KEY CONSIDERATIONS FOR IMPLEMENTING FINANCIAL INSTRUMENTS STANDARDS FOR NON-FINANCIAL INSTITUTIONS”

2017

KEYUR DAVE

BDO

DEFINITION

DEFINITION

Financial Instrument

Financial instrument is

Any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

DEFINITION
Financial Asset

Financial asset is

- cash
- an equity instrument of another entity
- a contractual right**:**
  - to receive cash or another financial asset from another entity
  - to exchange financial assets / liabilities under favorable conditions
- a contract that will or may be settled in the entity's own equity instruments and is
  - a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
  - a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments

DEFINITION
Financial Liability

Financial liability is

- A contractual obligation
  - to deliver cash or other financial assets to another entity
  - to exchange financial assets / liabilities under potentially unfavourable conditions; or

- a contract that will or may be settled in the entity’s own equity instruments and is:
  - a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity’s own equity instruments; or
  - a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity’s own equity instruments

DEFINITION

Financial Liability

CATEGORIES OF FINANCIAL ASSETS

Based on subsequent measurement

1

Amortised cost

2

Fair Value

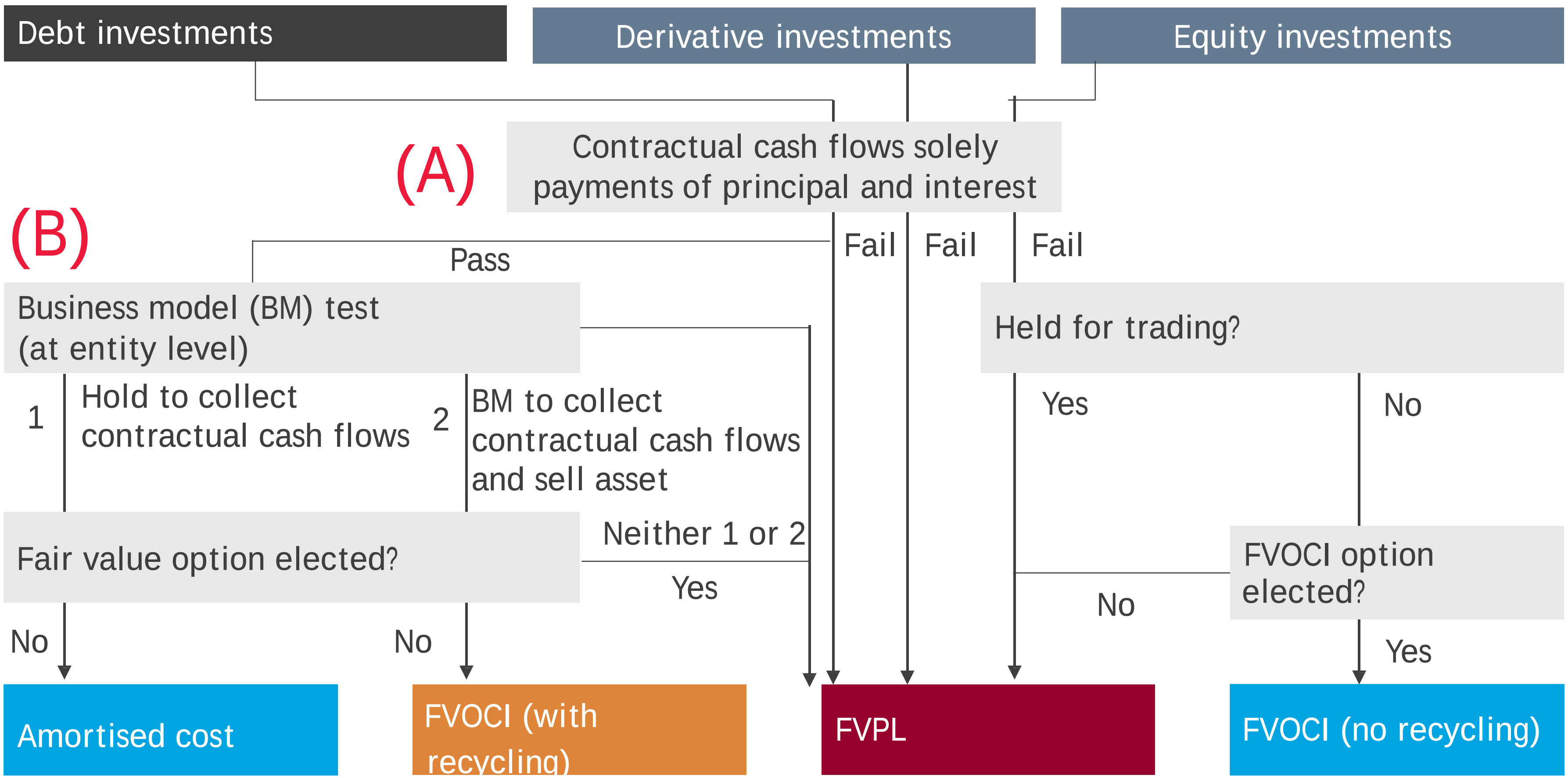
2A

Fair value through OCI

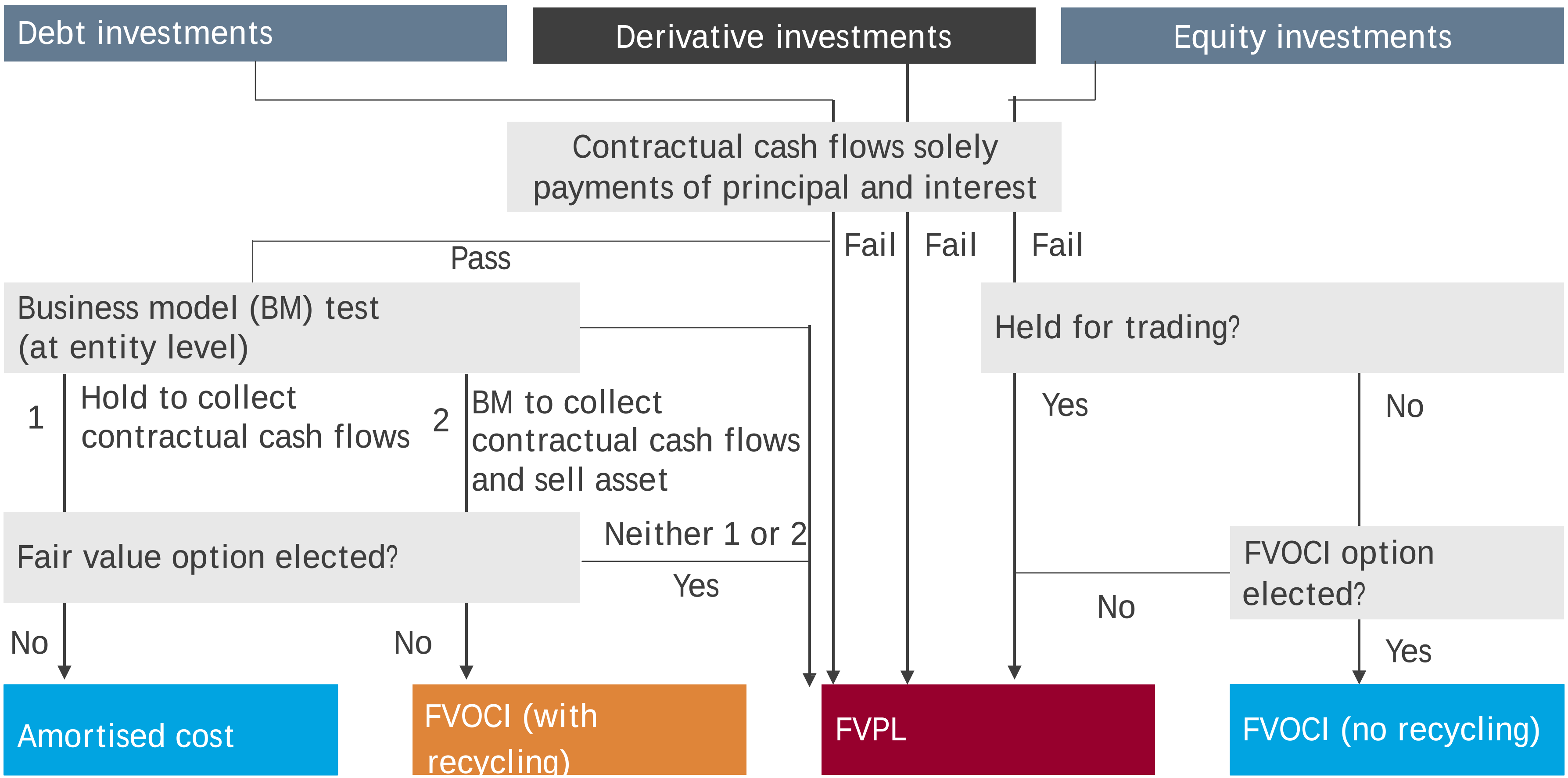
2B

Fair value through P&L

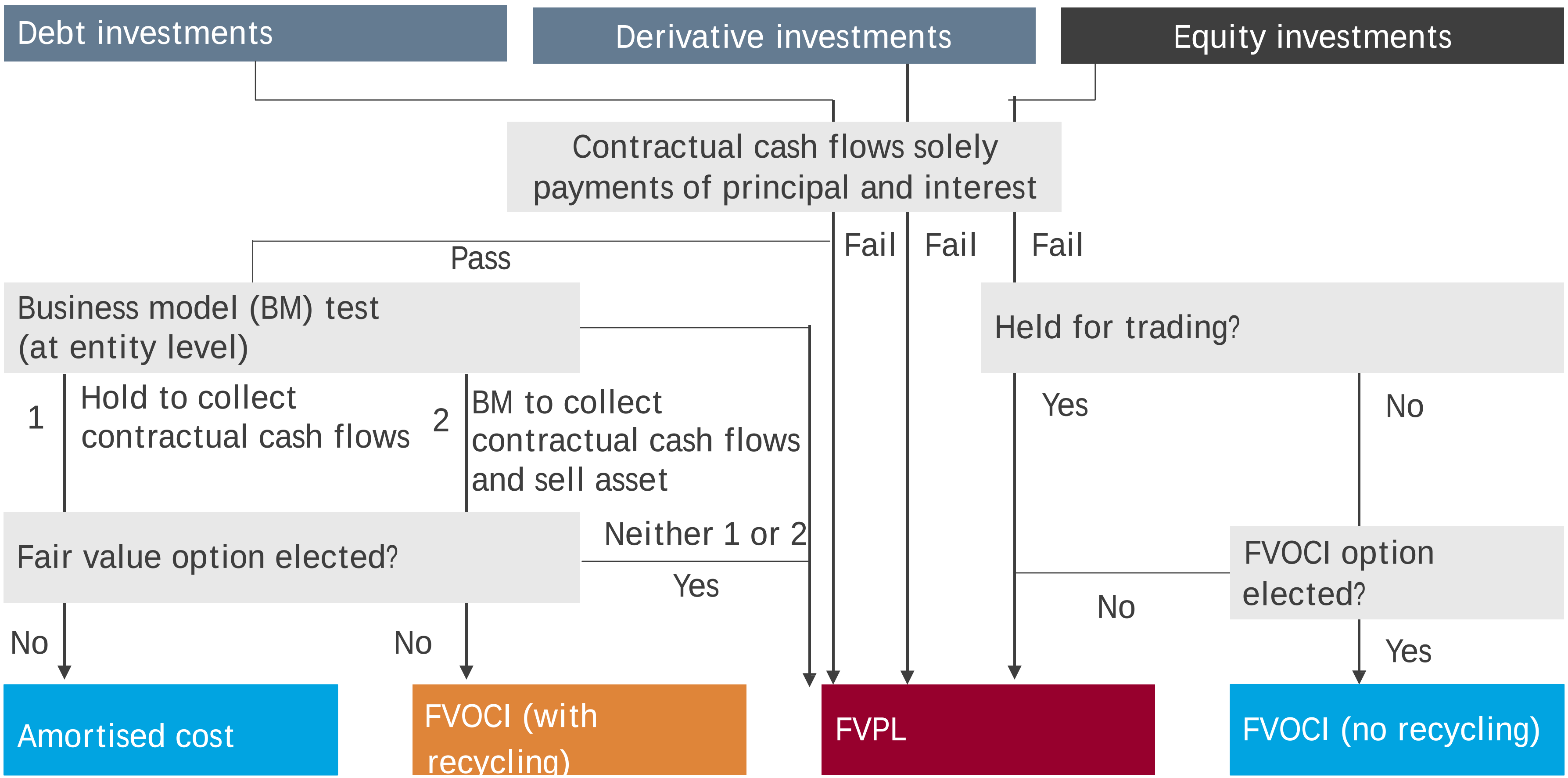
APPLICATION TO INVESTMENTS IN DEBT SECURITIES



