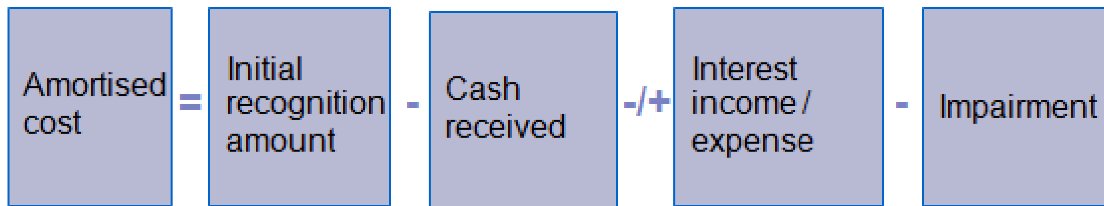
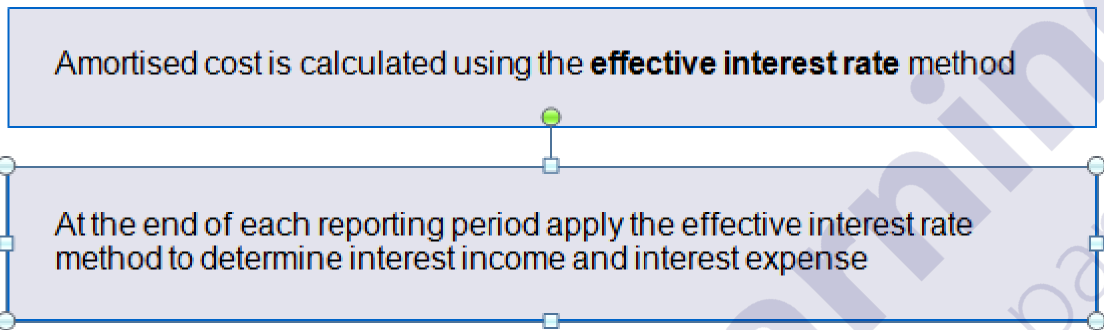
5.2) **Amortized cost and effective interest method**





Example – Loan granted

Date	1.4.2011
Amount	1,000
Transaction cost	22
Contractual interest rate	10%
Period	4 years
Repayment (p.a)	315.47
Effective rate	9%

Illustrate how the loan will be accounted for over the 4 years.

Example – Loan taken

Date	1.4.2011
Amount	1,000
Transaction cost	42
Contractual interest rate	10%
Period	4 years
Repayment (p.a)	315.47
Effective rate	12%

Illustrate how the loan will be accounted for over the 4 years.

Example – Government bond

Date	1.4.2011
Purchase price	900

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Face value	1,000
Coupon rate - Paid bi annually	10% p.a.
Period	2 years
Effective rate / yield	16% p.a.

5.2.1) Impairment

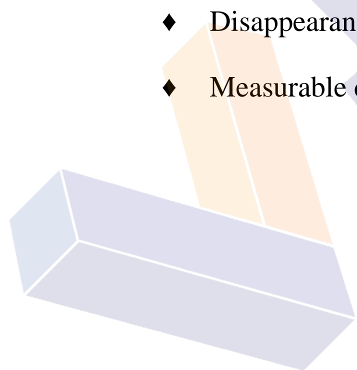
Impairment requirements

- **A financial asset or a group of financial assets is impaired if, and only if,**
  - there is objective evidence of impairment as a result of one or more events that occurred after initial recognition; and
  - the loss event has an impact on estimated future cash flows than can reliably be measured
- **An impairment loss is measured as the difference between:**
  - the asset's carrying amount and the present value of estimated future cash flows

5.2.2) **Objective evidence of impairment for financial assets measured at amortized cost**

Examples of loss events that may provide objective evidence of impairment

- Significant financial difficulty of the issuer
- Payment defaults
- Renegotiation of asset terms due to financial difficulty of the borrower
- Significant restructuring due to bankruptcy or financial difficulty
- Disappearance of an active market for the assets concerned due to financial difficulties
- Measurable decrease in the estimated future cash flows of the financial asset(s) concerned



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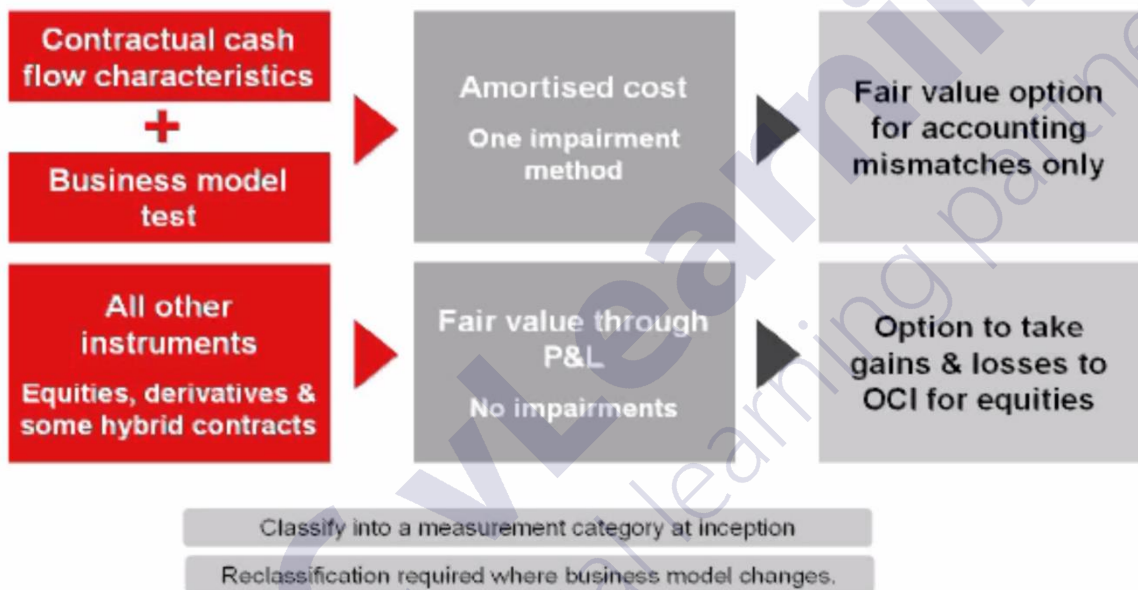
5.2.3) **Evaluation of impairment on a portfolio basis**

- **Future cash flows**
  - Estimate cash flows,
  - Based on historic loss experience,

– Adjusted for current conditions as necessary

♦ **Discount rate**

– Original effective interest rate



6.) **Reclassification**

When and only when entity changes its business model for managing financial assets, reclassification of financial assets is required. Such changes expected to be very rare

Reclassification of financial liabilities not allowed

If financial asset is reclassified from amortised cost to FVTPL, its fair value is determined at reclassification date and gains or losses recognised in profit or loss

If financial asset reclassified from FVTPL to amortised cost, its fair value at reclassification date becomes new carrying amount

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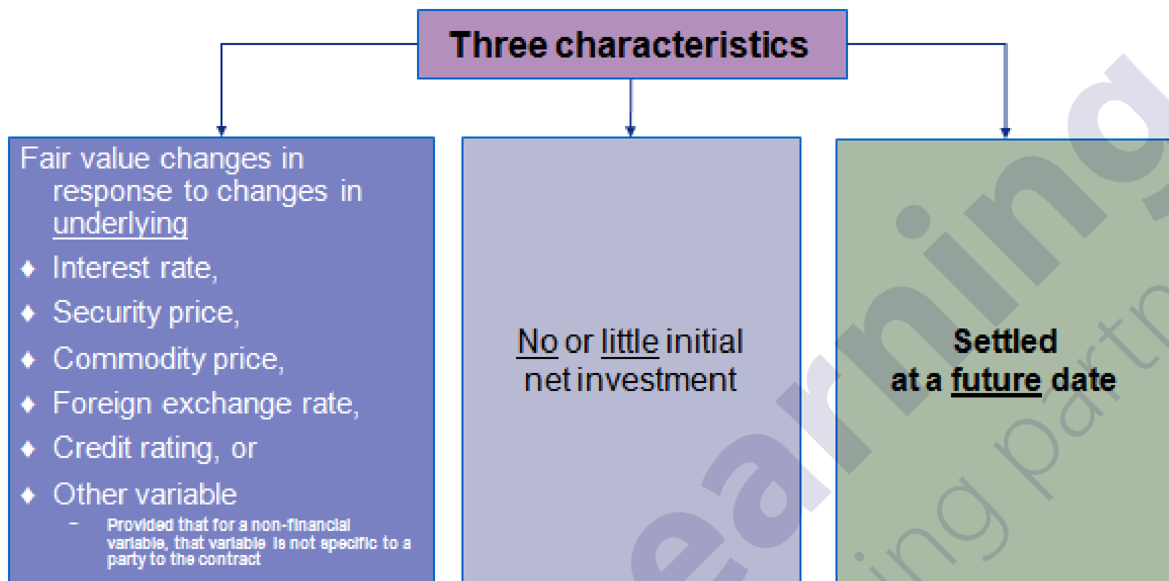
7.) **Definition – Derivative**



