

The Institute of Chartered Accountants of India

**Ind AS 109- Financial Instruments: Initial recognition
& Measurement**

Agenda

1

Setting the context

2

Meaning of Financial instruments

3

Classification of financial instruments

4

Initial measurement

5

Subsequent measurement

6

Compound Instruments

7

Embedded derivative

8

Expected credit loss model

Setting the context

Financial Instrument– Industry Impact

Standard	Percentage of companies impacted
Financial Instrument	83%
Income taxes	87%
Property, plant and equipment	27%
Share-based payments	22%
Business combination	15%
Operating segment	38%

01 Infrastructure

Witnessed a **27.70%** decrease in net profit due to the application of ECL on financial asset.

02 Consumer products and retail

Witnessed a **6%** increase in net profit due to notional income from corporate guarantees in favor of subsidiaries

03 Pharma

Witnessed a **31%** decrease in net profit due to accounting for financial instruments

04 Telecom

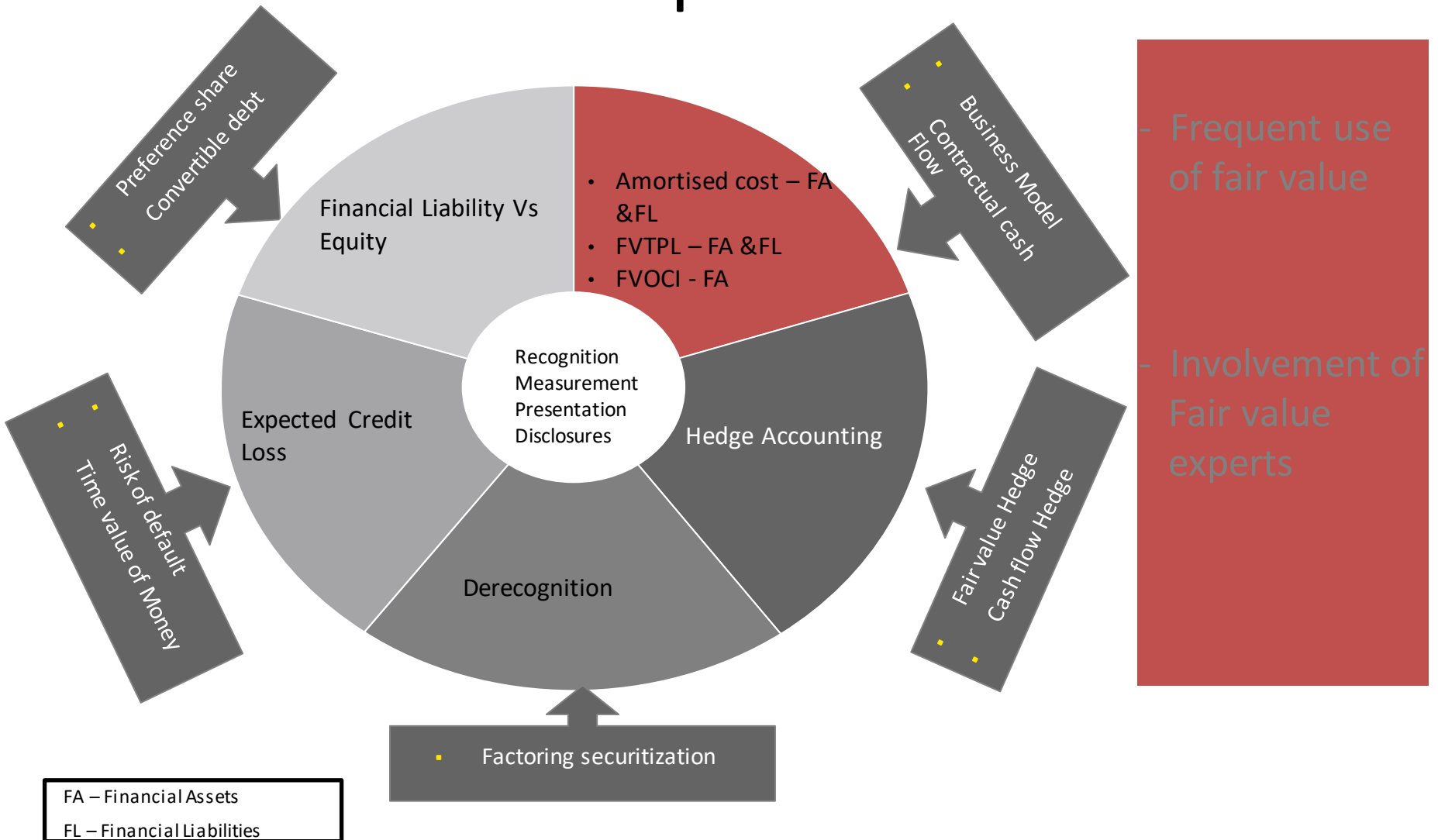
Witnessed a **16%** decrease in net profit due to fair value of financial instruments

Key adjustments observed:

- ▶ Measurement of financial assets such as investment in mutual fund/equity instruments at FVTPL
- ▶ Use of amortised cost, FVOCI and FVTPL for debt instruments
- ▶ Recognition of impairment losses – expected credit loss (ECL)
- ▶ Changes in fair values of derivatives
- ▶ Fair value of compound instruments such as convertible debenture and preference shares
- ▶ Use of effective interest rate (EIR) – transaction cost related to borrowing, redemption premium on debentures, preference dividend
- ▶ Long-term interest-free security deposit and employee loan measured at fair value
- ▶ Notional income from corporate guarantees given to subsidiaries

Based on the financial result of 60 companies in BSE's top 100 list that are covered in phase 1 of Ind AS roadmap

Financial instrument – Area of complexities



Meaning of Financial Instruments

Financial instrument

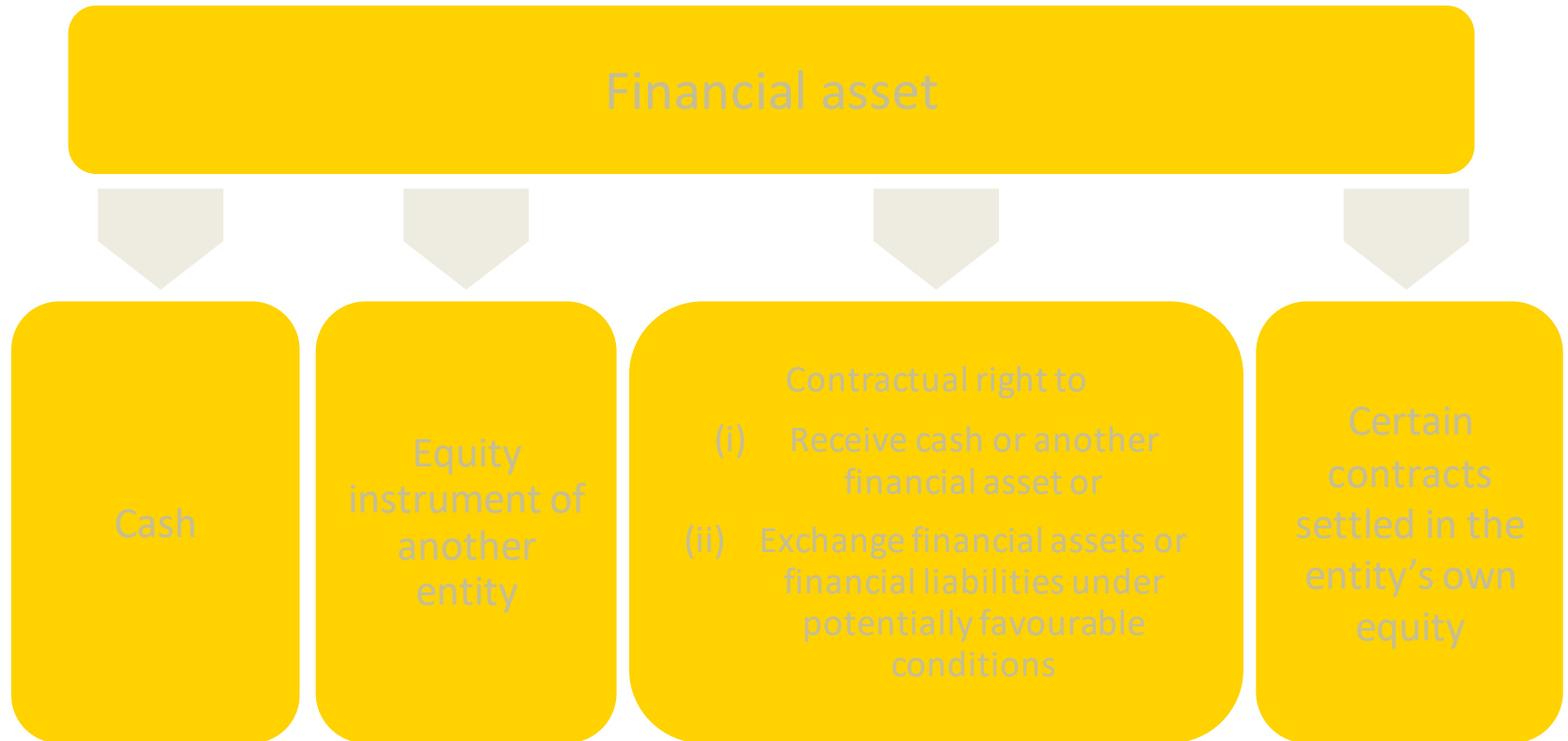
A financial instrument is a contract that gives rise to both:

a financial asset
of one entity

&

a financial liability or
equity instrument of
another entity

Financial asset



Exercise – Identify financial assets?