APPLICATION TO DERIVATIVES



APPLICATION TO EQUITY INVESTMENTS



BUSINESS MODEL

What it is…

- a **matter of fact** and not merely an assertion
- determined by **entity's key management personnel** (KMP)
- determined at a level that reflects how **groups of financial assets are managed** together to achieve a particular business objective
- **observable through the activities** that the entity undertakes to achieve the objective of the business model
- a single entity may have **more than one business model** for managing its financial instruments

What it is not…

- **does not depend on management's intentions** for an individual instrument
- need not be determined at the reporting entity level
- not determined on the basis of scenarios that the entity does not reasonably expect to occur ('worst case' or 'stress case' scenarios)

'SOLELY PAYMENT OF PRINCIPAL AND INTEREST' ('SPPI') TEST – (A)

- Contractual cash flows that are SPPI are consistent with a basic lending arrangement

- Principal is the fair value of the financial asset at initial recognition – principal amount may change over the life of the financial asset (for example, if there are repayments of principal)

- Interest elements – consideration consistent with basic lending arrangement:
  - time value of money
  - credit risk
  - other basic lending risks (example, liquidity risk)
  - costs associated with holding the financial asset for a particular period of time
  - profit margin that is consistent with a basic lending arrangement

- Assessment done in the currency in which financial asset is denominated

SUMMARY OF EFFECT OF DIFFERENT CLASSIFICATION CATEGORIES

Category	Balance sheet	Statement of comprehensive income
Amortised cost	▪ Amortised cost ▪ Impairment allowance	▪ Presented in P&L • Interest using effective interest rate (EIR) • Initial impairment allowance and subsequent changes
FVOCI	▪ Fair value	▪ Changes in FV in OCI ▪ Presented in P&L: • interest calculated using EIR • initial impairment allowance and subsequent changes (offsetting entry presented in OCI) • FOREX gains and losses ▪ Cumulative FV gains/losses recycled on derecognition or reclassification
FVPL	▪ Fair value	Change in FV presented in P&L
Equity FVOCI	▪ Fair value	▪ changes in fair value presented in OCI ▪ no reclassification to P&L on disposal ▪ dividends recognised in P&L

FINANCIAL LIABILITIES - CATEGORIES

At fair value through profit or loss

2 categories

Other financial liabilities

- Accounting mismatch
- Management view portfolio at fair value

NB: Different rules apply if the above financial instruments are part of a hedging relationship

Some changes:

- counterintuitive results of accounting treatment of own credit risk addressed (taken to OCI)
- reclassification prohibited