Examples of derivatives and underlyings

Type of contract	Main pricing-settlement variable (underlying variable)
Interest rate swap	Interest rate
Currency forward	Currency rates
Commodity option	Commodity prices
Credit swap	Credit rating
Purchased or written stock option (call or put)	Equity prices

8.) **Derecognition of a financial asset**

- **First, consolidate all subsidiaries (including all SPEs)**
  - Derecognition provisions are applied on a consolidated level
  - **Then, consider the subject of the derecognition analysis** (financial asset, group of similar financial assets or a portion of a financial asset)
- **Then, apply derecognition rules:**
  Derecognise when contractual rights to cash flows expire or
  - There is a "transfer" of a financial asset and
  - That transfer qualifies for derecognition
- **"Transfer" of a financial asset requires**
  - A transfer of the contractual rights to receive the cash flows; or
  - Meeting the "pass-through requirements" in LKAS 39.19
- **If financial asset has been transferred, then assess whether transfer qualifies for derecognition**
  - If substantially all risks and rewards are retained – retain the asset
  - If substantially all risks and rewards are transferred - derecognise
  - If some but not substantially all risks and rewards have been transferred:
    - Control -> Continuing involvement
    - No Control -> Derecognise

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Derecognition

Example 1

Company A is a manufacturing entity that has several arrangements whereby it sells trade receivables to financial institutions for cash with no conditions attached. The Company favours these arrangements as it receives cash more quickly than waiting for customers to pay their outstanding balances in the normal 30 or 60 day terms. The customers are notified of the sale and pay directly to the bank. There is no recourse for the bank and Company A only guarantees the existence of the trade receivables, but not creditworthiness of the customers etc.

Does the described transaction qualify for derecognition?

Example 2

Company B sells 100 of short-term receivables to a Bank for cash by guaranteeing to buy back up to the first 20 of defaulted receivables, while the historic default rates on such receivables are up to 5 receivables. The customers are notified of the sale and pay directly to the bank.

Does the described transaction qualify for derecognition?

Example 3

Investor PLC, a limited liability company, has a portfolio of Government Bonds. These bonds are held to collect interest and are usually held until maturity. Therefore these are carried at amortized cost. Off these bonds, a bond with a carrying amount of Rs. 10,000 as at 1st April 2012, was sold to a bank at a price of Rs. 8,000 and the company has agreed to buy the bond back on 31st March 2013 at a price of Rs. 9,200. The coupon rate on the bond was 8% (paid annually) on 31st March and Investor PLC received the coupon. The yield on the bond was 14%. As at 31st March 2013 the market value of the bond was Rs.11,000

The company has recorded the sale of the bond on 1st April 2012 and has recognized a loss of Rs.2,000 and the coupon of 8% was recorded as interest income. The purchase of the bond on 31st March 2013, was recorded as a new investment.

The extract of the Statement of Financial position as at 31st March 2013 was as follows.

	Rs.
Investments Government bonds	100,000
Retained earnings	20,000

Discuss the appropriateness of the accounting treatment and show the effect on the financials.

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8.1) **Derecognition of a financial liability**

- Financial liability (or part thereof) is removed from the statement of financial position when it is extinguished, i.e. when the obligation is discharged or cancelled or expires

9.) Hedge Accounting

9.1) Hedged item

- The hedged item is the underlying item that is exposed to the specific risk that the entity has chosen to hedge
- The following can be designated as hedged items:
    - A single (or a group if they share the same risk):
        - recognised asset or liability
        - unrecognised firm commitment
        - highly probable forecast transaction
        - net investment in a foreign operation

9.2) Hedging instrument

- The following can be designated as hedging instruments:
    - derivatives with third parties
    - non-derivatives for a hedge of foreign currency risk only
    - combination of two or more derivatives or non-derivatives, except for net written options
    - A proportion of a financial instrument (for example, 50% of the fair value changes of an interest rate swap)

9.3) Hedge accounting models

9.3.1) Fair value hedges

- Hedge of exposure to changes in fair value of:
    - a recognised asset or liability; an unrecognised firm commitment; or an identified portion of any of these two;
    - that is attributable to a particular risk; and
    - could affect profit or loss

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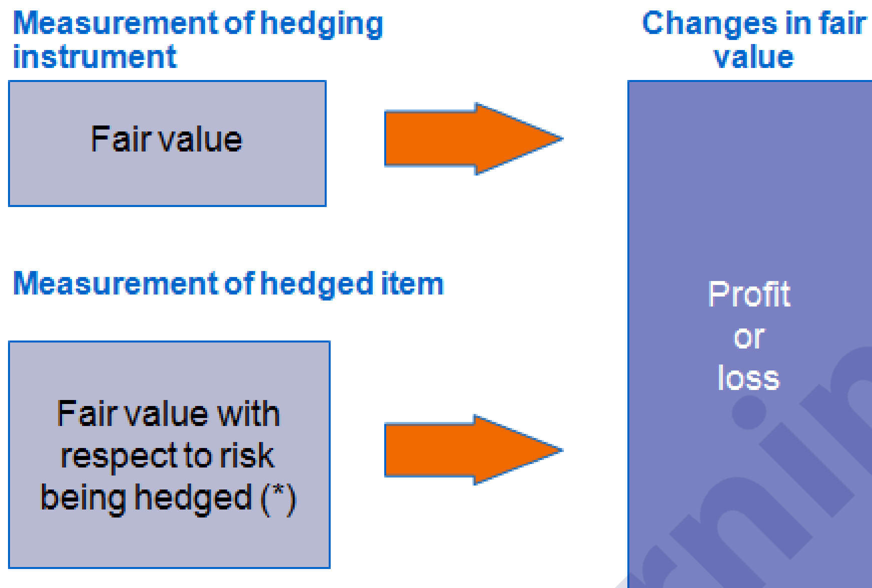
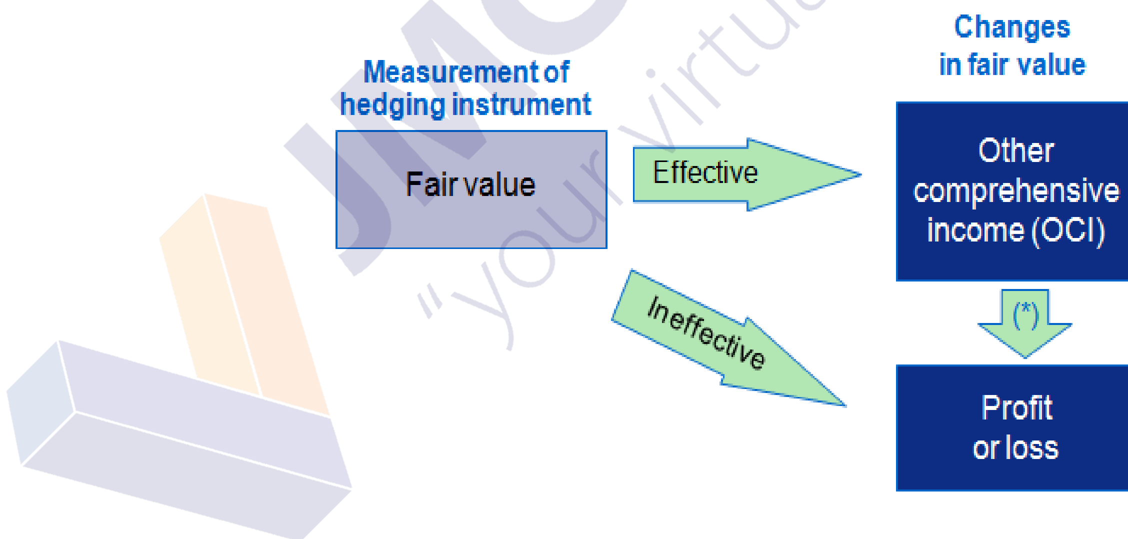


9.3.2) Cash flow hedges

- Hedge of exposure to variability in cash flows that is:
  - attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction (including inter-company transactions); and
  - could affect profit or loss



9.3.3) Hedges of a net investment in a foreign operation

Practice questions

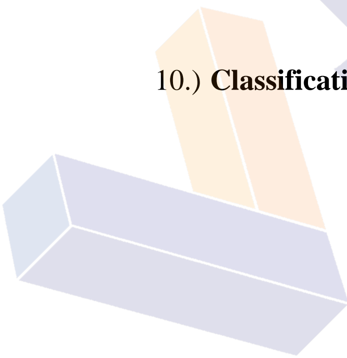
1.) ABC Ltd entered into a forward exchange contract as at 1-1-2015 to purchase $100,000 on 31-12-2015 at a price of LKR 120 : $1. As at 31-3-2015 The forward rate of 1$ to be purchased on 31-12-2015 was 135. Determine the value of the forward contract and the necessary entries to record it for the year ended 31-3-2015.

2.) DEF Ltd had recognized a contract to purchase oil at a fixed price on a future date as a derivative. The fair value of the derivative as at 31-3-2014 was Rs. 30mn (asset). During the year there was a sharp decline in oil prices and as a result the fair value of the derivative had reduced to Rs. 12Mn (liability). Show the entries to record this change in value.

