Financial Instruments Standards
Ind AS 32, 109 and 107

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Disclaimer: This is my personal view and no one else other than me shall be responsible for any omission or errors

Financial Instruments Standards Ind AS 32, 109 and 107

- Financial Instruments
- Presentation
- Recognition and measurement
- Derecognition
- Hedge accounting
- Disclosures

Ind AS 32 defines financial instruments and establishes principles for presenting financial instruments as liability or equity from the issuer's perspective

Ind AS 109 specifies the recognition and measurement principles of financial instruments and situations for hedge accounting

Ind AS 107 specifies disclosures on financials assets and the nature of risks associated with the financial assets

Financial Instruments: Presentation (Ind AS 32)

I. Presentation (from issuer's perspective) sets out principles for –
   - Debt v/s Equity
     - Compound Financial Instruments
     - Treasury shares;
   - Offsetting financial assets and financial liabilities

II. Complement the principles of Ind AS 109 and Ind AS 107

III. Out of Scope – Associates, JVs, Employee benefits, Insurance Contracts, Share-based payment

Financial Instruments – Ind AS 32

FINANCIAL ASSETS

- Cash;
- Equity instrument of another entity;
- Contractual right to receive cash or another financial asset or to exchange with entity financial assets or financial liabilities under potentially favorable conditions;
- Certain contracts settled in entity's own equity.

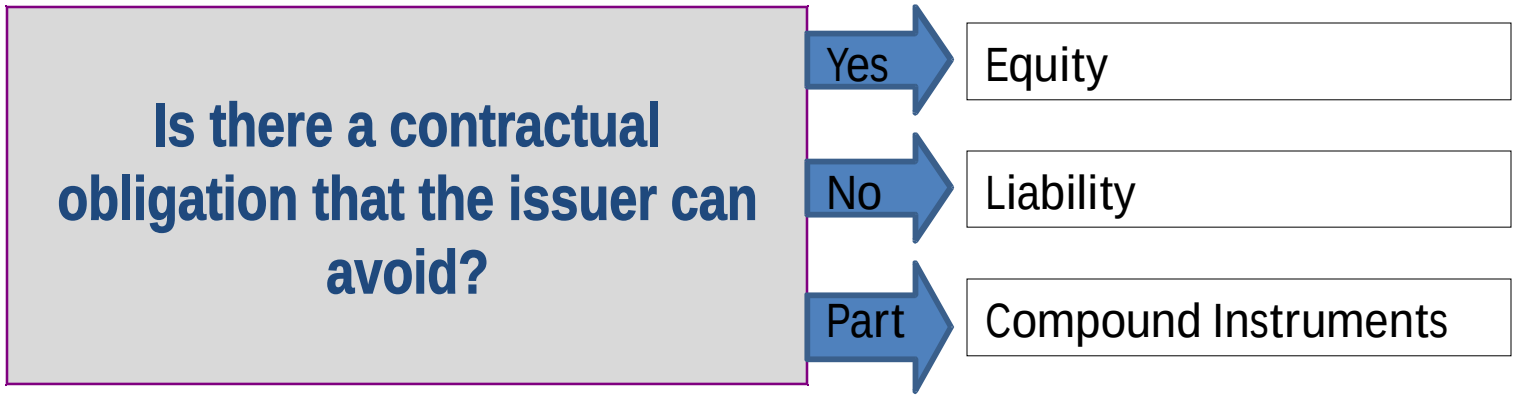
FINANCIAL LIABILITIES

- Contractual obligation to deliver cash or another financial asset or to exchange financial assets or financial liabilities under potentially unfavorable conditions;
- Certain contracts settled in entity's own equity

EQUITY INSTRUMENT

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

Presentation: Liabilities and equity



- Equity: Exchange of fixed amount of cash or FA for fixed number of its own shares
- Rights options and warrants to acquire fixed number of shares for fixed currency
- Derivative contracts for future receipt of own shares are ***not*** equity
- Puttable Instruments which are share in entity's net assets, subordinate to other classes, no exchange under unfavorable conditions, cash flow based on profit and loss and change in assets and no other instrument restricting residual return

- Liability : Preference Shares carrying fixed rate and are preferential in payment
- Puttable instruments, Open-ended mutual funds, unit trusts
- Settlement in the entity own equity instruments in variable no. of shares linked to a fixed amount or linked to variable like interest rate, commodity price.
- Settlement in the entity own equity instruments in fixed no. of shares linked to a variable cash or variable like interest rate, commodity price.
- Contingent settlement provisions would lead to financial liability

Presentation:Liabilities and equity

- Compound financial instrument: Convertible bond , its allocation is done as fair value of the instruments less fair value of liability and the residual is equity.
- Transaction costs relating to the above are allocated in the proportion of proceeds

- Treasury shares : They are deducted from equity. No gain or loss is recognised in profit and loss on acquisition

- Interest, dividends, losses and gains: Relating to FA or FL are recognised in P/L. Relating to distribution to equity holders debited to equity, net of tax effect.
- Transaction costs relating to equity are deducted from equity

Presentation:Offsetting a financial asset and a financial liability

- Currently has a legally enforceable right to set off and intends to settle on net basis or realise the assets and settle the liability simultaneously
- Master netting agreement provides net settlement only on default and hence in the general course, the assets and liability are not netted off.

Chapter 1 Objective

IND AS 109

1.1 The objective of this Standard is to establish principles for the financial reporting of *financial assets and financial liabilities that will* present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of an entity's future cash flows.

Chapter 3 Recognition

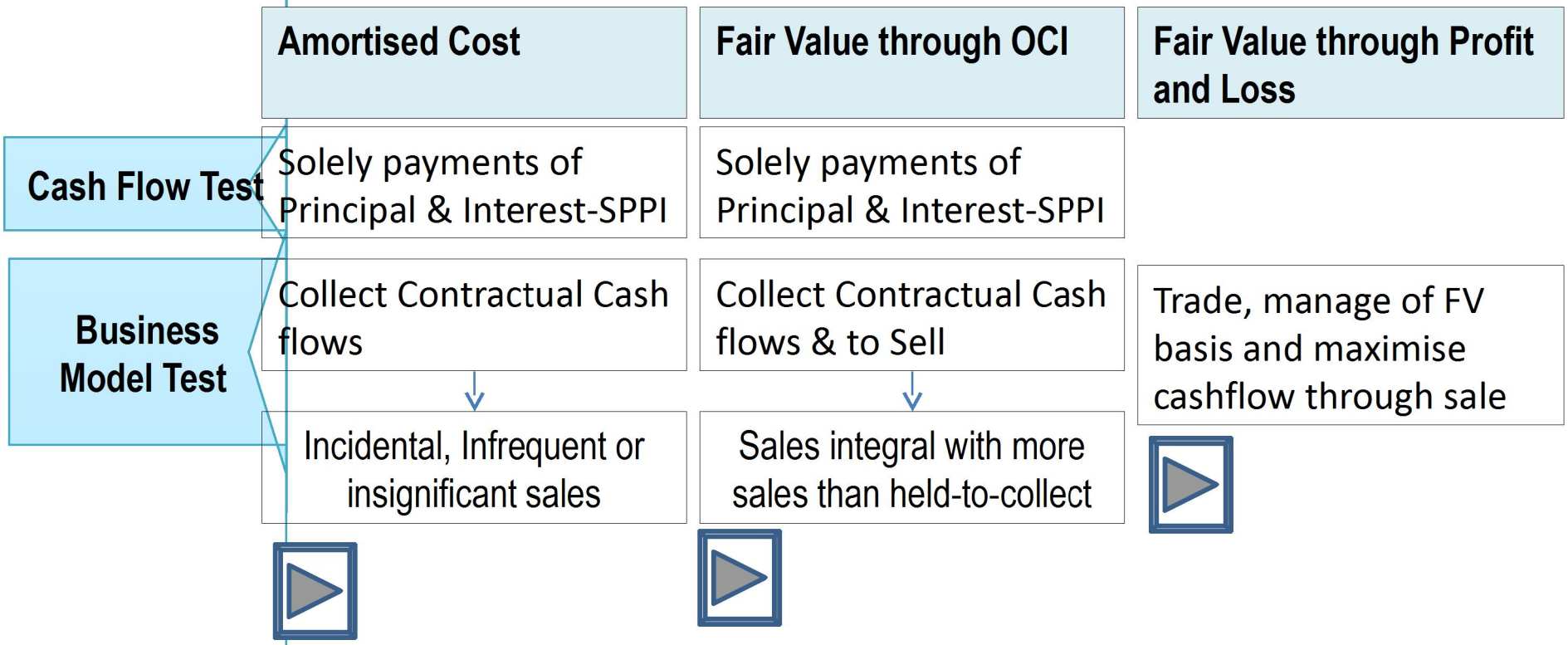
Recognition

Initial Recognition : All financial assets and financial liabilities, including derivatives, should be recognised on the balance sheet *at fair value* when the entity becomes party to the *contractual* provisions of financial instrument