S No.	Item	Classification	Reason
1	Investment in equity shares	Financial asset	Definition of financial asset specifically includes equity instrument of another entity
2	Investment in bond and debentures	Financial asset	Contractual right to receive cash/other financial assets
3	Loans and receivables	Financial asset	Contractual right to receive cash/other financial assets
4	Deposits given	Financial asset	Contractual right to receive cash/other financial assets
5	Trade and other receivables	Financial asset	Contractual right to receive cash/other financial assets
6	Perpetual debt instrument held	Financial asset	Contractual right to receive cash/other financial assets
7	Cash and cash equivalents	Financial asset	Definition of financial asset specifically includes cash

Financial liability

Financial liability

- Contractual obligation to
- (i) Deliver cash or another financial asset or
 - (ii) Exchange instruments under potentially unfavourable conditions

Certain contracts settled in the entity's own equity

Exercise – Identify financial liability?

S No.	Item	Classification	Reason
1	Deposits received	Financial liability	Contractual obligation to pay cash
2	Trade and other payables	Financial liability	Contractual obligation to pay cash
3	Mandatory redeemable preference shares	Financial liability	Contractual obligation to pay cash
4	Finance lease obligation	Financial liability	Contractual obligation to pay cash
5	Financial guarantee	Financial asset / financial liability	Contractual right/obligation to receive/pay cash, even if those are contingent on certain events
6	Deferred revenue	Not financial instrument	Does not fulfil definition. No contractual obligation to pay cash or another financial asset
7	Warranty obligations	Not financial instrument	Does not fulfil definition. No contractual obligation to pay cash or another financial asset
8	Income taxes/ Deferred tax	Not financial instrument	Does not fulfil definition. Income taxes are statutory assets or liability but not contractual assets or liability

Equity instruments

Equity instruments

Contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities

Examples

- Equity shares
- Preference shares (if certain criteria are met)
- Warrants
- Written call options to issue fixed number of equity shares for a fixed price

Liabilities vs. equity – key differentiators

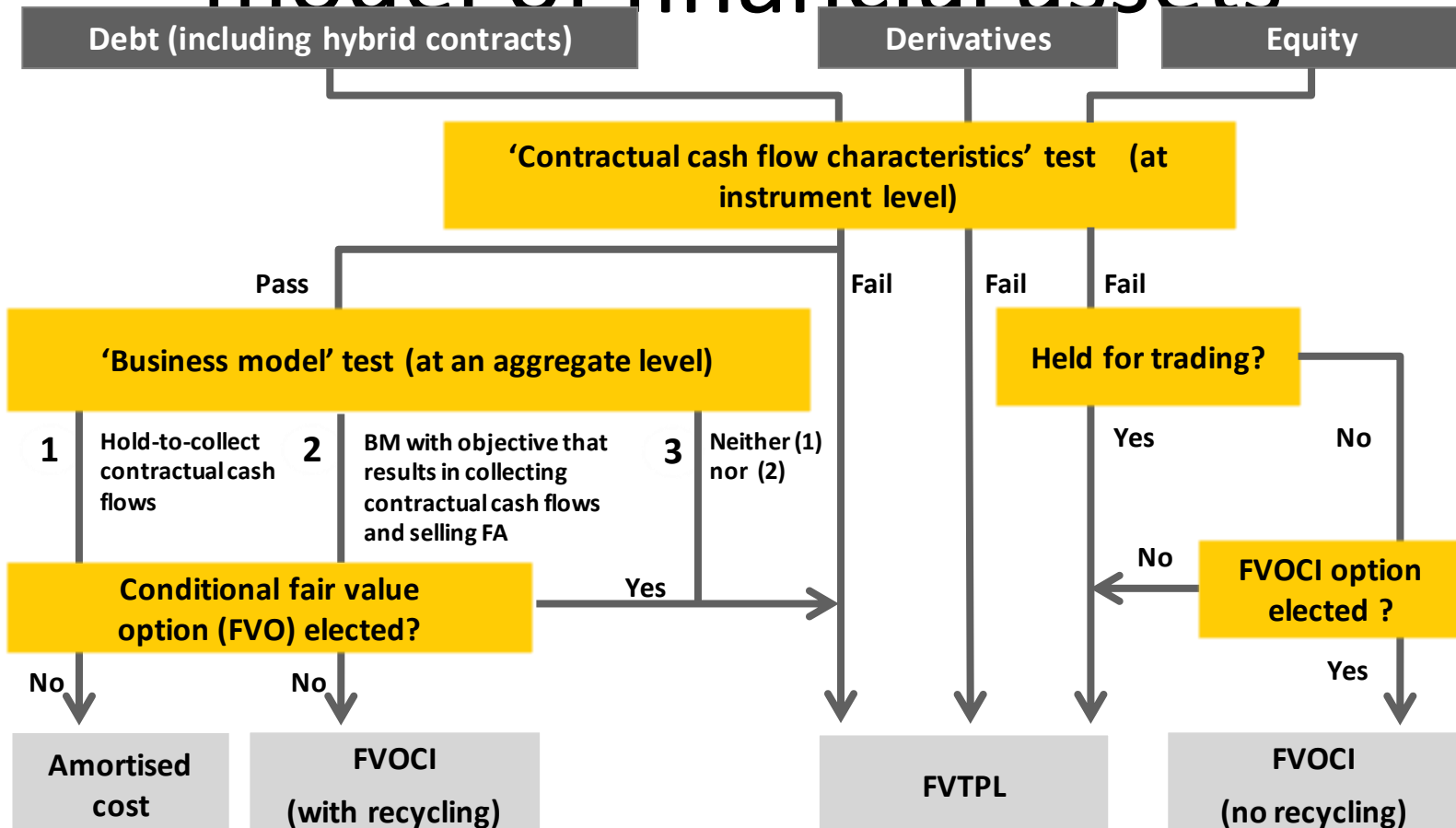
▶ Critical feature differentiating a financial liability from equity:

- ▶ Existence of a contractual obligation
- ▶ To deliver cash/ another financial asset or
- ▶ To exchange financial assets /financial liabilities under conditions that are potentially unfavourable to the issuer

▶ An issuer of an equity instrument does not have a contractual obligation to make distributions because it cannot be required to

Classification of Financial Instruments

Classification and measurement model of financial assets



Classification and measurement

model financial liabilities

Financial liabilities has been classified into two categories.

Category	Main use
Fair value through profit or loss	<ul style="list-style-type: none">▶ Financial liabilities that are held for trading (including derivatives)▶ Financial liabilities that are <u>designated as FVTPL on initial recognition</u>▶ Contingent consideration recognised by an acquirer in a business combination
Amortised Cost	<ul style="list-style-type: none">▶ All liabilities not in the above category

Initial Measurement

Initial measurement – fair value

“The fair value of a financial instrument on initial recognition is normally the transaction price.”

However, if fair value differs from transaction price, an entity shall account for that instrument as follows:

- (a) If fair value is evidenced by quoted price in an active market (i.e. Level 1 input) or based on valuation technique that uses only data from observable markets, entity shall recognise difference between fair value at initial recognition and transaction price as gain or loss (Day 1 gain or loss).
- (b) In all other cases, difference is deferred. After initial recognition, entity shall recognise deferred difference as gain or loss only to extent that it arises from change in factor (including time) that market participants would take into account when pricing asset or liability.

Initial measurement

Financial asset	Initial measurement	Transaction costs
At fair value through profit or loss	Fair value	Expense
At fair value through OCI	Fair value	Capitalize
At amortized cost	Fair value	Capitalise

Financial liability	Initial measurement	Transaction costs
At fair value through profit or loss	Fair value	Expense
Other financial liabilities	Fair value	Deduct from the amount originally recognized

Case Study – Interest free loan to subsidiary

Particulars	Amount
Amount of loan to subsidiary	10,000,000
Period	5 years
Market interest rate	12%
PV factor	0.5675
Initial recognition of loan to subsidiary	5,675,000

What should be the appropriate treatment for above under Ind AS?

What should be the appropriate treatment for difference of INR 4,325,000?		
Period	Loan to subsidiary	Interest income@ 12%
0	5,675,000	0
1	6,355,180	680,912
2	7,117,802	762,622
3	7,971,938	854,136
4	8,928,571	956,633
5	10,000,000	

- ▶ Initially loan needs to be recognized at fair value i.e. at INR 5,675,000
- ▶ The difference of INR 4,325,000 need to be recorded as “Investment in subsidiary”.
- ▶ Company need to accrue interest at market rate in subsequent years.

Case Study – Security Deposit

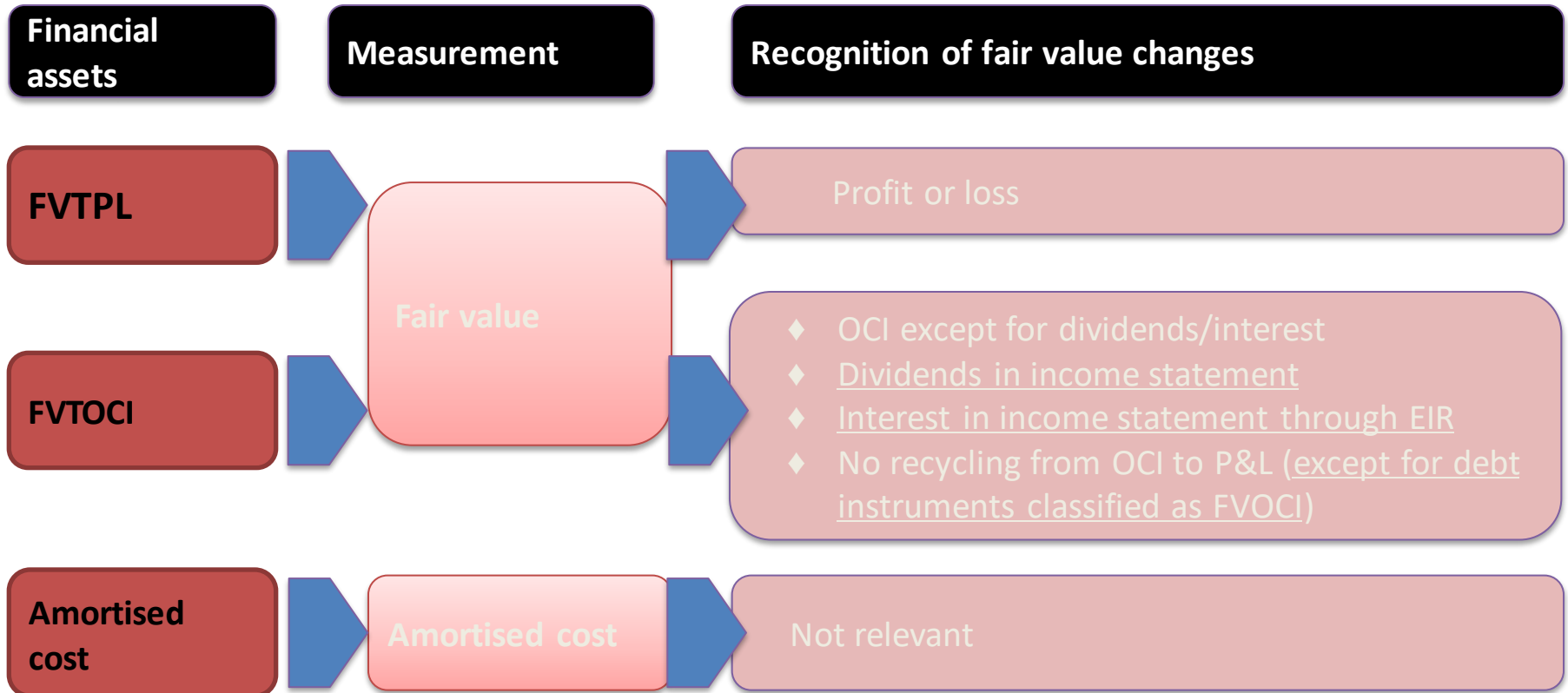
A lessee makes an interest-free security deposit of INR1,000 on entering into a five year lease. It assesses an appropriate rate of interest for the deposit to be 4% and accordingly the fair value of the deposit at inception is INR 822.