3.) Coatmin's creditworthiness has been worsening but it has entered into an interest rate swap agreement which acts as a hedge against a Rs'2 million 2% bond issue which matures on 31 May 2016. The notional amount of the swap is Rs'2 million with settlement every 12 months. The start date of the swap was 1 December 2013 and it matures on 31 May 2016. The swap is enacted for nil consideration. Coatmin receives interest at 1·75% a year and pays on the basis of the 12-month LIBOR rate. At inception, Coatmin designates the swap as a hedge in the variability in the fair value of the bond issue.

	Fair value	Fair value
	1 December 2013	30 November 2014
	Rs'000	Rs'000
Fixed interest bond	2,000	1,910
Interest rate swap	Nil	203

Coatmin wishes to know the circumstances in which it can use hedge accounting and needs advice on the use of hedge accounting for the above transactions. (7 marks)



10.) **Classification of Equity and liabilities**

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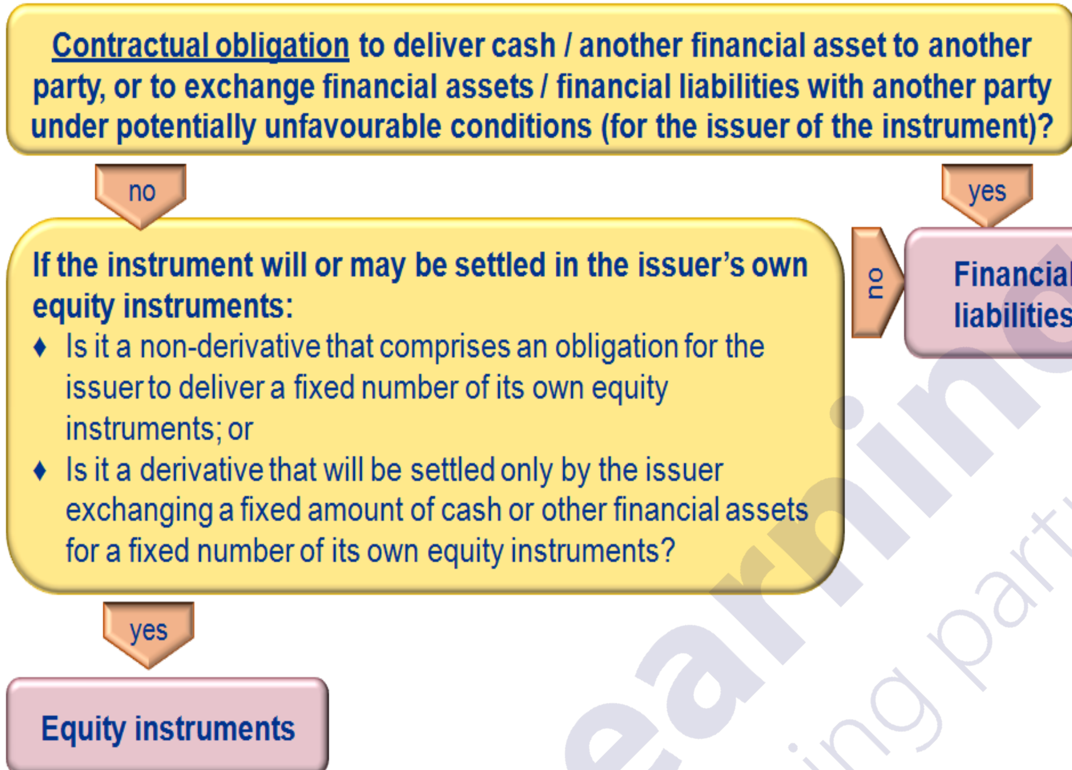
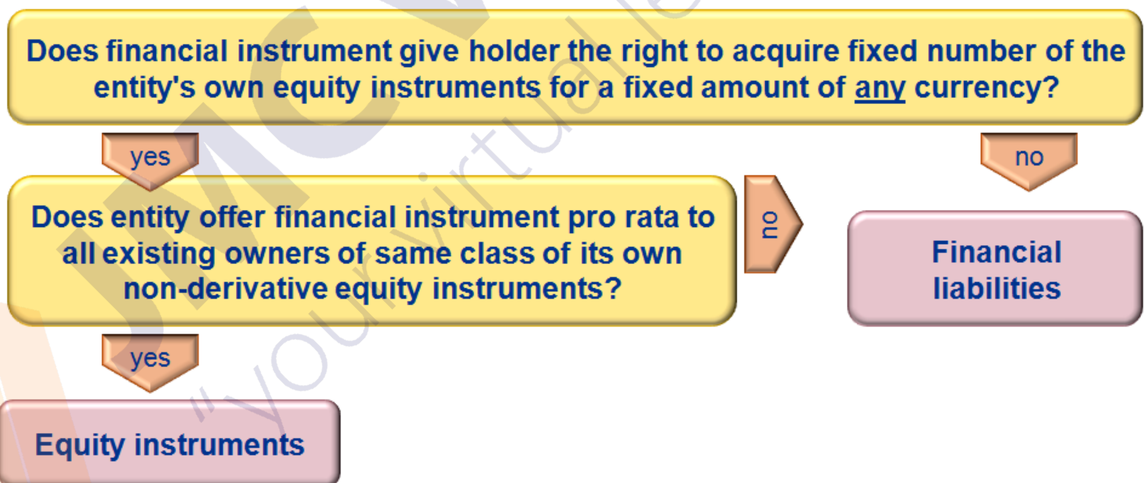
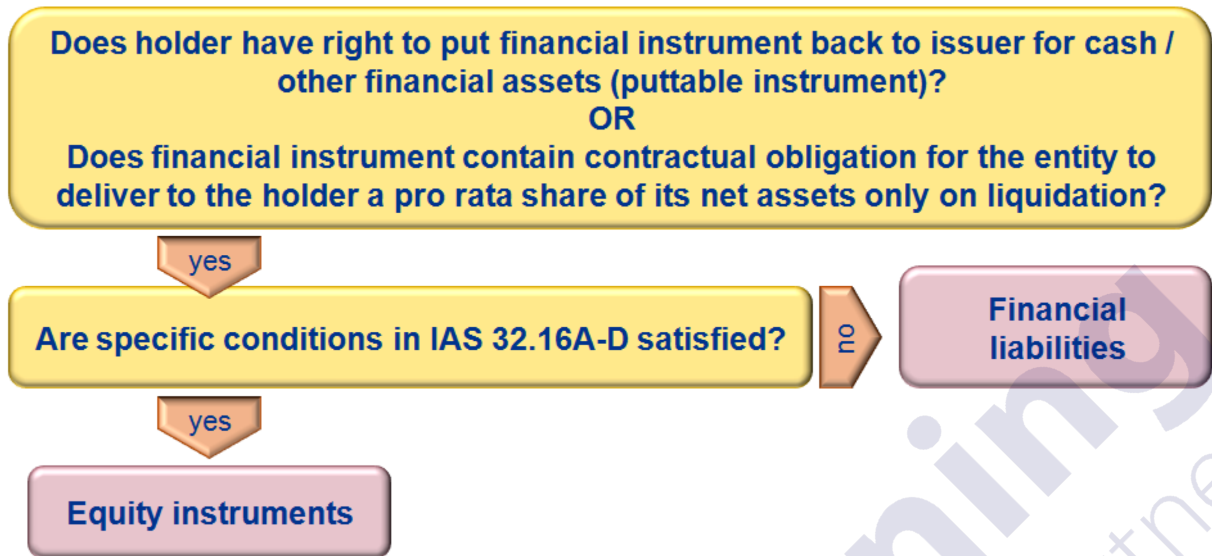


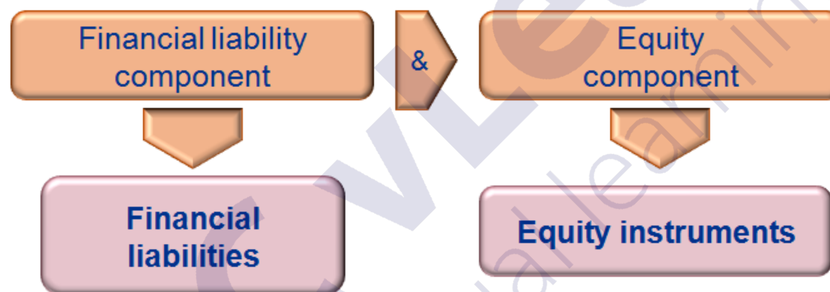
10.1) **Derivative contracts settled in own equity: amendment to LKAS 32**



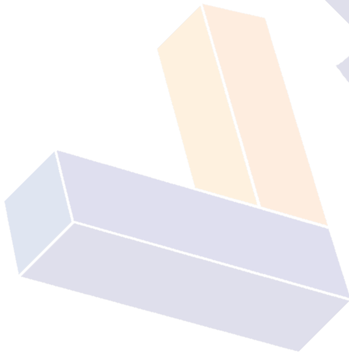
10.2) **Obligation to acquire own equity instruments and exceptions to classification criteria**