Fair Value –
is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date

Chapter 4 – Classification

Financial Assets – Categories



Principal is the fair value of the financial asset at initial recognition
Interest consists of consideration for the time value of money, credit risk ,costs, as well as a profit margin.

Chapter 4 – Classification

Financial Assets – Consequences

At initial recognition, an entity shall measure trade receivables at their transaction price

Chapter 5: Measurement- Finan ts

	Amortised Cost	Fair Value through OCI	Fair Value through Profit and Loss
Initial Measurement	Fair Value + Transaction Costs	Fair Value	Fair Value
Subsequent Measurement	Amortised Cost using EIR	Fair Value	Fair Value
Gain / Loss	Profit or Loss	OCI	Profit or Loss
Impairment	Profit or Loss	Profit or Loss	Does not Applies
Interest revenue	Using EIR on gross outstanding	Using EIR on gross outstanding	Coupon rate on gross outstanding

Transaction costs include fees and commission paid to agents, advisers, brokers and dealers, levies by regulatory agencies and security exchanges, and transfer taxes and duties.

Ch. 5 Classification & Measurement

Initial Measurement

Subsequent Measurement

Gain / Loss

Compound financial liability needs to be assessed for separation

Derivatives

Derivatives are instruments with all three of the following characteristics

- Value changes in response to changes in specified underlying price/ index (e.g. interest rate, FX rate, share price)
- Requires no or little net investment
- Settled at a future date

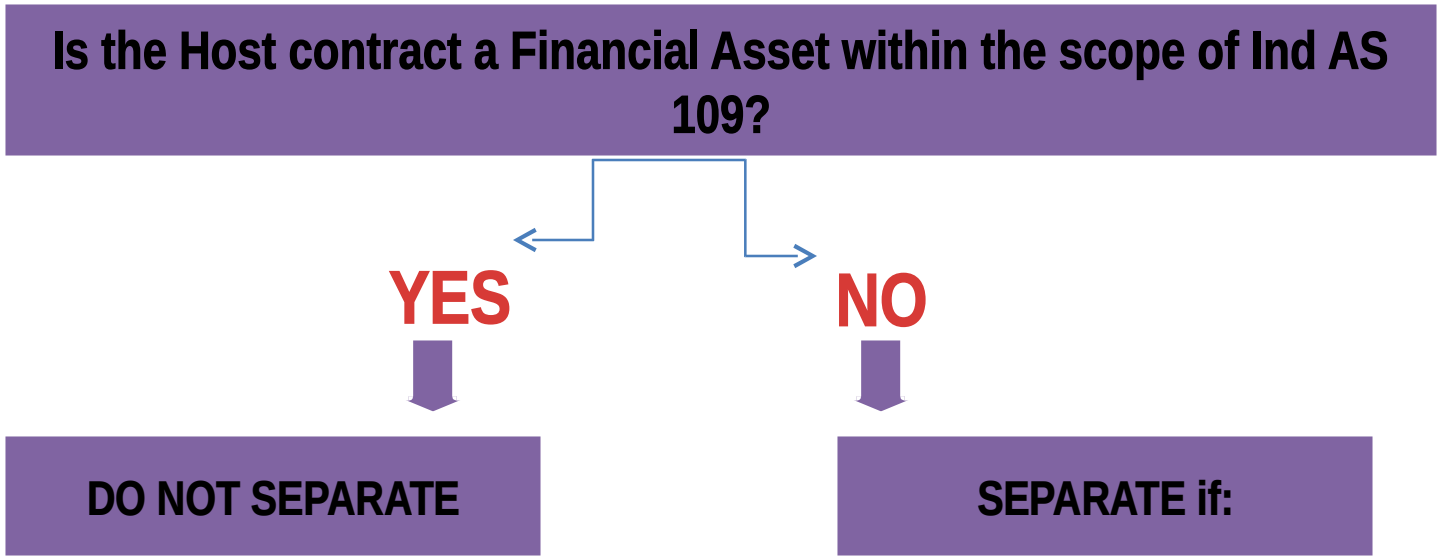
Examples of derivatives:

- Forward FX contract
- Interest rate swap
- Collar and Caps

Embedded Derivatives

- Component of hybrid (combined) instrument that includes a non- derivative “host contract” – with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand alone derivative.

Embedded Derivatives – Separation – Financial Assets

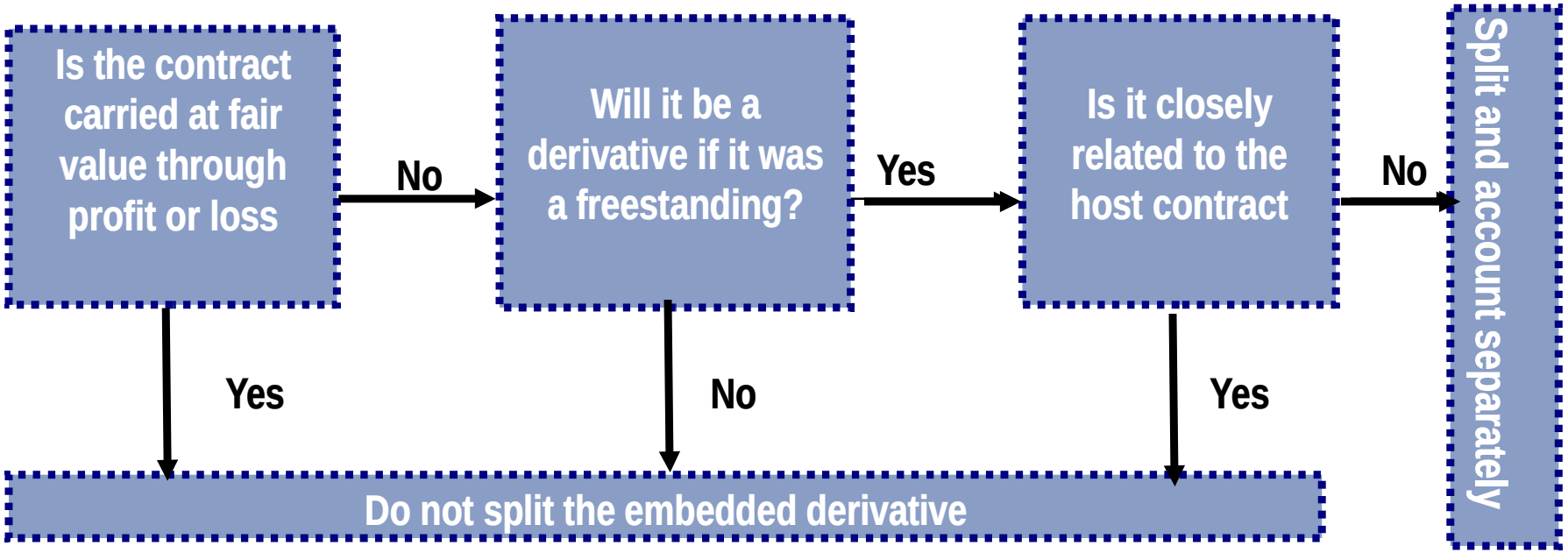


- Economic characteristics not closely related
- Separate instrument would meet the definition of derivative
- Hybrid instrument not classified as FV through P or L

Embedded Derivatives – Separation – Financial Liabilities

Whether an embedded derivative is required to be separated is assessed when the entity first enters into the contract. Subsequent reassessment is prohibited.