What will be the accounting treatment for recording the lease in the books of accounts for the lessee?

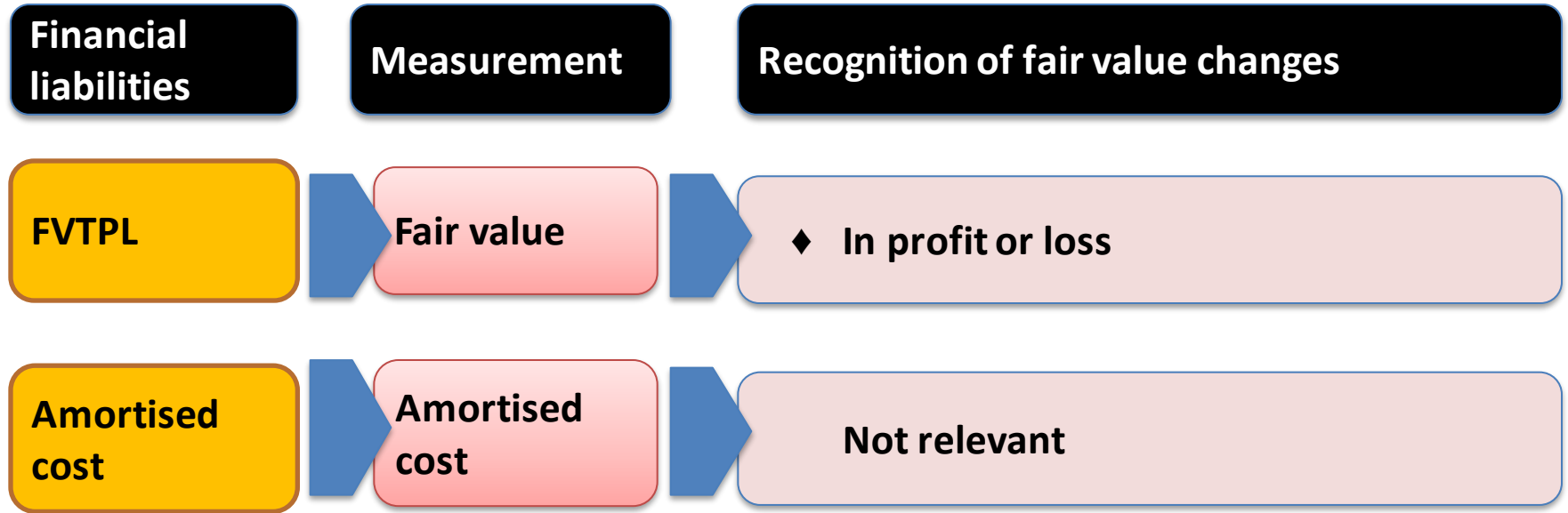
Period	Opening Balance of Security Deposit	Opening Balance of Advance Rental	Interest income @4%	Rental expense	Closing Balance of Security Deposit	Closing Balance of Advance Rental
1	822	178	33	-35	855	143
2	855	143	34	-35	889	108
3	889	108	36	-36	925	72
4	925	72	37	-36	962	36
5	962	36	38	-36	1,000	-