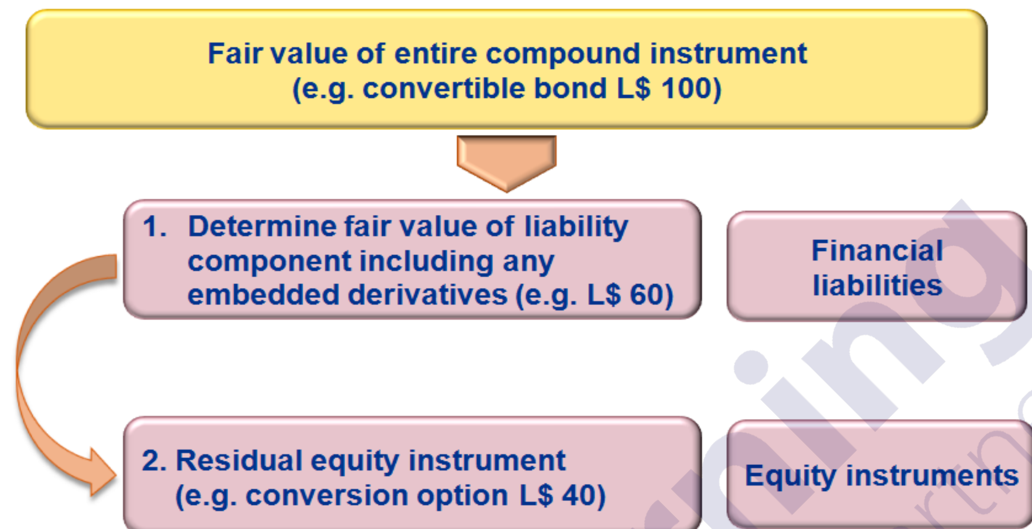
10.3) **Compound instruments**



Split accounting:
Issuer of compound instruments classifies the liability and equity components of the compound instrument separately as financial liability and equity



10.3.1) **Allocation of initial carrying amount of a compound instrument**



Example 1

Assess the classification (financial liability, equity or compound instrument) of the following financial instruments in the financial statements of the issuer

- Ordinary shares
- Redeemable preference shares with a 5% fixed annual dividend which is payable only if there are sufficient distributable profits available
- Redeemable preference shares with mandatory dividends
- Convertible bond paying fixed interest that is convertible into a fixed number of shares

Example 2

Date	1.4.2011
Issue price	1,000
Coupon rate - p.a.	10%
Period - years	2
Conversion option	100 shares after 2 years
Interest rate of a similar bond without the conversion option	15%

Calculate the amount to be recognized in the statement of financial position and the statement of Comprehensive income for the 2 years

10.4) **Reclassification**

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- Did the entity amend the contractual terms or
- Have the effective terms of the instrument changed U
- Is there a relevant change in the composition of the entity?

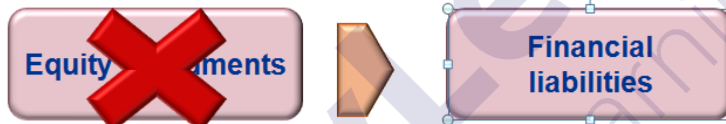
yes

Reclassification subsequent to initial recognition may be required

E.g.:

- Company J issued perpetual shares which carry the right to receive discretionary dividends. J amends the terms of its perpetual preference shares such that redemption is required in the event of a change of control of the entity.

10.4.1) **Reclassification from equity to liability**



Is there a reclassification from equity to liability?

yes

- **Derecognise carrying amount of equity instrument**
- **Recognise liability at fair value**
- **Recognise an adjustment in equity for the difference**

Example:

- Lila-Tech issued perpetual shares for L$ 100 that carry the right to receive discretionary dividends. Lila-Tech amends the terms of its perpetual preference shares such that redemption is required in the event of a change of control of the company.
- Market interest rates have fallen and therefore fair value liability amounts to L$ 120
- Recognise an adjustment in equity for L$ 20

10.4.2) **Reclassification from liability to equity**

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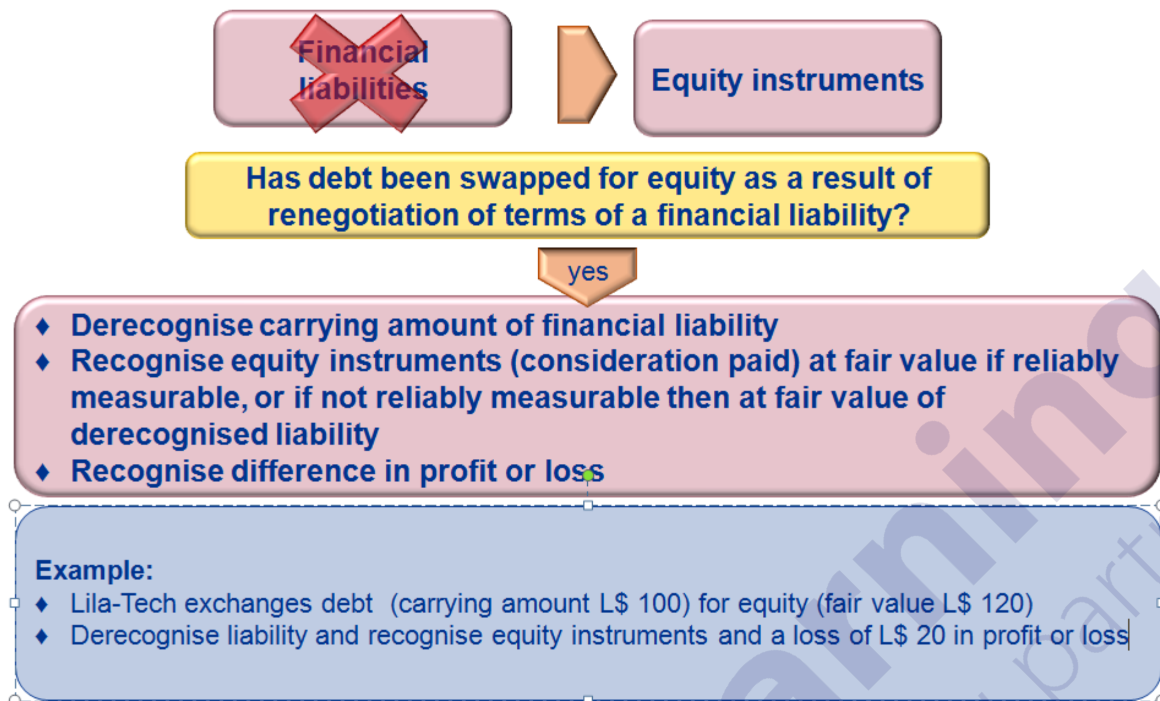
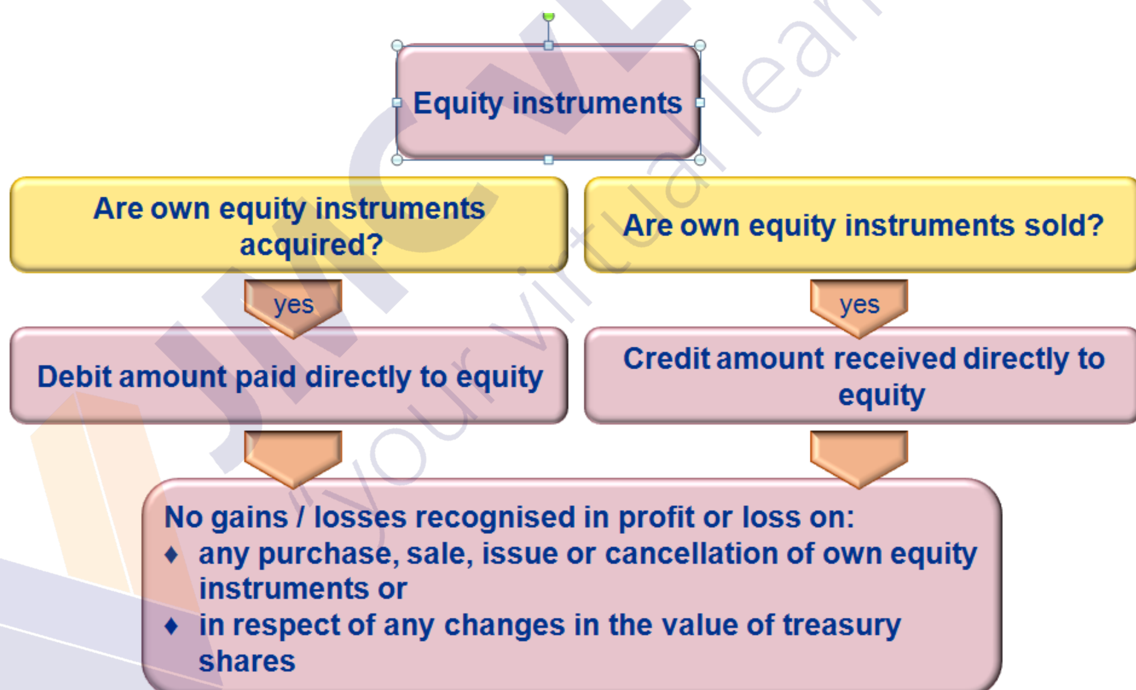


10.5) **Treasury shares – Acquisition of own shares**



11.) Offsetting a financial asset and a financial liability

- A legally enforceable right to offset &
- An intention to settle net or to realize the asset and settle the liability simultaneously

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Consider,

- Master netting agreements
- Several instruments used to emulate a single instrument (synthetic instrument)
- Items with the same risk, but different counterparties
- Financial assets pledged as collateral for non-recourse liabilities
- Assets set aside in a trust to discharge a liability that have not been accepted by the creditor (sinking fund arrangements)
- Obligations as a result of losses recoverable via insurance

12.) SLFRS 9 Effective date and transition

- SLFRS 9 effective for annual periods beginning on or after 1 January 2018 - Earlier application permitted

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Practice Questions

Question 1

InvestCo had entered in to the following contracts as at 1st January 2014. You are required to determine the category to which these should be classified based on the requirements of SLFRS 9.