Conditions for separation:



Re-classification

When, and only when, an entity changes its business model for managing *financial assets* it shall reclassify all affected financial assets

Amortised Cost	Fair Value through OCI	Fair Value measured and difference to OCI
Amortised Cost	Fair Value through Profit and Loss	Fair Value measured and difference to P/L
Fair Value through OCI	Fair Value through Profit and Loss	Fair Value continues and Cumm gains into P/L
Fair Value through OCI	Amortised Cost	Fair Value measured and is adjusted with Cumm gains
Fair Value through Profit and Loss	Amortised Cost	Fair Value becomes new carrying cost
Fair Value through Profit and Loss	Fair Value through OCI	Fair Value continues

An entity shall not reclassify any *financial liability*.

Impairment

Scope

The following financial instruments are included within the scope of the impairment requirements in IFRS 9 *Financial Instruments:*

- Debt instruments measured at amortised cost, e.g. Trade receivables,
- Loans receivable from related parties or key management personnel,
- Deferred consideration receivable, and
- Intercompany loans in separate financial statements.
- Debt instruments that are measured at fair value through other comprehensive income (FVOCI)
- Loan commitments (except those measured at FVTPL)
- Financial guarantee contracts (except those measured at FVTPL)
- Lease receivables within the scope of IAS 17 *Leases*
- Contract assets within the scope of IFRS 15 *Revenue from Contracts with Customers*
- Receivables arising from transactions within the scope of IAS 18 *Revenue and IAS 11 Construction Contracts (if adoption of IFRS 9 is before the adoption of IFRS 15).*

Recognition of impairment (and interest revenue) is summarised

Stage	1	2	3
Recognition of Impairment	12-month expected credit losses	Life time expected credit losses	
Recognition of interest	Effective interest on the gross carrying amount		Effective int on the net carrying amt.

However as a practical expedient, a simplified model applies for:
Trade receivables with maturities of less than 12 months and
Other long term trade and lease receivables

In estimating expected credit losses, entities must consider a range of possible outcomes and not the 'most likely' outcome. The standard requires that at a minimum, entities must consider the probability that:
A credit loss occurs and
No credit loss occurs.

General Impairment model

Recognition of impairment – 12-month expected credit losses

12-month expected credit losses are calculated by multiplying the probability of a default occurring in the next 12 months with the total (lifetime) expected credit losses that would result from that default, regardless of when those losses occur. **Stage 1.**

Recognition of impairment – Lifetime expected credit losses

Lifetime expected credit losses are the present value of expected credit losses that arise if a borrower defaults on its obligation at any point throughout the term of a lender's financial asset.

Determining significant increases in credit risk and credit-impaired financial assets

The transition from recognising 12-month expected credit losses (i.e. **Stage 1) to lifetime expected credit losses (i.e. Stage 2) in IFRS 9 is based on the notion of a significant increase in credit risk over the remaining life of the instrument in comparison with the credit risk on initial recognition.**

A significant increase in credit risk (moving from **Stage 1 to Stage 2) can include:**

- Changes in general economic and/or market conditions (e.g. expected increase in unemployment rates, interest rates)
- Significant changes in the operating results or financial position of the borrower
- Changes in the amount of financial support available to an entity (e.g. from its parent)
- Expected or potential breaches of covenants
- Expected delay in payment (Note: Actual payment delay may not arise until after there has been a significant increase in credit risk).

General impairment model

Credit-impaired financial assets are those for which one or more events that have a detrimental effect on the estimated future cash flows have already occurred. This is equivalent to the point at which an incurred loss would have been recognised under IAS 39. These financial assets would be in **Stage 3 and lifetime expected losses would be recognised. Indicators that an asset is credit-impaired would include observable data about the following events:**

- Actual breach of contract (e.g. default or delinquency in payments)
- Granting of a concession to the borrower due to the borrower's financial difficulty

Simplified impairment model

Trade receivables and contract assets without significant financing component

For trade receivables and contract assets that do not contain a significant financing component in accordance with IFRS 15 (so generally trade receivables and contract assets with a maturity of 12 months or less), 'lifetime expected credit losses' are recognised. Because the maturities will typically be 12 months or less, the credit loss for 12-month and lifetime expected credit losses would be the same.

The new impairment model allows entities to calculate expected credit losses on trade receivables using a provision matrix. Under the new model, entities will need to update their historical provision rates with current and forward looking estimates. A similar approach might be followed for contract assets.

Company M has trade receivables of CU30 million at 31 December 20X4. The customer base consists of a large number of small clients. In order to determine the expected credit losses for the portfolio, Company M uses a provision matrix. The provision matrix is based on its historical observed default rates, adjusted for forward looking estimates. At every reporting date, the historical observed default rates are updated. Company M estimates the following provision matrix at 31 December 20X4:

	Expected default rate	**Gross carrying amount**	**Credit loss allowance (Default rate x Gross carrying amount)**
Current	0.3%	CU15,000,000	CU45,000
1-30 days past due	1.6%	CU7,500,000	CU120,000
31-60 days past due	3.6%	CU4,000,000	CU144,000
61-90 days past due	6.6%	CU2,500,000	CU165,000
More than 90 days past due	10.6%	CU1,000,000	CU106,000
		CU30,000,000	**CU580,000**

Chapter 3 Derecognition

An entity shall derecognise a ***financial asset*** when, and only when:
(a) the contractual rights to the cash flows from the financial asset expire, or
(b) it transfers the financial asset that qualifies for derecognition
(c) retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement
Further "When an entity transfers a financial asset it shall evaluate the extent to which it retains the risks and rewards of ownership of the financial asset"

On derecognition of a financial asset in its entirety, the difference between:
(a) the carrying amount (measured at the date of derecognition) and
(b) the consideration received shall be ***recognised in profit or loss.****