Subsequent Measurement

Subsequent measurement: Financial assets



Subsequent measurement: Financial liabilities

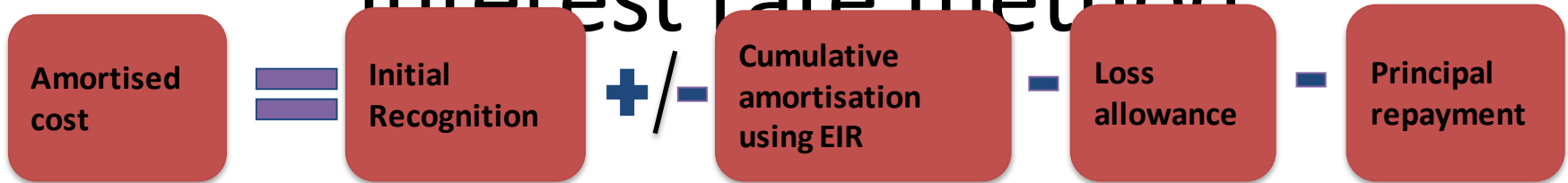


Calculation of amortised cost of financial instrument and effective interest rate method

- Amortised cost is calculated using the effective interest method.
 - The effective interest rate inherent in a financial instrument is the rate that exactly discounts the cash flows associated with the financial instrument through maturity to the net carrying amount at initial recognition. The computation includes all fees and points paid or received, transaction cost and all other premiums or discounts
-

Calculation of amortised cost of financial instrument and effective

interest rate method



◆ **Effective interest Method** – Method of calculating amortisation cost and of allocating interest income / expense over the relevant period

◆ **Effective interest rate** – Rate that exactly discounts estimated future cash payments and receipts through the expected life of the financial instruments

Case study: Calculation of amortised cost of financial liability

Illustration:

- ▶ Company has issued debentures with face value INR 1,00,000 , 5 years maturity, 6% coupon rate
- ▶ Issue / transaction cost – INR 4,100

How the amortised cost of debentures will be recorded by the company?

Case Study – Solution

Particulars	Amount
Face value	1,00,000
Transaction cost	4100
Coupon rate	6%
Effective interest rate (calculated using goal seek)	7%

Year	Opening balance (A)	Effective interest rate (B=A*EIR)	Coupon 6% (C)	Closing AC of debenture (D=A+B-C)	Transaction cost amortization (E=B-C)
1	95,900	6,713	6,000	96,613	713
2	96,613	6,763	6,000	97,376	763
3	97,376	6,816	6,000	98,192	816
4	98,292	6,873	6,000	99,065	873
5	99,065	6,935	6,000	1,00,000	935
	Total	34,100	30,000		4,100

- Over the period of 5 years transaction cost of INR 4,100 gets adjusted

Extinguishing Financial Liabilities with Equity Instruments

[Appendix E (equivalent
to IFRIC 19)]

- Scope excludes transactions where:
 - The creditor is also a direct/ indirect shareholder, acting as a shareholder
 - The creditor and the entity are under common control and the substance of the transaction includes an equity distribution/contribution
 - Transactions whereby under the original terms, the liability is extinguished
- To be applied retrospectively
- Equity instruments issued measured at most reliable of:
 - Fair value of the equity instruments issued
 - Fair value of the liability extinguished
- Gain or loss recognised in P&L as difference between carrying amount of extinguished financial liability and amount at which equity instruments measured
- Partial settlement:
 - ~~Apply normal Ind AS 109 'modification' rule to retained portion~~
- Disclosure of resulting gains or losses required

Case study

An entity issues 1 million equity shares with face value INR20 per share with total fair value of INR100 million to extinguish the whole of a loan under restructuring package.

Solution.

- The carrying amount of the loans on the date of extinguishment is INR90 million.
- Accounting entries would be as follows (all figures in INR million):

Loans	Dr.	90
Profit and loss	Dr.	10
Share Capital	Cr.	(20)
Share premium	Cr.	(80)

Modification of terms

Quantitative 10% assessment:

Does net present value of the cash flows under the new terms (including any fees paid / received), discounted using original effective interest rate, differ at least 10% from the present value of the remaining cash flows under the original terms?

yes

Substantial modification of terms

Derecognise

yes

Qualitative assessment:

Are there substantial differences in terms that by their nature are not captured by the quantitative assessment?

no

no

Continue to recognise

Modification of terms

A gain or loss is recognised based on the difference between the carrying amount of the financial liability extinguished and the consideration paid

The consideration paid includes non-financial assets transferred and the assumption of liabilities, including the new modified financial liability

Any new financial liability recognised is measured initially at fair value

Any costs or fees incurred are recognised as part of the gain or loss on extinguishment

Accounting for a modification of terms that is not substantial

No gain or loss is recognised

Carrying amount of liability is adjusted for fees and transaction costs

Fees, transaction costs and difference in present value due to modification amortised over remaining new life of the liability

Any difference in present value arising as a result of the modification is recognised as an adjustment to effective interest rate