1.) Granted a loan of Rs. 10mn to ABC ltd, which is to be repaid in installments of Rs.2.9mn each over 4 years. The entity expects to recover the loan through the installment the borrower pays.
2.) Purchased shares of Apple Inc. at a value of Rs. 5mn. The Company plans to dispose these shares when it makes a target return on the investment
3.) Purchased a Treasury Bill amounting to Rs. 20Mn which will mature on 30th September 2014. The treasury division is of the view that since the Bills provides a good yield, it should be held until maturity and the management intends to do so.
4.) Purchased treasury bonds at a value of Rs. 30 Mn which will mature on 31st December 2018 and this also generates a significant yield and the management is of the view that it should be held until maturity. However, the treasury division is not very positive on holding this investment for 4 years in the view of the current liquidity status of the Company and expect disposals to occur
5.) Purchase of Debentures of ABC Bank, at a value of Rs.4 Mn, which are listed in the Country's Stock Exchange. These debentures mature in 2020 and the Company has no intention to hold in until that date. However, the debentures give a fixed cashflow return at a rate of 10% on the investment value.
6.) Purchase of shares of Finance Co. PLC at a value of Rs. 50Mn. InvestCo views this as a strategic long term investment and has plans to make this company a subsidiary.
7.) Payment of an advance to purchase a property in Colombo amounting to Rs. 1mn. The total value of the property is Rs. 12Mn and the full payment should be made within 3 months. If the full payment is not made within 3 months the seller has the right to sell the property to another buyer and InvestCo will have no right to request for a refund as this is considered as a breach of contract.
8.) Granted a loan of Rs. 14Mn to XYZ PLC, a listed company, and the interest rate on the loan is determined based on the AWPLR at the beginning of the month. The repayment takes place every quarter where an equal amount of capital is repaid together with the calculated interest.
9.) Purchased Debentures of Packer Co. amounting to Rs. 10Mn. The capital value will be paid back after 5 years. During the period of the debenture a return based on the performance the All Share Price Index will be paid to the debenture holder. In an average a return of 8%-12% is expected over the 5 years

Question 2

Robby holds a portfolio of trade receivables and enters into a factoring agreement with a bank, whereby it transfers the receivables in exchange for cash. Robby additionally agreed to other terms with the bank as regards any collection shortfall and repayment of any monies to Robby. Robby derecognised the receivables. This is an example of the type of complex transaction that can arise out of normal terms of trade. The rules regarding derecognition are quite complex and are often not understood by entities.

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Describe the rules of SLFRS 9 Financial Instruments relating to the derecognition of a financial asset and how these rules affect the treatment of the portfolio of trade receivables in Robby's financial statements.

Question 3

1.) Ethan wishes to apply the fair value option rules of SLFRS 9 Financial Instruments to debt issued to finance its investment properties. Ethan's argument for applying the fair value option is based upon the fact that the recognition of gains and losses on its investment properties and the related debt would otherwise be inconsistent.

Ethan argued that there is a specific financial correlation between the factors, such as interest rates, that form the basis for determining the fair value of both Ethan's investment properties and the related debt.

Discuss the appropriateness of the suggestion

Answer

Normally debt issued to finance Ethan's investment properties would be accounted for using amortised cost model. However, Ethan may apply the fair value option in IFRS 9 Finanical Instruments as such application would eliminate or significantly reduce a measurement or recognition inconsistency between the debt liabilities and the investment properties to which they are related. The provision requires there to be a measurement or recognition inconsistency that would otherwise arise frommeasuring assets or liabilities or recognising the gains and losses on them on different bases. The option is not restricted to financial assets and financial liabilities. The IASB concludes that accounting mismatches may occur in a wide variety of circumstances and that financial reporting is best served by providing entities with the opportunity of eliminating such mismatches where that results in more relevant information. Ethan supported the application of the fair value option with the argument that there is a specific financial correlation between the factors that form the basis of the measurement of the fair value of the investment properties and the related debt. Particular importance was placed on the role played by interest rates, although it is acknowledged that the value of investment properties will also depend, to some extent, on rent, location and maintenance and other factors. For some investment properties, however, the value of the properties will be dependent on the movement in interest rates.

Under IFRS 9, entities with financial liabilities designated as FVTPL recognise changes in the fair value due to changes in the liability's credit risk directly in other comprehensive income (OCI). There is no subsequent recycling of the amounts in OCI to profit or loss, but accumulated gains or losses may be transferred within equity. The movement in fair value due to other factors would be recognised within profit or loss. However, if presenting the change in fair value attributable to the credit risk of the liability in OCI would create or enlarge an accounting mismatch in profit or loss, all fair value movements are recognized in profit or loss. An entity is required to determine whether an accounting mismatch is created when the financial liability is first recognised, and this determination is not reassessed. The mismatch must arise due to an economic relationship between the financial liability and the associated asset that results in the liability's credit risk being offset by a change in the fair value of the asset. Financial liabilities that are required to be measured at FVTPL (as distinct from those that the entity hasdesignated at FVTPL), including financial guarantees and loan commitments measured at FVTPL, have all fair value movement recognised in profit or loss. IFRS 9 retains the

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flexibility that existed in IFRS 7 Financial Instruments: Disclosures to determine the amount of fair value change that relates to changes in the credit risk of the liability.

2.) Ethan has an operating subsidiary, which has in issue A and B shares, both of which have voting rights. Ethan holds 70% of the A and B shares and the remainder are held by shareholders external to the group. The subsidiary is obliged to pay an annual dividend of 5% on the B shares. The dividend payment is cumulative even if the subsidiary does not have sufficient legally distributable profit at the time the payment is due.

In Ethan's consolidated statement of financial position, the B shares of the subsidiary were accounted for in the same way as equity instruments would be, with the B shares owned by external parties reported as a non-controlling interest.

Answer

Ethan's classification of the B shares as equity instruments does not comply with IAS 32 Financial Instruments: Presentation. IAS 32 paragraph 11, defines a financial liability to include, amongst others, any liability that includes a contractual obligation to deliver cash or financial assets to another entity. The criteria for classification of a financial instrument as equity rather than liability are provided in IAS 32 paragraph 16. This states that the instrument is an equity instrument rather than a financial liability if, and only if, the instrument does not include a contractual obligation either to deliver cash or another financial asset to the entity or to exchange financial assets or liabilities with another entity under conditions that are potentially unfavourable to Ethan. IAS 32 paragraph AG29 explains that when classifying a financial instrument in consolidated financial statements, an entity should consider all the terms and conditions agreed between members of a group and holders of the instrument, in determining whether the group as a whole has an obligation to deliver cash or another financial instrument in respect of the instrument or to settle it in a manner that results in classification as a liability. Therefore, since the operating subsidiary is obliged to pay an annual cumulative dividend on the B shares and does not have discretion over the distribution of such dividend, the shares held by Ethan's external shareholders should be classified as a financial liability in Ethan's consolidated financial statements and not non-controlling interest. The shares being held by Ethan will be eliminated on consolidation as intercompany.

Question 4

(a) Bental, a listed bank, has a subsidiary, Hexal, which has two classes of shares, A and B. A-shares carry voting powers and B-shares are issued to meet Hexal's regulatory requirements. Under the terms of a shareholders' agreement, each shareholder is obliged to capitalise any dividends in the form of additional investment in B-shares. The shareholder agreement also stipulates that Bental agrees to buy the B-shares of the minority shareholders through a put option under the following conditions:

– The minority shareholders can exercise their put options when their ownership in B-shares exceeds the regulatory requirement, or

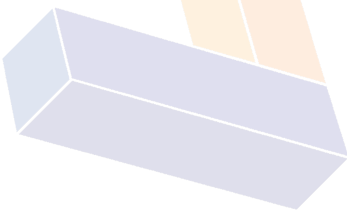
– The minority shareholders can exercise their put options every three years. The exercise price is the original cost paid by the shareholders.