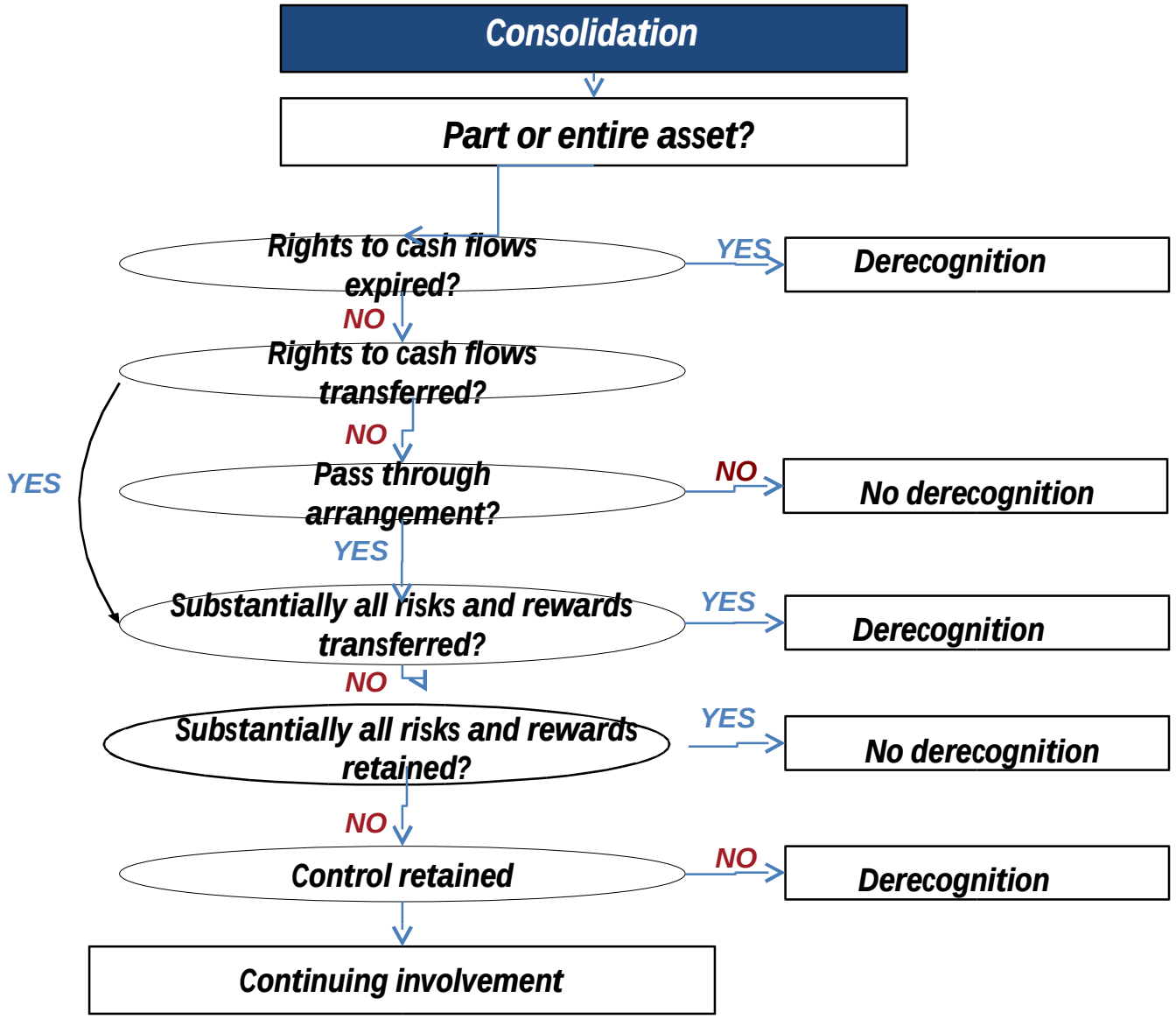
An entity shall remove a ***financial liability*** (or a part of a financial liability) from its balance sheet when, and only when, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires.

The difference between the carrying amount of a financial liability extinguished or transferred to another party and the consideration paid, shall be ***recognised in profit or loss..***

Ch. 3 - Derecognition: Securitisation

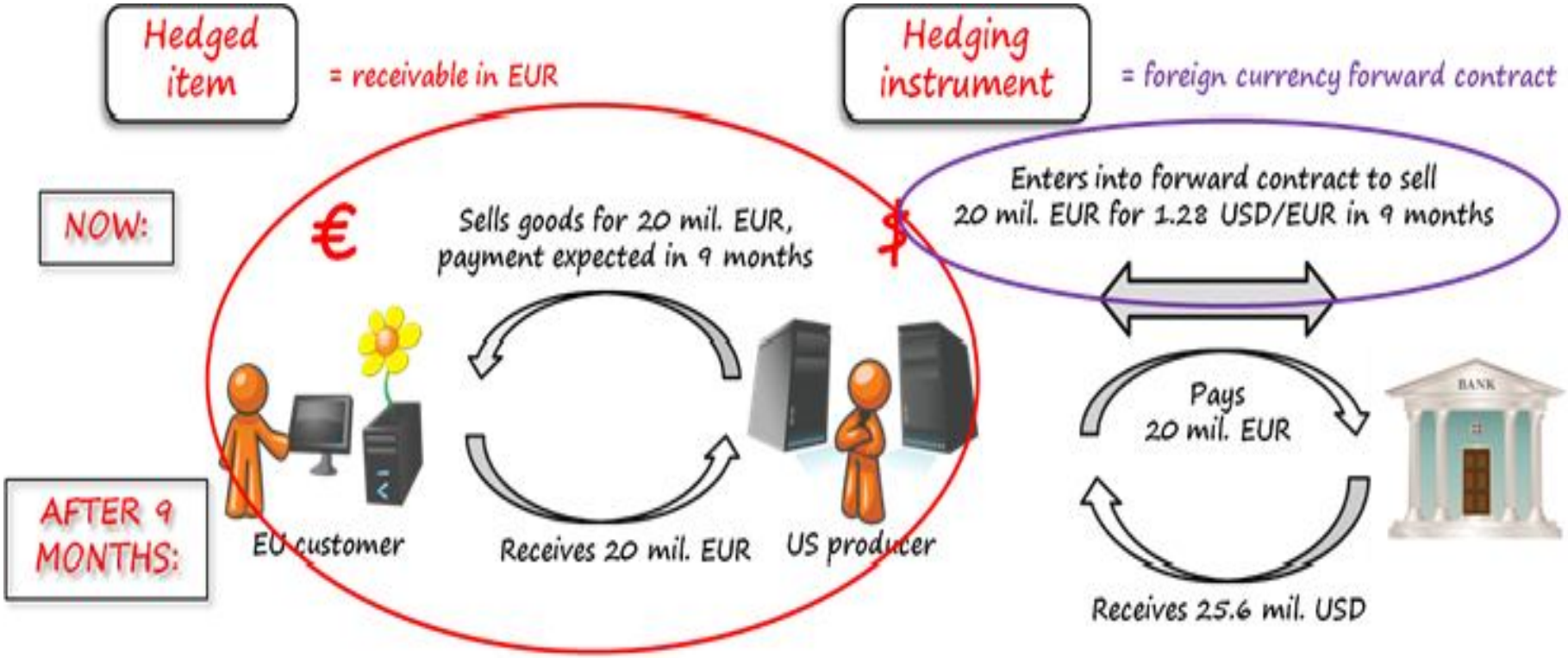
SECURITISATION

- A securitisation is a transaction that transforms a financial asset(s) into securities
- Intent is often to achieve derecognition of the financial assets securitized
- Securitised assets often are transferred to a special purpose entity (SPE)



Ch. 6 – Hedge accounting

What's a Hedge?



Hedge Accounting : Accounting mismatch

Hedge Models

Fair value hedge	Cash flow hedge	Hedge of a net investment in a foreign operation
Risk= exposure to changes in fair value	Risk = Variability in cash flows	Risk = Change in FV or cash Flows of foreign operation
Change in fair value of hedging instrument and adjustment to hedged item in Profit & Loss	Hedging instruments change in fair value Effective portion=OCI & Ineffective portion=P/L	Hedging instruments change in fair value Effective portion=OCI & Ineffective portion=P/L
	Portion of Cash flow reserve classified to P/L when hedged item cash flow occurs	

Qualifying Criteria for Hedge Accounting

- the hedging relationship consists only of eligible hedging instruments and eligible hedged items.
- at the inception there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. (how it determines the *hedge ratio).*
- the hedging relationship meets all of the following hedge effectiveness requirements:

(i) there is an economic relationship between the hedged item and the hedging instrument (ii) the effect of credit risk does not dominate the value changes that result from that economic relationship and (iii) the hedge ratio of the hedging relationship is the same as actual

Hedged items & Hedging instruments

Hedged items

Risk components as hedged items

- Risk components of financial items are already eligible hedged items.
- However, this does not extend to non-financial items, for which only a foreign exchange component can be separated.
- To be an eligible risk component, the risk component needs to be separately identifiable and reliably measurable. The eligible risk component can be contractually or non-contractually specified
- An unrecognised firm commitment
- A highly probable forecast transaction
- A net investment in a foreign operation

Hedging instruments

Under IFRS 9, new guidance was added in relation to the use of hedging instruments with the aim of further aligning hedge accounting with the internal risk management. In a major change to IAS 39, certain components of hedging instruments are treated as a 'cost of a hedging' and may be deferred or amortised.