Compound Instruments

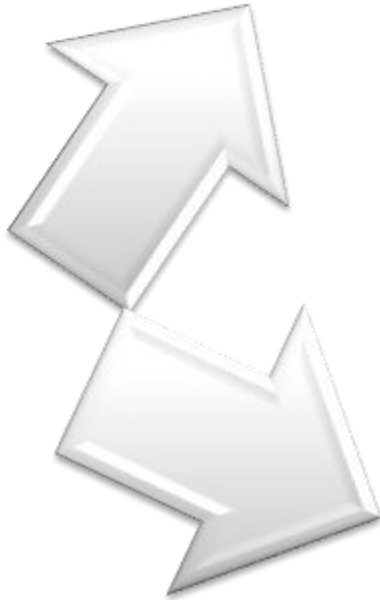
Compound instruments

- The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity instrument.
- Such components shall be classified separately as financial liabilities, financial assets or equity instruments.
- Example:

Instrument	Liability component	Equity component
Preference shares with discretionary dividends	Principal redemption liability	Discretionary dividend
Convertible bonds	Principal redemption and interest payment liability	<u>Convertibility option to the holder</u>

- The economic components of this instrument are:
 - a liability component - discounted fixed rate debt, and
 - an equity component - holder's right to convert at any time before maturity (a written call option)
-

Separation



The liability component is determined by fair value of expected cash flows (for future interest payments and for principal payments)

The residual value is allocated to the equity component.

Transaction costs are allocated to the liability and equity components in the same proportion as above.

Case study - Compound instrument

During 2015-16, A Ltd. issues 2,000 6% Optionally Convertible Debentures (OCD) having 3 year maturity and face value of ₹ 1,000 each giving total proceeds of INR 20 lakhs. 1 OCD is convertible into is 250 Equity Shares of A Ltd. At the time of OCD issue, the prevailing market interest rate for a similar debenture without conversion option is 9% p.a. Total issue costs incurred by A Ltd. are INR 1 lakh.

Line Items / Ratios (₹ Lakhs)	Indian GAAP (₹ Lakhs)	Ind AS (₹ Lakhs)	Ind AS Working
Optionally Convertible Debentures (amount net of issue costs = ₹ 17.56)	20.00	18.48	PV = Future CFs of OCD are discounted @ 9%
Equity component of OCDs (amount net of issue costs = ₹ 1.44)	--	1.52	Total proceeds less PV
Equity Shares issued by A Ltd.	10.00	10.00	Assumed same for both GAAP
Unamortized Issuance Costs	1.00	--	This is deducted from resp. debt & equity line items
Total Finance Cost charged to P&L till conversion / maturity (i.e. for 3 years)	4.60	6.04	Refer next slide for working
Forecasted EBIT (Avg. of 3 years)	10.00	10.00	Assumed same for both GAAP
Debt / Equity Ratio	2.00	1.53	Refer next slide for working
Interest Coverage Ratio	2.17	1.66	Refer next slide for working

Compound Instrument – Indian GAAP v. Ind AS (Workings)

Workings of Line Items / Ratios (₹ Lakhs)	Indian GAAP (₹ Lakhs)	Ind AS (₹ Lakhs)
Finance Cost charged to P&L till conversion / maturity (i.e. for 3 years)	4.60	6.04
• Cash Interest	3.60	3.60
• Gross issue proceeds originally allocated to equity component	--	1.52
• Issue costs amortized to P&L	1.00	1.00
Debt / Equity Ratio = OCDs / (Equity component of OCDs + Equity Shares)	20.00 / 10.00 = 2.00	17.56 / 11.44 = 1.53
Interest Coverage Ratio = Forecasted EBIT / Total Finance Cost	10.00 / 4.60 = 2.17	10.00 / 6.04 = 1.66

Embedded derivative

Embedded derivatives

An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract

An embedded derivative causes some of the cash flows of the combined instrument to vary in a similar way to a stand-alone derivative

Requirements on separation of embedded derivatives retained from Ind AS 39 in relation to Financial Liability and non-financial host contracts