In Bental's consolidated financial statements, the B-shares owned by minority shareholders are to be reported as a non-controlling interest

Discuss the appropriateness of the suggestion (7 marks)

Answer

Bental's decision to classify B-shares as non-controlling interests is incorrect and the shares with a contingent put option are a financial liability in accordance with IAS 32 Financial Instruments: Presentation. Bental has a clear contractual obligation to buy B-shares from the non-controlling interest under agreed terms and thus this contractual obligation is a financial liability as defined in IAS 32. IAS 32 defines a financial liability as a contractual obligation to deliver cash or another financial asset to another entity. If there were an unconditional right to avoid delivering cash or another financial liability, the instrument would be considered as an equity instrument. Otherwise, a financial instrument qualifies as a financial liability if the contingent payment condition is beyond the control of both the entity and the holder of the instrument. A contingent settlement provision which requires settlement in cash or variable number of the entity's own shares only on the occurrence of an event which is very unlikely to occur is not considered to be genuine and, hence, an instrument including such a provision would be an equity instrument (IAS 32). A financial liability is partly defined (IAS 32) as any liability which is a contractual obligation to deliver cash or another financial asset to another entity. However, Bental does not have an unconditional right to avoid delivering cash or another financial asset to settle the obligation. Thus, the minority shareholders' holdings of B-shares should be treated as a financial liability in the consolidated financial statements.



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Question 5

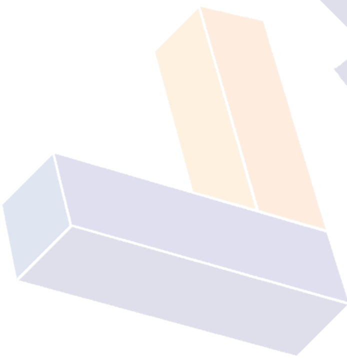
(b) Recently, criticisms have been made against the current SLFRS impairment model for financial assets (the incurred loss model). The issue with the incurred loss model is that impairment losses (and resulting write-downs in the reported value of financial assets) can only be recognized when there is evidence that they exist and have been incurred. Reporting entities are not allowed currently to consider the effects of expected losses. There is a view that earlier recognition of loan losses could potentially reduce the problems incurred in a credit crisis.

Required:

(i) Discuss briefly the issues related to considering the effects of expected losses in dealing with impairment of financial assets. (4 marks)

Answer

(i) The expected loss model is more subjective in nature compared to the incurred loss model, since it relies significantly on the cash flow estimates prepared by the reporting entity which are inherently subjective. Therefore, safeguards are needed to be built into the process such as disclosures of methods applied. The expected loss model would involve significant operational challenges notably it is onerous in data collection since data needs to be collected for the whole portfolio of financial assets measured at amortised cost held by a reporting entity. This means that data is not only required for impaired financial assets but it also requires having historical loss data for all financial assets held at amortised cost. Entities do not always have historical loss data for financial assets, particularly for some types of financial asset or some types of markets. The historical loss data often does not reflect the losses to maturity or the historical data are not relevant due to significant changes in circumstances.



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CA Past Papers

Question 02

The net assets of Hope PLC (HP) were less than half of its stated capital (a situation of serious loss of capital) as at 31 December 2018. As a remedial action for the aforesaid situation the company converted a loan of Rs. 500 million granted by the chairman of HP into equity capital by way of a private placement with the approval of the relevant parties. However, HP incurred further losses during the first three quarters of 2019 due to the high cost of borrowings.

In order to repay a major portion of the high cost borrowing and also as a long-term strategy to strengthen the equity base of the company, the board of directors of HP proposed the following two options to raise funds, and requested recommendations from the finance department. You are the financial accountant of HP.

Option 1: Issue 5,000,000 'participative units' with a face value of Rs. 100 per unit.

The terms and conditions of the 'participative units' are as follows.

- A participative unit holder has the option to redeem the unit for cash after 5 years from the date of issue.

- A participative unit holder has no preferential rights to the net assets of the company on liquidation. The formula used to determine the redemption price of a unit on liquidation is similar to all other equity instruments.

- A participative unit holder is not entitled to vote at the meetings of the company.

- HP will pay a discretionary dividend maximum of 8% per unit based on the availability of distributable profits of the particular year.

- HP has not entered into any other contract that limits participative unit holders' entitlement to HP's residual interest.

Option 2: Issue 2,500,000 bonds with a face value of Rs. 200 per bond.

The terms and conditions of the bonds are as follows.

- A bond has a maturity of 5 years from its date of issue.

- A bond pays a 6% annual coupon payment in arrears.

- At any point up to its maturity, the bondholder has the option to convert the bonds into ordinary shares of the company, based on the market price of an ordinary share on the conversion day. The formula to determine the number of ordinary shares to be issued is:

$$= \frac{\text{Total face value of the bond investment}}{\text{Market price of an ordinary share of the company on conversion day}}$$

The prevailing market interest rate for a similar bond without the conversion option is 9%. The market price of an ordinary share of HP fluctuated between Rs. 58 and Rs. 65 during the last 12 months.

Required:

(a)As the financial accountant of HP, recommend the best fund raising option out of the two options mentioned above by analysing the impact on the financial statements of HP based on the principles of LKAS 32 Financial Instruments: Presentation. (10 marks)

Information on two investments currently held by HP is given below.

(i) On 1 January 2019 HP invested Rs. 100 million in 5-year quoted bonds and measures it at fair value through other comprehensive income. The contractual maturity value of this investment is Rs. 100 million, with an interest rate of 8% payable annually. The effective interest rate is also 8%. At initial recognition, HP determined that the asset is not purchased or originated credit-impaired.

Per the market information available up to date, the fair value of the bonds has decreased to Rs. 95 million due to recent changes in the market interest rate. However, HP has determined that there was no significant increase in credit risk since the initial recognition of the bonds.

Cash inflows will be received on the due dates.

HP uses the loss rates of 1.3% and 2.8% to estimate 12-month expected credit losses or lifetime expected credit losses respectively of the investments segment, which the aforesaid quoted bonds are classified under.

(ii) HP acquired 6,000,000 ordinary shares of Trust Investment (Pvt) Ltd (TI) on 1 December 2015 at a cost of Rs. 60 million. This acquisition was a strategic investment. At initial recognition, HP classified this investment as an investment measured at fair value through other comprehensive income.

The company has used the following share prices based on the fair value of the net assets of TI which is given below.

* Share price is based on the estimated fair value of net assets as at the 2019 year-end.

Due to several management issues that occurred in TI and adverse changes in the economy, this investment was unable to generate reasonable operational results over the year ending 31 December 2019. The company concluded in December 2019 that the decline in the investment value is significant and prolonged.

As at 31 December	**2015**	**2016**	**2017**	**2018**	**2019***
Per share value as at the year-end (Rs.)	10.00	14.50	9.00	7.50	3.80

** Share price is based on the estimated fair value of net assets as at the 2019 year-end.*

Due to several management issues that occurred in TI and adverse changes in the economy, this investment was unable to generate reasonable operational results over the year ending 31 December

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2019. The company concluded in December 2019 that the decline in the investment value is significant and prolonged.

Required:

(b)Evaluate separately the possible impacts of each of the investments given in (i) and (ii) above on the financial statements of HP for the year ending 31 December 2019 in accordance with the principles of SLFRS 9 Financial Instruments. (10 marks)

June 2019

Question 01

(a) DAC PLC has an equity investment classified as 'available for sale', purchased on 1 January 2017, at a cost of Rs. 14 million. The investment is an unquoted investment, and therefore under LKAS 39, Financial Instruments, Recognition and Measurement, this was measured at cost.

Under SLFRS 9, Financial Instruments the management does not want to take fair value changes to profit or loss, as this is a strategic investment. Fair value as at 31 December 2017 has been estimated as Rs. 15 million. The date of initial application of SLFRS 9, Financial Instruments by DAC PLC, is 1 January 2018.

Required:

Advise the management of DAC PLC on how the above investment should be classified and measured, (including impairment), under SLFRS 9, Financial Instruments, in the financial statements for the year ended 31 December 2018. (6 marks)

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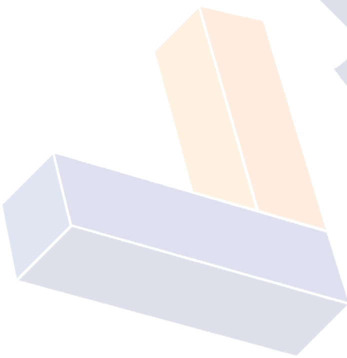

December 2018 - Question 02

(a) You are the finance manager of AW Limited, a company that prepares financial statements in accordance with Sri Lanka Accounting Standards comprising of LKASs and SLFRSs.

(i) The company holds a portfolio of quoted shares. Historically, sales have been due to the following reasons:

- To obtain profit from short-term gains due to rise in share prices
- To achieve overall profit target set by the management

(ii) The government treasury bill portfolio revealed the following pattern of sales during the last 4 years.

Year	Sales (%)	Hold to collect (%)
2014	20%	80%
2015	15%	85%
2016	18%	82%
2017	25%	75%

Required:

Evaluate how SLFRS 9, Financial Instruments will impact the classification, and indicate the measurement required in relation to (i) and (ii) above. (14 marks)

December 2017

Question 02
(a) Become First Ltd (BFL) is a public limited company operating in the construction industry. Financial statements of BFL included the following financial instruments:

(i) BFL had issued two million convertible debentures at par for Rs. 100 each on 1 April 2016. An interest of 6% per annum is payable in arrears. A similar debenture without the conversion option would attract an interest rate of 9%. Further, BFL incurred a cost of Rs. 2 million with regard to the issue of the above debentures and charged it to profit or loss. The debentures have a maturity of three years and if the investors do not convert them into ordinary shares of BFL at the time of maturity then the debentures are redeemed at par. The treasury manager of BFL estimated that the impact of the issue costs will increase the effective interest rate to 9.39% per annum.