Example are:

- Time value component of options
- Time value component of zero-cost collars
- Forward point component of forwards
- Foreign-currency basis spread for foreign currency swaps

Effectiveness Test: Prospective & Retrospective

Effectiveness Test: Critical Comparison Test

- Comparing the critical terms of the hedging instrument with those of the hedged item.
- Hedge relationship is expected to be highly effective where all the principal terms of the hedging instrument and the hedged item match exactly – for example, notional and principal amounts, credit risk (AA), term, pricing, re-pricing dates (aligned to test date), timing, quantum and currency of cash flows – and there are no features (such as optionality) that would invalidate an assumption of perfect effectiveness.
- Does not require any calculations.
- May only be used in the limited cases, but in such cases it is the simplest way to demonstrate that a hedge is expected to be highly effective (prospective effectiveness testing).

Effectiveness Test: Dollar Offset Method

Effectiveness Test: Regression Analysis

Discontinuation of Hedge Accounting

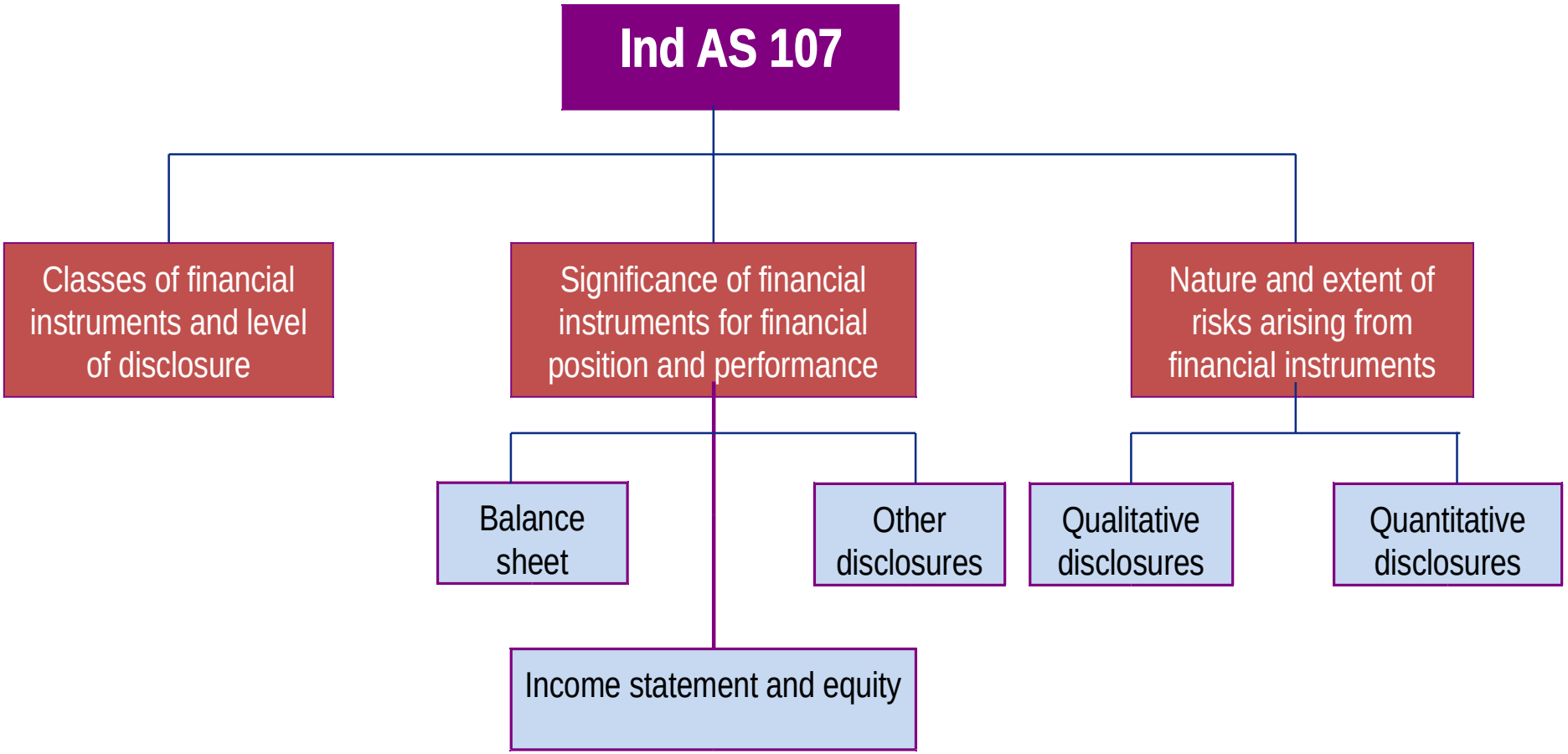
Hedge accounting must be discontinued prospectively if:

- The hedging instrument expires or is sold, terminated or exercised
- The hedge no longer meets the criteria for hedge accounting (e.g. forecast transaction no longer highly probable)
- The entity revokes the designation

Disclosures: Ind AS 107

Scope

Overall Structure



Ind AS 107 - Disclosures

- Credit risk exposure alongwith the mitigants like credit derivatives
- Change in the credit risk of the loan portfolio and also change in fair value of the credit derivatives
- Re-classification of assets from one class to another
- Assets which do not qualify for de-recognition
- Financial Assets pledged as securities
- Compound financial instruments with multiple embedded derivatives
- Defaults and breaches on loans
- Hedge accounting: a description of each type of hedge; a description of the financial instruments designated as hedging instruments; the nature of the risks being hedged.
- Cashflow hedge: period of hedge, OCI disclosures
- Fair value hierarchy: Level 1, Level 2, Level 3 assets
- Qualitative and Quantitative disclosure about Credit Risk, Liquidity Risk, Market Risk,

Thank you

Which of these of FA and FL

Trade receivable	Property
Trade payable	Patents
Loan receivable	Trademarks
Loan payable	Interest receivable
Currency	Interest payable
Bank FD	Perpetual debt
Finance lease	Contingent asset
Gold	Contingent liability
Prepaid expenses	Preference Shares
Advance tax	Purchased Call Option
Operating lease	Warrants on equity shares
Inventory	Written Call Option

Financial Instruments Standards

Presentation: Compound Instrument

- Entity A issues 2000 bonds convertible into its own shares in 3 years. The bonds are issued at par with a face value of INR 1000/- per bond. Interest is payable annually at nominal interest at 6% p.a. Each bond is convertible at anytime up to maturity in 250 equity shares. When bonds are issued the prevailing market interest rate for similar debt without conversion options is 9% p.a.
- **Solution:**

  Under this approach, the liability element is valued first, and the difference between the proceeds of the bond issue and the fair value of the liability is assigned to the equity component. The present value of the liability component is calculated using a discount rate of 9%, the market rate for similar bonds with no conversion rights.

- PV of the principal 2000,000/- payable at the end of 3 yrs 1544367

  PV of the interest 6,000/- payable annually for 3 years 303755

  Total Liability Component 1848122

- Proceeds of the Bond 2000,000

- Equity component (bal. fig) 151878

  =======

- Discounting factor @ 9%
  1 year 0.917
  2 year 0.842
  3 year 0.772

Chapter 2 Scope

A number of financial assets and liabilities are scoped out of IFRS 9 *Financial Instruments. These, together with the accounting standards that apply to them, are as follows:*	
Interests in subsidiaries	IND AS 110
Interests in associates and joint ventures	IND AS 27/28
Employer's rights and obligations under employee benefit plans	IND AS 19
Insurance contracts (except embedded derivatives and some financial guarantee contracts)	IND AS 104
Financial instruments with discretionary participation features	IND AS 104
Share-based Payments	IND AS 102
Rights and obligations under leases	IND AS 17
An entity's own equity instruments	IND AS 32
Financial liabilities issued by an entity that are classified as equity in accordance with IND AS 32:16A to D	IND AS 32

Chapter 2 Scope

A number of financial assets and liabilities are scoped out of IFRS 9 *Financial Instruments. These, together with the accounting standards that apply to them, are as follows:*	
Forward contracts between an acquirer and selling shareholder for a transaction that meets the definition of a business combination	IND AS 103
Loan commitments, other than for the IFRS 9 requirements for impairment and derecogniton (except those which are designated at FVTPL, can be settled net or represent a commitment to provide a loan at a below-market interest rate which are in the scope of IFRS 9 in its entirety).	-
Reimbursement rights for provisions	IND AS 37
Financial instruments that represent rights and obligations within the scope of IND AS 115 *Revenue from Contracts with Customers, except those which IND AS 115 specifies are accounted for in accordance with IND AS 109*	IND AS 115

Chapter 2 Scope

- In addition, certain contracts to buy or sell a non-financial item (such as a commodity, motor vehicles or aircraft) may be required to be accounted for in accordance with IFRS 9. Although non-financial items fall outside the scope of IFRS 9, if those contracts can be settled net in cash, then they are within the scope of IFRS 9 (subject to an exception).
- A number of different ways exist in which a contract to buy or sell a non-financial item can be settled net. These include:
  - The contractual terms permit net settlement
  - The ability to settle net is not explicit in the contract, but the entity has a practice of settling similar contracts net
  - For similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period to generate a profit or dealer's margin
  - The non-financial item is readily convertible to cash.
- The exception is where, despite the ability to settle net, the entity meets what is termed the 'own use' exemption. This applies where the purpose of entering into the contract is to meet the entity's expected purchase, sale or usage requirements.