SUBSEQUENT MEASUREMENT

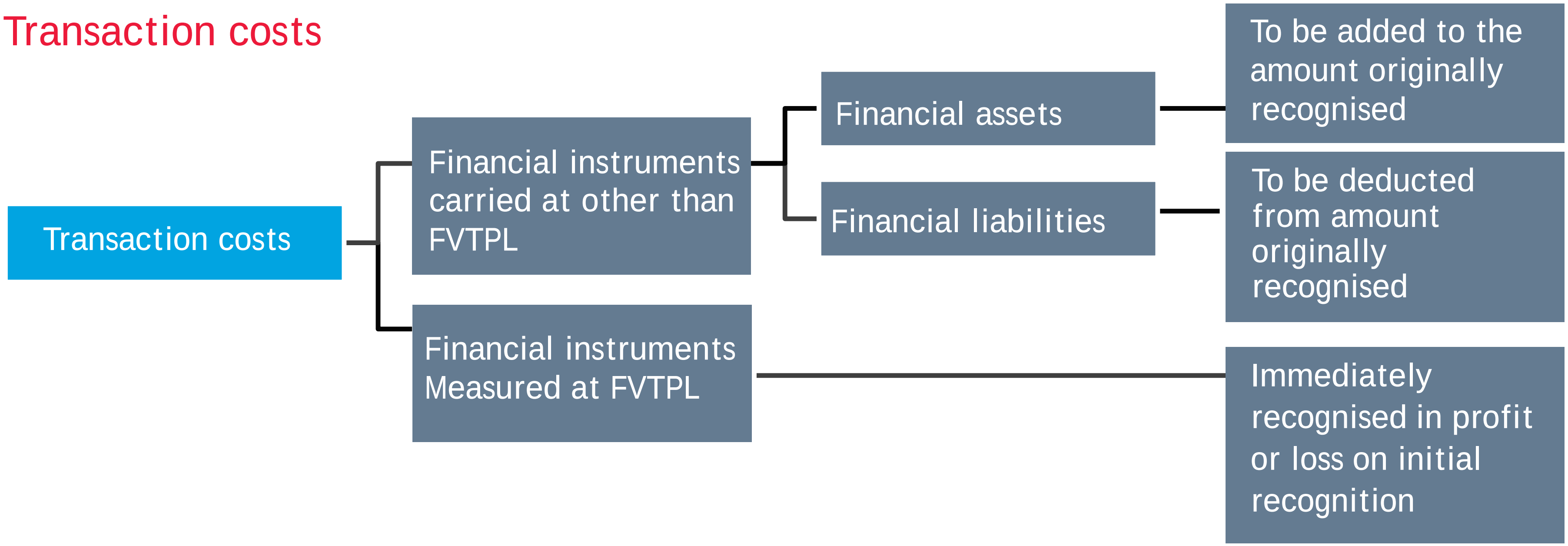
Financial liabilities

Subsequent measurement - financial liabilities

At fair value through Profit or loss	Carried at fair value, changes taken to income statement
Other Liabilities	Carried at amortised cost

INITIAL MEASUREMENT

Transaction costs



an entity shall measure a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

Transaction costs are incremental costs that are directly attributable to the acquisition or issue or disposal of a financial asset or financial liability.

Example of transaction cost are regulatory and registration fees, loan processing fees, brokerage, etc.

Note : Transaction costs expected to be incurred on a financial instrument's transfer or disposal are not included in the financial

APPLYING EFFECTIVE INTEREST RATE (EIR) IN PRACTICE

Microsoft Excel
Worksheet

IMPAIRMENT OF FINANCIAL ASSETS
EXPECTED CREDIT LOSS (ECL)

Credit losses increase as credit risk increases

Deterioration in credit quality →

	Stage 1	Stage 2	Stage 3
Credit quality	Not deteriorated significantly since initial recognition or have low credit risk at reporting date	deteriorated significantly in credit quality since initial recognition but that do not have objective evidence of a credit loss event	have objective evidence of impairment at the reporting date
Recognition of expected credit losses	12-month expected credit losses when asset originated or purchased	lifetime expected credit losses when credit quality deteriorates significantly	lifetime expected credit losses when credit losses are incurred or asset is credit impaired
Recognition of interest	Interest based on gross carrying amount of asset	Interest based on gross carrying amount of asset	Interest based on net carrying amount of asset
	Performing	Under-performing	Non-performing

If the financial instrument is determined to have low credit risk at reporting date, it may be assumed that the credit risk on a financial instrument has not increased significantly

IND AS 32

Financial Instruments: Presentation

IND AS 32

Equity or liability distinction Why does it matter?

- Presentation in statement of financial position
- Initial and subsequent measurement
- Treatment of payments, repurchases etc

DEFINITION
Equity

Equity

Any contract that evidences a residual interest in net assets of an entity

Examples

- Ordinary shares
- Share warrants
- Mandatorily convertible preference shares

in other words, contracts that are not liabilities

EQUITY AND LIABILITY CLASSIFICATION

Financial instrument is an equity instrument only if both criteria are met:

- There is no obligation to deliver cash or another financial asset or to exchange financial assets or financial liability; and
- The issuer will exchange fixed amount of cash or another financial asset for a fixed number of its own equity instruments.

Does the entity have an unavoidable contractual obligation?

Yes → Liability

No → Equity

EXAMPLES

Type of instrument	Liability	Equity
Non-redeemable shares with discretionary dividends ('ordinary shares')		
Shares that are redeemable at the option of the holder ('puttable shares')		
Shares that are redeemable at the option of the issuer ('callable shares')		

CARVE-OUT: IND AS CLASSIFICATION FOR FCCBS

- Ind AS 32 considers -
  - the equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of entity's own equity instruments as an equity instrument if the exercise price is fixed in any currency.
- This exception is not provided in IAS 32 (carve out).

KEY CONSIDERATIONS FOR IMPLEMENTING FINANCIAL INSTRUMENTS STANDARDS FOR NON-FINANCIAL INSTITUTIONS

- **Fair value approach**
- **Classification of debt Vs Equity**
- **Rather than long term Investments and current investments**
  - **Now we moved to fair value and amortized cost model**
  - **Equity Investments are always measured at fair value**
- **Conditions to be applied for fair value or amortized model**
  - **SPPI**
  - **Business Model**
- **Concept of amortization of transaction cost in the form of interest**
- **Expected Credit losses**