(ii) BFL uses steel in its construction projects and expected the steel prices to rise in the future. Hence, it entered into a futures contract on 1 April 2016 so that it can obtain the steel at a predetermined price. The treasury manager of BFL suggested designating the above transaction as a cash flow hedge. At the year ended 31 March 2017, the steel prices had increased and raised the cost of steel to BFL by Rs. 29 million. The value of the futures contract was estimated to be Rs. 30 million (assets) on that date.

Required:

Advise the board of BFL on how the above financial instruments will be treated in the financial statements of BFL for the year ended 31 March 2017. (15 marks)

June 2017

Question 01
(a) You have recently joined SC PLC (SCP) as the chief financial officer (CFO). The company has been operating without a CFO for the last 6 months, and the senior management has proposed the following accounting treatments to be followed prior to the year-end closure.

1. SCP has issued preference shares redeemable at the option of SCP during the year. A dividend of 14% per annum is paid to the holder until redemption (the date of redemption is not specified in the contract). The instrument contains a liability and as such the liability component and equity component should be split.

2. The debtors schedule of SCP is as follows.

Debtors	**Value (Rs. million)**	
Five debtors taken over by the bank	40	Note A
Debtor: Anil	80	Note B
Debtor: Basil	60	
Other debtors (consists of 200 trade debtors)	20	
Total	200	

Note A - SCP encountered significant cash flow issues and thereby entered into a contract where five of its debtors amounting to Rs. 40 million were identified and sold to the bank. As per the contract, the bank will collect the amounts due from the identified debtors. However, if one of these debtors defaults, SCP will be liable to make good such amounts owed by them. The management is of the view that debtors amounting to Rs. 40 million should be derecognised from the books.

Note B - For the balance debtors amounting to Rs. 160 million, an impairment provision of 50% will be made for the balances that have not been paid for the last 6 months. For any debts not paid for more than 12 months, a 100% provision will be made.

3. SCP has obtained a loan from ABC bank amounting to Rs. 1,000,000 at an interest rate of 5% per annum for 5 years.

- Rs. 50,000 interest to be paid annually for 5 years.
- Rs. 1,000,000 capital to be repaid at the end of 5 years.

The market rate at the time the loan was obtained was 8%. As at the reporting date Rs. 1,000,000 has been recorded as borrowings under non–current liabilities in the financial statements.

Required:
Comment on the validity of the proposed accounting treatments for SCP, mentioned in points 1, 2 and 3 above.
(15 marks)

December 2016

Question 02

(a) AH (Pvt) Ltd has an investment in 100,000 equity shares classified under available- for-sale. The finance manager is preparing the 31 March 2016 financial statements and has noted that the fair value (FV) of the shares has decreased. Further evaluation of shares disclosed the following.

Date	FV per share (Rs.)
31 March 2014 (Purchase date)	100 (cost)
31 December 2014	120
31 March 2015	90
31 December 2015	70
31 March 2016	60

Required:
(i)Advise the finance manager on the accounting treatment of the shares as at 31 March 2016. (5marks)

(b) HL (Pvt) Ltd has issued preference shares with the following features.

- the holder has the right to require the HL (Pvt) Ltd to redeem the instrument after 5 years for a fixed amount.
- dividends on the instrument are paid at the discretion of HL (Pvt) Ltd

Required:
Outline the accounting implications of the above instrument in the financial statements of HL (Pvt) Ltd. (5 marks)

June 2016
Q2 (2)

The CFO, before going on leave, has proposed to sell part of the receivables portfolio to a factoring company and obtain short term advances in order to address the current liquidity issues. Based on the initial discussions she had with the factoring company, she stated, "we would sell our identified receivables that have a total carrying value of Rs. 30 million and the factoring company will pay us Rs. 27.5 million. However, the factoring company will not take any responsibility of recoverability of the assigned receivables".

(i) Explain the accounting implications of obtaining an advance from the factoring company as given in point (2). (4 marks)

December 2015

Menik Lanka (Pvt) Limited (MLL) is a family owned business wanting a mid-term loan to finance its working capital. The directors of MLL have evaluated various options and one of directors who has experience working with a listed company, suggested to issue 30,000 convertible debentures with a three-year term to known parties. Further, he explained that to raise the required amount from the market, considering the current situation of the company it will have to offer a 10% per annum without the conversion option. If they issued with the convertible option it will have to offer a 7% per

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annum. Moreover, he said an attractive convertible option can be offered such as one ordinary share for 10 debentures. The other directors agreed with his suggestion and the convertible option was agreed to be granted to the debenture holders.

Accordingly, all the directors agreed to issue debentures to raise Rs. 3,000,000 at a face value of Rs. 100 each. The interest is payable annually in arrears at a nominal annual interest rate of 7%. To get process completed the company incurred stamp duty of Rs. 50,000 and documentation charges of Rs. 25,000. MLL also had to pay Rs. 125,000 to the consulting firm they obtained service from in relation to this.

Required:
(a) Compute the value of each component of the financial instrument considering the maximum potential cash payments MLL could be required to make in the above scenario. (excluding the issue costs).
(3 marks)

(b) Recommend the required adjustment for the issue costs in accordance with the relevant accounting standard and compute the net proceed for each component.
(5 marks)

(c) Advise on the subsequent measurement for each component assuming that the liability is accounted for under the effective interest rate method. You may use the format below to present the subsequent measurement of the liability. (8 marks)

Year	Liability B/F	Interest	Cash paid	Liability C/F
1				
2				
3				

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June 2015

Question 01
Freeland Investment (Pvt) Limited (FIL) has invested in a number of different instruments. You have been newly recruited by the company as the accountant and the CEO has requested your advice on the following instruments.

Instrument I
Purchased 12%, debentures at par for Rs. 100 million on 1 January 2013 at the initial public offering. The debentures are redeemable in 3 years and coupon is paid annually.
According to the published stock market details, the yield of the debenture as at 31 December 2013 and 2014 are as follows;

	2013	2014
Ask	9%	8%
Bid	10%	9%

Required:
(a) Discuss the classification options available for the above instrument. (4 marks)

(b) Develop financial statements extracts (Statement of comprehensive income, Statement of other comprehensive income and Statement of financial position) for each of the two years for the classification options identified in (a) above. (6 marks)

(c) The CEO of FIL would like to classify the debentures as an available-for-sale instrument in the first 2 years but then reclassify the instrument based on market behaviour. If the market conditions improve, the instrument is to be classified as fair value through profit or loss (FVTPL) and if the market conditions continue to deteriorate, the instrument is to be classified as held to maturity (HTM).

Advise the CEO on the proposed classifications. (5 marks)

(d) The CEO is of the view that the Sri Lankan debenture market is not an active market since there are no frequent transactions as in the equity market. Explain what an active market is in accordance with SLFRS 13 – Fair Value Measurement. (3 marks)

Instrument II
FIL entered into a 4 year interest rate swap with Gall National Bank on 1 July 2013 for speculative purposes. The company has agreed to pay interest at a fixed rate of 6% per annum, and receive interest at an annual variable rate equivalent to SLIBOR+1%, reset at 6 monthly intervals. Interest is determined on a notional amount of Rs. 400 million.

	SLIBOR
30/6/2013	5%
31/12/2013	5%
30/6/2014	6%
31/12/2014	6.5%

The fair values of the SWAP
31/12/2013 Rs. 11.7 million
31/12/2014 Rs. 10.3 million

Required:

(e) Advise the company on how to account for the above Instrument. (4 marks)

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(f) Develop financial statements extracts for the year ended 31 December 2014 for the Instrument II (your answer should be supported with calculations and journal entries). (3 marks)
(Total: 25 marks)

June -2014
Question No. 02

(a) Nethu PLC has been in the business of manufacture and sale of floor tiles. The following two transactions relating to financial instruments have taken place during the financial year ended 31 March 2014:
(i) The company invested Rs. 45 million in redeemable bonds issued by Himas PLC on 1 April 2013. The nominal value of the bonds purchased was Rs. 50 million and the bonds carried a coupon rate of 12% and are redeemable at par on 31 March 2018. Nethu PLC expects to hold these bonds until maturity. The internal rate of return of the bond is 15%. Interest on the bond is paid on 31 March every year. (5 marks)

(ii) The company negotiated and agreed with a supplier in China to purchase a plant for a consideration of US$ 1 million on 1 September 2014. Due to the volatility in foreign exchange rates, the company purchased a foreign currency forward contract to hedge the commitment towards the foreign supplier. (5 marks)

Required:
Advise the accountant of Nethu PLC as to how the above transactions should be recorded and presented in the financial statements of the company for the year ended 31 March 2014. Your answer should be accompanied by calculations where appropriate.