Ch. 4 Finanical Asset Classification

Amortised cost

A financial asset is classified as subsequently measured at amortised cost if it meets both of the following criteria:

'Hold-to-collect' business model test – The asset is held within a business model whose objective is to hold the financial asset in order to collect contractual cash flows; and

'SPPI' contractual cash flow characteristics test – The contractual terms of the financial asset give rise to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding on a specified date.

Examples of sales that would not contradict holding financial assets to collect contractual cash flows include:

–Selling the financial asset close to its maturity (meaning that there is little difference between the fair value of the remaining contractual cash flows and the cash flows arising from sale),

–Selling the financial asset to realise cash to deal with an unforeseen need for liquidity,

–Selling the financial asset as a result of changes in tax laws,

–Selling the financial asset due to significant internal restructuring or business combinations; or

–Selling the financial asset due to concerns about the collectability of the contractual cash flows (i.e. increase in credit risk).

Chapter 4 Finanical Asset Classification -Amortised cost

Eg 1: 'Hold-to collect' business model Entity A sold one of its diverse business operations and currently has Rs 10 million of cash. It has not yet found another suitable investment opportunity in which to invest those funds so it buys short dated (6 month maturity) high quality government bonds in order to generate interest income. It is not considered likely but, if a suitable investment opportunity arises before the maturity date, the entity will sell the bonds and use the proceeds for the acquisition of a business operation. Otherwise it will hold the bonds to their maturity date. Question: Is the 'hold-to-collect' business model test met?

Eg 2 : SPPI test for loan with zero interest and no fixed repayment terms Parent A provides a loan to Subsidiary B. The loan is classified as a current liability in Subsidiary B's financial statements and has the following terms:
––No interest ––No fixed repayment terms ––Repayable on demand of Parent A.
Question: Does the loan meet the 'SPPI' contractual cash flows characteristic test?

Eg 3 : SPPI test for loan with zero interest repayable in five years Parent A provides a loan of Rs 10 million to Subsidiary B. The loan has the following terms:
––No interest ––Repayable in five years.
Question: Does the loan meet the 'SPPI' contractual cash flows characteristic test?

Chapter 4 Finanical Asset Classification -Amortised cost

Eg 4 – SPPI test for a loan with interest rate cap Entity B lends Entity C Rs 5 million for five years, subject to the following terms: ––Interest is based on the prevailing variable market interest rate ––Variable interest rate is capped at 8% ––Repayable in five years.
Question: Does the loan meet the SPPI contractual cash flows characteristic test?

Eg 5 – SPPI test for loan with profit linked element Entity D lends Entity E Rs 500 million for five years at an interest rates of 5%. Entity E is a property developer that will use the funds to buy a piece of land and construct residential apartments for sale. In addition to the 5% interest, Entity D will be entitled to an additional 10% of the final net profits from the project.
Question: Does the loan meet the 'SPPI' contractual cash flows characteristic test?

Eg 6 – SPPI test for loan with prepayment option Entity D lends Entity E Rs 5 million at a fixed interest rate. The loan is repayable in 5 years. Entity E has the option to repay the loan at any time at Rs 5 million plus any accrued interest plus a prepayment penalty fee of 2.5% which reduces by 0.5% for each complete period of one year during which the loan has been outstanding.
Question: Does the loan meet the 'SPPI' contractual cash flows characteristic test?

Chapter 4 Finanical Asset Classification -Amortised cost

Eg 7 – SPPI test: Modified time value of money Entity B invests in a variable interest rate bond that matures in five years. The variable interest is reset every six months to a 5 year rate. At the time of initial investment, the 6 month interest rate is not significantly different to the 5 year rate.
Question: Can Entity B conclude that the modification is not significant without any additional analysis?

Eg 8 – SPPI test for loan with extension option (with rate reset) Company K lends Company L Rs 10 million at a fixed market interest rate. The loan is repayable in 5 years. Company L has the right to extend the term for another 3 years. If Company L decides to extend the loan, a variable market interest rate will be charged from year 6 to 8.
Question: Does the loan meet the 'SPPI' contractual cash flows characteristic test?

Eg 9 – SPPI test for loan with extension option (with no rate reset) Company M lends Company N Rs 10 million at a fixed market interest rate of 5%. The loan is repayable in 5 years. Company N has the right to extend the term for another 3 years at the original fixed interest rate of 5%.
Question: Does the loan meet the 'SPPI' contractual cash flows characteristic test during the extension period?

Chapter 4 Finanical Asset Classification -Amortised cost

Eg 10 – SPPI test for loan with interest rate reset Company I lends Company J Rs 5 million at a fixed interest rate of 8%. The loan is repayable in five years. If Company J misses two interest payments, the interest rate is reset to 15%.
Question: Does the loan meet the 'SPPI' contractual cash flows characteristic test?

Eg 11 – SPPI test for convertible note
Question: Does an investment in a convertible note that converts into equity instruments of the issuer meet the 'SPPI' contractual cash flows characteristic test?

Eg 12 – SPPI test for commodity linked note Question: Does an investment in a bond with contractual interest payments linked to a commodity price (e.g. the price of gold, copper etc.) meet the 'SPPI' contractual cash flows characteristic test?

Eg 13 – SPPI test for deferred consideration receivable in a business combination Company O sold one of its subsidiaries to Company P. The purchase consideration consists of a deferred payment of Rs 10 million payable in two years.

Chapter 4 Debt instruments at FVOCI

A financial asset is measured at fair value through other comprehensive income (FVOCI) under IFRS 9 if it meets both of the following criteria:
‘Hold-to-collect and sell’ business model test: The asset is held within a business model whose objective is achieved by both holding the financial asset in order to collect contractual cash flows and selling the financial asset, and
‘SPPI’ contractual cash flow characteristics test: The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding

This business model typically involves greater frequency and volume of sales than the ‘hold-to-collect’ business model discussed. Integral to this business model is an intention to sell the instrument before the investment matures.
Examples of financial instruments that may be classified and accounted for at FVOCI :
Investments in government bonds where the investment period is likely to be shorter than maturity
Investments in corporate bonds where the investment period is likely to be shorter than maturity.

It is unlikely that intercompany loans or trade receivables would be classified in the FVOCI category.

Chapter 4 Debt instruments at FVOCI

The accounting requirements for debt instruments classified as FVOCI are:
Interest income is recognised in profit or loss using the effective interest rate method that is applied to financial assets measured at amortised cost
Credit impairment losses/reversals are recognised in profit or loss using the same credit impairment methodology as for financial assets measured at amortised cost
Other changes in the carrying amount on remeasurement to fair value are recognised in OCI
The cumulative fair value gain or loss recognised in OCI is recycled from OCI to profit or loss when the related financial asset is derecognised.