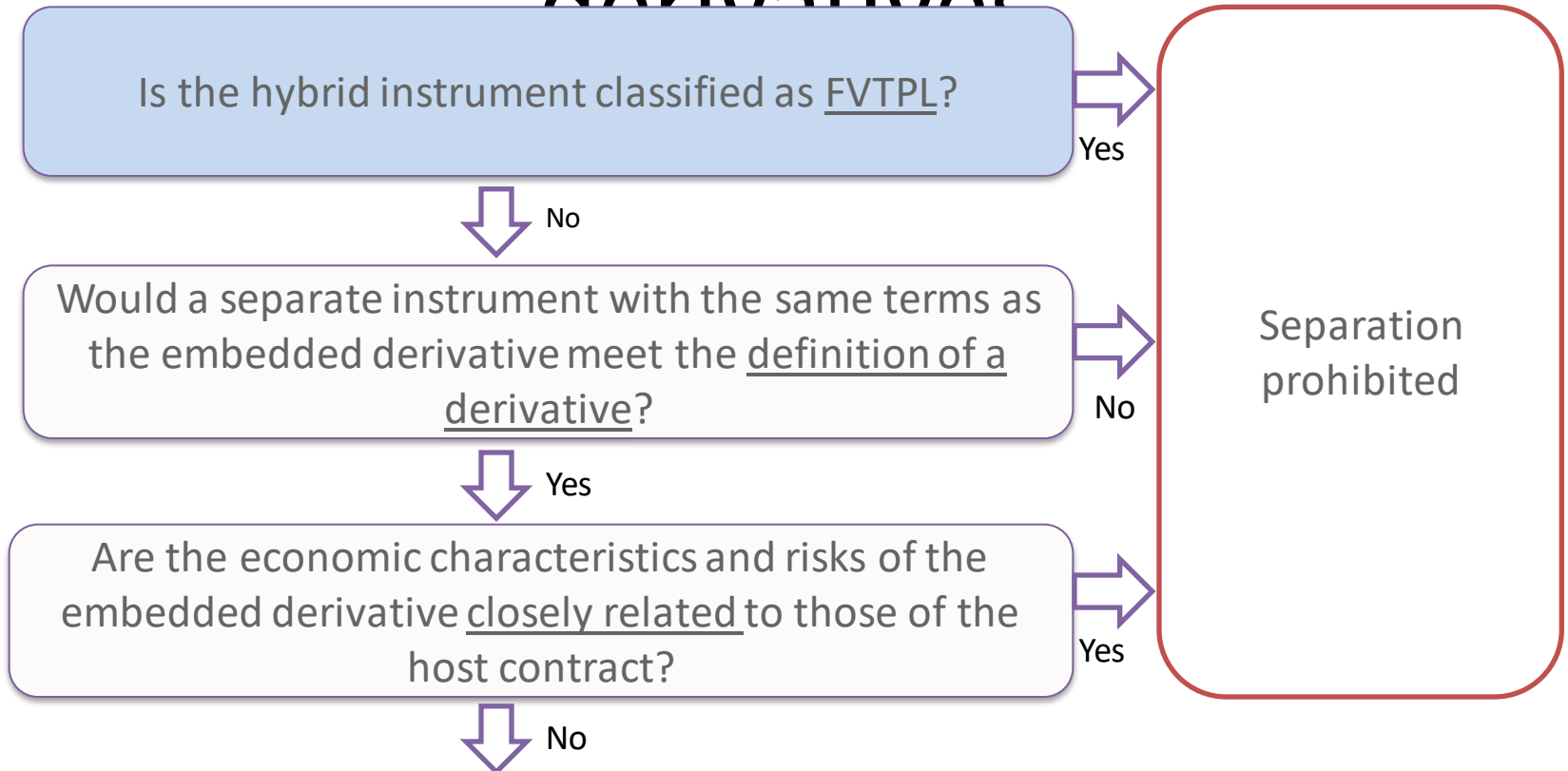
An embedded derivative is attached to a financial instrument and is not contractually transferable independently of that instrument and has the same counterparty

Examples of embedded derivatives

Type of contract	Embedded derivative
Bond with interest payments linked to an equity index	Equity-indexed payments
Inflation-indexed lease contract	Inflation-indexed payments
Bond with a call option	Call option
Sales contract in third currency	FX forward

Separation of embedded

derivatives



- ◆ Separation required ; or
- ◆ FVTPL classification of entire combined contract in certain circumstances

Accounting for separable embedded derivatives

Is fair value of embedded derivative reliably measurable?

Yes

- ◆ Determine fair value of embedded derivative directly
- ◆ Carrying value of host contract is difference between fair value of hybrid contract and embedded derivative

No

Is fair value of host contract reliably measurable?

Yes

- ◆ Determine fair value of embedded derivative indirectly based on difference between fair value of hybrid contract and host contract

No

Designate the entire hybrid (combined) contract as FVTPL

The initial bifurcation of an embedded derivative does not result in recognition of a gain or loss

Expected Credit Loss Model

Expected credit loss model – general approach

Start here

Stage 1

Stage 2

Stage 3

Loss allowance
updated
at each
reporting date

12-month expected
credit losses

Lifetime expected
credit losses

Lifetime expected
credit losses

Lifetime
expected
credit losses
criterion

Credit risk has increased significantly since initial recognition (individual or collective basis)

+
Credit-impaired

Interest
revenue
calculated
based on

Effective interest rate on
gross carrying amount

Effective interest rate on
gross carrying amount

Effective interest rate on
amortised cost

Change in credit risk since initial recognition

Improvement

Deterioration

Simplified approach: Provision

matrix

- According to the simplified approach, for trade receivables and contract assets that do not contain a significant financing component, an entity shall always measure loss allowance at an amount equal to lifetime expected credit losses.
 - A provision matrix could be used to estimate ECL for these financial instruments.
 - For example, an entity may set up the following provision matrix based on its historical observed default rates, which is adjusted for forward-looking estimates:
 - non-past due: 0.3% of carrying value
 - 30 days past due: 1.6% of carrying value
 - 31-60 days past due: 3.6% of carrying value
 - 61-90 days past due: 6.6% of carrying value
 - more than 90 days past due: 10.6% of carrying value
-

Thank You !