(e) Equity First Ltd invested Rs. 100,000,000 in 500,000 equity shares of Go Green Plantation PLC ("Go Green") in financial year 2012/13. The investment is classified as available-for-sale and the fair value of the investment as at 31 March 2013 was Rs. 105,000,000.

Based on market information, it was observed during the last 10-12 month period that the average market price per share of the Go Green has been in the range of Rs.160 - Rs.140. The market price at 31 March 2014 was Rs. 155.

During the year, the company disposed of 20% of the investment at Rs. 160 per share.
Subsequent to the balance sheet date the instrument was trading at an average market price of Rs.160 – Rs. 165.

Required:
Analyse with reasons whether the investment in Go Green is impaired.

Your answer should be accompanied by calculations where appropriate and include the relevant extract of the income statement and other comprehensive income for the year ended 31 Mach 2014.
(5 marks)

December 2013
Question No. 02

(b) Mathurata Plc has been in the business of manufacture and sale of rubber gloves. The company lent Rs.5 million to a latex supplier on 1 April 2012. Further the company spent Rs.100,000 to arrange this loan and agreed not to charge annual interest from the supplier. However the supplier was

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requested to pay Rs.6.8 million in full settlement of this loan, on 31 March 2015. Effective annual interest rate of this loan is 10%.

At the end of March 2013 the supplier has informed the company that he is experiencing lot of difficulties due to bad weather and economic conditions. As a result the company agreed to reduce the amount payable to Rs. 6 million.

Explain how the above transaction should be reflected in the financial statements of Mathurata Plc for the year ended 31 March 2013. (6 marks)

June -2013
Question No. 04

The finance manager (FM) of Good Luck Bank is in the process of preparing its financial statements for the year ended 31 December 2012. The FM has made the following suggestions.

(a) The Bank has invested Rs. 1 billion in treasury bonds with 5 years maturity period. The head of treasury of the Bank has confirmed based on the Bank's future strategies, the bank may not be able to hold the instrument till their maturity. Therefore, FM is of the view that the instrument can be classified as loans and receivables. (2 marks)

(b) The Bank has invested Rs. 750 million in quoted ordinary shares of Redymix PLC. These shares were classified as available for sale at the beginning of the year. According to the Bank's future business strategy, the head of treasury has suggested that it expects to trade these shares frequently. Therefore, the FM is of the view these shares can be classified as fair value through profit or loss (FVTPL) as at 31 December 2012. (2 marks)

(c) The Bank has invested Rs. 50 million in 15% unquoted corporate debentures with 3 year maturity period. According to the Bank's business strategy, these investments are managed and their performance is evaluated on a fair value basis as per the Bank's documented risk management procedures. The FM is of the view that these instruments can be designated as fair value through profit or loss instruments. (2 marks)

(d) The Bank has invested in 6 year corporate bonds of Incredible PLC that earn interest at 14% and it contains an early redemption option that allows Incredible PLC to redeem it any time after the third year of issue date if the volume-weighted average price of equity shares of Incredible PLC is not less than 30% of its share price at the date of issue of bond. The FM is of the view that this instrument can be classified as loans and receivables. (4 marks)

You are required to:
Evaluate the appropriateness of the accounting treatments suggested by the FM.

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(c) Goodluck PLC has been in the business of import and sale of home appliances. The company issued 12% convertible debentures valued at Rs. 200 million at par on 1 April 2011. These debentures are redeemable at a premium of 5% on 31 March 2016. Alternatively the company has given an option to the debenture holders to convert these debentures into ordinary shares of Goodluck PLC on the basis of 2 ordinary shares for each Rs. 100 debenture. The coupon rate for an equivalent debenture without the conversion rights would have been 15%.

You are required to advice the accountant of Goodluck PLC as to how to record the above transaction in the 2011/2012 books of accounts of the company. (6 marks)

<u>Model Questions</u>

1.) "Preference shares can be considered as equity instruments" Do you agree with this statement? Discuss. (03 Marks)

<u>Suggested answer</u>

On a financial instrument when the entity has a contractual obligation, which it cannot avoid, then the financial instrument is a financial liability. In the case of preference shares if the repayment of the capital of the preference shares is not specified and if the dividend payment is at the discretion of the entity then the preference shares can be classified as equity.

2.) Alpha limited has repurchased 5% of its own equity shares with the view of maximizing its equity holders' wealth. Chief accountant of Alpha Ltd is of the view that the equity shares repurchase should be recognized as a financial asset. Discuss the possibilities for Alpha Ltd to recognize its own equity shares as a financial asset. (04 Marks)

<u>Suggested answer</u>

As per LKAS 32, a financial asset is defined as

- Cash
- Right to receive cash or,
- An equity instrument of another entity

Therefore, the equity shares of the same entity cannot be considered as a financial asset of that entity.

Further, as per LKAS's, when an entity purchases its own shares it is considered as "Treasury Shares" and is deducted from Equity.

As per the Companies Act No 7 of 2007, when a Company purchases its own shares it is considered as those shares are immediately cancelled.

Thus, based on the above, the accounting treatment for the shares repurchased, is to debit the proceeds to retained earnings.

4.) Lanka Petroleum PLC purchases crude oil from Iranian Petroleum Ltd. On 01st April 2012 Lanka Petroleum entered in to an agreement with Iranian Petroleum to purchase crude oil for US$ 500 million when the exchange rate is US$ 1= Rs.130/-. The cargo is to be supplied and paid for on

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31st May 2012. As on 01st April 2012, the forward rate for the delivery of US Dollars on 31st May 2012 was US$ 1 = Rs.135/-.

You are required to:

(i) State whether the forward agreement signed by the Lanka Petroleum can be considered as a derivative as per Sri Lanka Accounting Standards. (02 Marks)

(ii) Identify the type of hedge, hedging instrument, and hedge item relating to the above scenario. (03 Marks)

Suggested answer

(i) **A derivative** is a financial instrument with all three of the following characteristics.

(a) Its value changes in response to the change in a specified underlying such as interest rate, foreign exchange rate

(b) 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.

(c) It is settled at a future date.

Since the fair value of the forward contract will change in accordance with the exchange rate between LKR and $, requires no investment initially and is to be settled at a future date it could be considered as a Derivative.

(ii)

- Type of hedge – Cash flow hedge
- Hedging instrument – Forward Contract
- Hedged item – price to be paid to purchase oil

5.) Holland PLC has issued perpetual debentures at an interest of 14% p.a. Do you consider the debenture of Holland as a financial liability? Explain. (03 Marks)

Suggested answer

When an entity has a contractual obligation which it cannot avoid, then the financial instrument is considered as a financial liability.

In the case of the perpetual debenture it could be said that the principle remains with the Company for eternity. However, the Company has to pay the interest annually at 14% p.a. This is a contractual obligation which the company has to abide by and thus the debenture should be considered as a financial liability.

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6.) Accountant of Cee PLC requires offsetting a financial asset and a financial liability and the net amount to be reported in the financial statements.

Do you agree with the accountant? Explain. (04 Marks)

Suggested answer

A financial asset and a financial liability shall be offset and the net amount presented in the statement of financial position only when, an entity:

(a) currently has a legally enforceable right to set off the recognized amounts; and

(b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

Therefore if Cee PLC has the right to net off and intends to settle the assets and liabilities on a net basis, it can net off the financial asset and liability.

7.) Greenie showed irredeemable preference shares as equity instruments in its statement of financial position.

The terms of issue of the instruments give the holders a contractual right to an annual fixed cash dividend and the entitlement to a participating dividend based on any dividends paid on ordinary shares. Greenie felt that the presentation of the preference shares with a liability component in compliance with IAS 32 'Financial instruments: Presentation' would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in the IASB's 'Framework for the Preparation and Presentation of Financial Statements'.

The reason given by Greenie for this presentation was that the shares participated in future profits and thus had the characteristics of permanent capital because of the profit participation element of the shares

Discuss the appropriateness of the suggestion

Answer

Normally irredeemable preference shares would be classified as equity. The contractual obligation to pay the fixed cash dividend creates a liability component and the right to participate in ordinary dividends creates an equity component. If Greenie were to comply with IAS 32 'Financial instruments: Presentation', it would require the preference shares to be treated as compound financial instruments with both an equity and liability component. The value of the equity component is the residual amount after deducting the separately determined liability component from the fair value of the instrument as a whole.

Under IAS 32, it would seem that substantially all of the carrying value of Greenie's preference shares would be allocated to the liability component because of the dividend elements and the fixed net cash dividend would be treated as a finance cost.

IAS 1 'Presentation of financial statements' requires departure from a requirement of a standard only in the extremely rare circumstances where management conclude that compliance would be so

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misleading that it would conflict with the objective of financial statements set out in the Framework. Greenie's argument that the presentation of the preference shares in accordance with IAS 32 would be misleading, is not acceptable. The fact that it would not reflect the nature of the instruments as having characteristics of permanent capital providing participation in future profits is not a valid argument. IAS 1 requires additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable a user to understand the impact of particular transactions or conditions on financial position and financial performance. A fair presentation would be achieved by complying with IAS 32 and providing additional disclosures to explain the characteristics of the preference shares.

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