Eg 15 – FVOCI for debt instruments On 1.1.20X1 a financial asset is purchased at its face value of Rs 1,000. The contractual term is ten years with an annual coupon of 6%. Expected credit losses as determined under the impairment model are Rs 20. On 31.12.20X1 the fair value of the financial asset decreases to Rs 950. Expected losses increase by Rs 10 to Rs 30. A coupon payment is received. On 1.1.20X2 the financial asset is sold for Rs 950.
Question: What are the journal entries on initial recognition, 31.12.20X1 and 1.1.20X2 under the FVOCI category?

Chapter 4 Equity investments at FVOCI

IFRS 9 requires all equity investments to be measured at fair value. The default approach is for all changes in fair value to be recognised in profit or loss.
However, for equity investments that are not held for trading, entities can make an irrevocable election at initial recognition to classify the instruments as at FVOCI, with all subsequent changes in fair value being recognised in other comprehensive income (OCI). This election is available for each separate investment.
Under this new FVOCI category, fair value changes are recognised in OCI while dividends are recognised in profit or loss.
On disposal of the investment the cumulative change in fair value is required to remain in OCI and is not recycled to profit or loss.

Eg 16 – Equity investments classified at FVOCI Entity X has a 31 December financial year end and pays tax at a rate of 30%. It prepares financial statements on an annual basis. On 1 January 20X3, Entity X acquires 100 shares of List Co for Rs 10,000. What are the journal entry at 1 January 20X3**.** On 31 December 20X3, the fair value of the 100 shares in List Co has declined to Rs 8,000. What are the journal entries at 31 December 20X3. On 31 March 20X4, Entity X receives a cash dividend of Rs 500. What are the journal entry at 31 March 20X4. On 31 December 20X4, the fair value of the 100 shares in List Co is Rs 13,000 and Entity X decides to dispose of the entire investment. What are the journal entries.

Financial instruments at FVTPL

Fair value through profit or loss (FVTPL) is the residual category in IFRS 9. A financial asset is classified and measured at FVTPL if the financial asset is:

A held-for-trading financial asset

A debt instrument that does not qualify to be measured at amortised cost or FVOCI

An equity investment which the entity has not elected to classify as at FVOCI

A financial asset where the entity has elected to measure the asset at FVTPL under the fair value option (FVO).

Examples of financial instruments that are likely to fall under the FVTPL category include:

Investments in shares of listed companies that the entity has not elected to account for as at FVOCI

Derivatives that have not been designated in a hedging relationship, e.g.: Interest rate swaps , Commodity futures/option contracts , Foreign exchange futures/option contracts

Investments in convertible notes, commodity linked bonds

Contingent consideration receivable from the sale of a business.

Hybrid contracts containing embedded derivatives

A hybrid contract is a financial instrument that contains both a non-derivative host contract and an embedded derivative.

In order to simplify the accounting, IFRS 9 has eliminated the requirement to separately account for embedded derivatives for financial assets. Instead, IFRS 9 requires entities to assess the hybrid contract as a whole for classification. If the terms of the hybrid contract still meet the criteria for subsequent measurement at amortised cost or FVOCI for debt instruments then it is accounted for at amortised cost or FVOCI, otherwise it is measured at FVTPL.

However, the existing requirements for embedded derivatives still apply to financial liabilities, and to contracts for assets that are not within the scope of IFRS 9.

FINANCIAL LIABILITIES – CLASSIFICATION

The classification and measurement of financial liabilities in accordance with IFRS 9 *Financial Instruments* remains largely unchanged from IAS 39 *Financial Instruments: Recognition and Measurement.*

Financial liabilities are either classified as:

Financial liabilities at amortised cost; or

Financial liabilities as at fair value through profit or loss (FVTPL).

Financial liabilities are measured at amortised cost unless either:

The financial liability is held for trading and is therefore required to be measured at FVTPL (e.g. derivatives not designated in a hedging relationship), or

The entity elects to measure the financial liability at FVTPL (using the fair value option).

In contrast to financial assets, the existing requirements in IAS 39 for the separation of embedded derivatives have been continued for financial liabilities, meaning that financial liabilities to be measured at amortised cost would still need to be analysed to determine whether they contain any embedded derivatives that are required to be accounted for separately at FVTPL.

Chapter 4 - FINANCIAL LIABILITIES - eg

Amortised Cost

--**Trade payables**
--**Loan payables with standard interest rates (such as a benchmark rate plus a margin) or the host contract arising from a loan agreement which contains separable embedded derivatives**
--Bank borrowings

FVTPL

--Interest rate swaps (not designated in a hedging relationship)
--Commodity futures/option contracts (not designated in a hedging relationship)
--Foreign exchange future/option contracts (not designated in a hedging relationship)
--Convertible note liabilities designated at FVTPL
--**Contingent consideration payable that arises from one or more business combinations.**

Amortised Cost & Effective Int Rate

Amortised cost =	Initial recognition amount -	Principal repayments -/+	Cummulative amortisation for diff in maturity -	Impairment reduction

Amortisation is calculated using the **effective interest rate** method.

The **effective interest rate** is defined as “the rate that exactly discounts expected stream of future cash flows through the **expected life** of the financial instrument or, where appropriate, a shorter period to the net carrying amount of the financial asset or financial liability (the next market based re-pricing date to the net carrying amount)”.

Zero Coupon Bond

Radia & Raja Ltd. issued a zero coupon bond of par value 100 at 68; maturity 5 years.				
Years	Cash flows	Interest	Amortized Cost	Journal Entry
0	68		68	Bank A/c Dr 68 Zero Coupon Bond A/c 68
1	0	5.453	73.4526	
2	0	5.89	79.3424	
3	0	6.362	85.7045	
4	0	6.872	92.5767	
5	-100	7.423	100	
IRR	8.02%			

Embedded Derivative: Example

- **Subordinated loan with equity kicker**

IStaR bank has granted a 20 year subordinated loan of ` 100 million to a start – up company at 7% which is below the market yield. As per the loan agreement, the borrower company shall issue 1% of its equity shares outstanding on the date of listing at 70% of the listing price apart from annual payment of interest and repayment of principal. Is the equity kicker an embedded derivative?

Analysis – It is an embedded derivative, because the host contract is a debt instrument and it is an option based derivative to exercise for 1% of equity shares of the borrower company at a strike price. The option can be valued based on current valuation of equity . It should be segregated from the host contract.

Embedded Derivative: Example

Question 1

A German company agrees to sell and deliver its produced cars to a car retailer in Uzbekistan in two months time. The contract is denominated in USD. USD is the commonly used currency in Uzbekistan for transactions of this kind since the local currency is relatively unstable. Does the contract contain an embedded derivative that should be separated?

Question 2

A Norwegian company agrees to sell oil to a company in France. The oil contract is denominated in Swiss francs (oil contracts are routinely denominated in US dollars in international commerce). The functional currency of the Norwegian company is Norwegian kroner and that the functional currency of the French company is Euro. Is there an embedded derivative that should be separated ?

Embedded Derivative: Example

Solution 1

No. The contract will not contain an embedded derivative that needs to be separated out under the Standard. This is because (of the assumption that) sales of cars and other durables in Uzbekistan are commonly denominated in USD (as a relatively stable and liquid) due to the country's own currency being unstable

Solution 2

Yes. The Norwegian company regards the supply contract as a host contract in Norwegian kroner with an embedded foreign currency forward to sell Norwegian kroner and purchase Swiss francs. The French company regards the supply contract as a host contract with an embedded foreign currency forward to sell Swiss francs and purchase Euro

Embedded Derivative: Example

Question 3

A manufacturer enters into a long-term contract to purchase a specified quantity of a commodity from a supplier. In future periods, the supplier will provide the commodity at the current market price but within a specified range, for example, the purchase price may not exceed 120 per unit or fall below 100 per unit. The current market price at the inception of the contract is 110 per unit. Is there an embedded derivative, which would require separation?

Question 4

Company A issues a debt instrument on which it pays interest indexed to the price of gold. Is there an embedded derivative that should be separated and accounted for as a derivative?

Embedded Derivative: Example

Solution 3

No. From the manufacturer's perspective, the price limits specified in the purchase contract can be viewed as a purchased call on the commodity with a strike price of 120 per unit (a cap) and a written put on the commodity with a strike price of 100 per unit (a floor). At inception, both the cap and floor on the purchase price are out of the money. Therefore, they are considered closely related to the host purchase contract and are not separately recognised as embedded derivatives

Solution 4

Yes. According to the Standard, a commodity-indexed interest would not be considered closely related to a host debt instrument. Therefore, Company A separates the embedded derivative, a forward indexed to the price of gold, from the host debt instrument and measures the derivative at fair value

Case Study 1: Hedge Accounting

- IStaR Bank issues $100m of debt at a fixed interest rate e.g. at 8%. To avoid a mismatch between the interest it pays for funding and the floating interest rate it receives on loans, the bank takes out an interest rate swap. The swap has the affect of IStaR paying a floating rate of interest on the issued debt, say at 11% instead of the 8% fixed (IStaR continues to pay fixed interest to the debt holders, but receives fixed interest from, and pays floating to, the swap counterparty)

- **Impact on financials:**

When the interest on debt increases leading to decrease in the carrying amount of the debt by $10m. This has equal corresponding effect on notional amount of swap.

Financial Instruments Standards

		Hedge Accounting	Normal Accounting
BALANCE SHEET		**USD Mio**	**USD Mio**
Derivative Asset / (Liability)		(13)	(13)
Issued Debt		(100)	(100)
Fair value adjustment to Issued debt (increase) / decrease		10	Nil
Net issued debt Liability		**(90)**	**(100)**
P & L ACCOUNT			
Net Interest Income	COUPON	(8)	(8)
	SWAP ACCRUAL	(3)	0
	NET	**(11)**	**(8)**
Trading Income	SWAP MTM	(10)	(13)
	ISSUED DEBT FV ADJUSTMENT	10	NIL
NET PROFIT AND LOSS		**(11)**	**(21)**

Forward Contract Accounting

Purchase of Buy USD - Sell INR forward contract (Assume Incremental Borrowing rate @ 6% or alternatively use WACC)					
		Forward	**Spot**		
Forecast purchase $ 10000					
1.10.2010		45.6	45.20		6 month
31.12.2010		45.5	45.10		3 month
31.3.2011			45.00		0 month
	Journal Entries				
1.10.2010	Entry with zero amount		Discounted	Undiscounted	
31.12.2010	Unrealized P & L A/c Dr	985.22	-985.22	-1,000	
	Forward Liability Cr	985.22			
31.3.2011	Unrealized P & L A/c Dr	5,014.78	-	-6,000	
	Forward Liability	5,014.78			
31.3.2011	Purchases Dr	4,50,000			
	To Bank	4,50,000			

Example 15 – FVOCI for debt instruments

On 1.1.20X1 a financial asset is purchased at its face value of CU1,000. The contractual term is ten years with an annual coupon of 6%. Expected credit losses as determined under the impairment model are CU20.
On 31.12.20X1 the fair value of the financial asset decreases to CU950. Expected losses increase by CU10 to CU30. A coupon payment is received.
On 1.1.20X2 the financial asset is sold for CU950.
Question: What are the journal entries on initial recognition, 31.12.20X1 and 1.1.20X2 under the FVOCI category?
Answer:

1.1.20X1

Dr	Financial asset		CU	1,000		
	Cr	Cash			CU	1,000
Dr	Impairment loss (P&L)		CU	20		
	Cr	OCI (loss allowance)			CU	20

Being the initial recognition of the financial asset at FVOCI and the recognition of the initial impairment allowance in OCI.

31.12.20X1

Dr	Cash		CU	60		
	Cr	Interest income			CU	60
Dr	Impairment loss (P&L)		CU	10		
Dr	OCI (of which CU20 loss allowance)		CU	40		
	Cr	Financial asset			CU	50

Being the receipt of the coupon payment, recognition of an additional CU10 impairment loss and the change in fair value of the financial asset.

1.1.20X2

Dr	Cash		CU	950		
	Cr	Financial asset			CU	950
Dr	Loss on sale (P&L)		CU	20		
Cr	OCI				CU	20

Being the sale of the financial asset and recognition of the loss on sale.

Example 21 – Calculating the effective interest rate

Entity A acquires a debt instrument with a nominal value of CU100 at the beginning of year 20X1 for CU90. Transaction costs in relation to the acquisition are CU8. The instrument bears a 5% coupon, which is paid out annually. The instrument matures in five years at the end of 20X5. Entity A accounts for the debt instrument at amortised cost.

Question: How does entity A calculate the effective interest rate? Answer: The internal rate of return (IRR) of the cash flows is the interest rate that discounts the expected cash flows to the initial carrying amount of CU98. The IRR is calculated using the following formula:

$$\frac{CU5}{1.0547} + \frac{CU5}{1.0547^2} + \frac{CU5}{1.0547^3} + \frac{CU5}{1.0547^4} + \frac{CU105}{1.0547^5} = CU98$$

Year	Carrying amount at 1.1	Effective interest (5.47%)	Cash flow	Carrying amount at 31.12
20X1	CU98.00	CU5.36	(CU5.00)	CU98.36
20X2	CU98.36	CU5.38	(CU5.00)	CU98.74
20X3	CU98.74	CU5.40	(CU5.00)	CU99.14
20X4	CU99.14	CU5.42	(CU5.00)	CU99.56
20X5	CU99.56	CU5.44	(CU105.00)	CU0.00

Cashflow hedge on a net basis

An entity having the CAD as functional currency anticipates sales of GBP100m in 12 months and also plans a major capital expenditure (fixed assets) of GBP80m in 12 months. The anticipated sales and capital expenditure (i.e., the group) are designated as hedged items and the resulting net position is hedged with a forward contract to sell GBP20m in 12 months. The fixed assets will be depreciated on a straight-line basis over eight years. For simplicity, assumethe spot rate equals the forward rate.
The GBP/CAD spot rates are:
At inception of the hedge (beginning of year 1) 1.50
After 12 months (end of year 1) 1.60
The entity would record the following journal entries:
Year 1
(Amounts in millions)
Other comprehensive income CAD2
Hedging derivative CAD2
To account for the fair value change in the hedging instrument (GBP20m ×[1.50 – 1.60]).
Cash CAD160
Sales CAD160
To account for the sales of GBP100m at the current spot rate of 1.60 (GBP100m × 1.60).
Property, plant & equipment CAD128
Cash CAD128
To account for the purchase of GBP80m fixed assets at the current spot rate of 1.60 (GBP80m × 1.60).
Hedging derivative CAD2
Cash CAD2
To account for the settlement of the forward contract.
Net position hedging gains/losses CAD2
Other comprehensive income CAD2
To reclassify the cash flow hedge reserve from OCI to profit or loss.
Net position hedging gains/losses CAD8
Other comprehensive income CAD8
To defer the natural hedge gain from profit or loss to OCI (GBP80m × [1.60 –1.50]).
Being the changes in fair value of the equity investments (hedged item) and the derivative (hedging instrument) in OCI.

Equity investments at FVTOCI

On 1 January 20X4, Entity E purchased 100 shares in ABC Ltd for CU100, a listed company.

Entity E elects to account for the shares at FVTOCI.

To hedge the changes in fair value of the shares, Entity E enters into market index futures (because experience from the past few years shows that the share price of ABC Ltd moves in line with the market index).

On 31 March 20X4, the share price of ABC Ltd is CU1.20 (fair value increase of CU20 for 100 shares).

The movement in fair value of the market index futures is CU(18).

The journal entries at 1 January and 31 March 20X4 are as follows:

1 January 20X4

Dr	Equity investment at FVTOCI	CU100
Cr	Cash	CU100

Being the purchase of 100 shares in ABC Ltd for CU100.

31 March 20X4

Dr	Equity investment at FVTOCI	CU20
Cr	OCI	CU20
Dr	OCI	CU18
Cr	Derivative liability	CU18