

Financial Instruments Ind AS 109

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Flow of Discussion

- Introduction
- Classification
- Recognition and Measurement
- Presentation and Disclosure

Financial Assets

Financial asset. Any asset that is:

- (a) Cash;
- (b) An equity instrument of another entity;
- (c) A contractual right to receive cash or another financial asset from another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity; or
- (d) A contract that may or will be settled in the entity's own equity instrument and is not classified as an equity instrument of the entity

Examples of assets that meet the definition of a financial asset are

1. *Cash, see (a) above*
2. *Investment in shares or other equity instrument issued by other entities, see (b) above*
3. *Receivables, see (c) above*
4. *Loans to other entities, see (c) above*
5. *Investments in bonds and other debt instruments issued by other entities, see (c) above*
6. *Derivative financial assets, see (c) above*
7. *Some derivatives on own equity, see (d) above*

Financial Liabilities

Financial liability. Any liability that is:

- (a) A contractual obligation to deliver cash or another financial asset to another entity; or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity; or
- (b) A contract that will or may be settled in the entity's own equity instruments and is not classified as an equity instrument of the entity (discussed below).

Examples of liabilities that meet the definition of financial liabilities are

1. *Payables (e.g., trade payables), see (a) above*
2. *Loans from other entities, see (a) above*
3. *Issued bonds and other debt instruments issued by the entity, see (a) above*
4. *Derivative financial liabilities, see (a) above*
5. *Obligations to deliver own shares worth a fixed amount of cash, see (b) above*
6. *Some derivatives on own equity, see (b) above*

Exclusions

- *Physical assets (e.g., inventories, property, plant, and equipment)*
- *Leased assets*
- *Intangible assets (e.g., patents and trademarks)*
- *Prepaid expenses. Such assets are associated with the receipt of goods or services. They do not give rise to a present right to receive cash or another financial asset.*
- *Deferred revenue. Such liabilities are associated with the future delivery of goods or services. They do not give rise to a contractual obligation to pay cash or another financial asset.*
- *Warranty obligations. Such liabilities are associated with the future delivery of goods or services. They do not give rise to a contractual obligation to pay cash or another financial asset.*
- *Income tax liabilities (or assets). Such liabilities (or assets) are not contractual but are imposed by statutory requirements.*
- *Constructive obligations*

Scope Exemption

Scope Exception	Applicable Standard
Interests in subsidiaries	Ind AS 27, Consolidated and Separate Financial Statements
Interests in associates	Ind AS 28, Investments in Associates
Interests in joint ventures	Ind AS 31, Interests in Joint Ventures
Employee benefit plans	Ind AS 19, Employee Benefits
Share-based payment transactions	Ind AS 102, Share-Based Payment
Contracts for contingent consideration in business Combinations	Ind AS 103, Business Combinations
Insurance contracts	Ind AS 104, Insurance Contracts

Case Study

Case Study - Facts

Company A is evaluating whether the following item is a financial instrument and should it be accounted for under Ind AS 32:

- (a) Cash deposited in banks
- (b) Gold bullion deposited in banks
- (c) Trade accounts receivable
- (d) Investments in debt instruments
- (e) Investments in equity instruments, where Company A does not have significant influence over the investee
- (f) Investments in equity instruments, where Company A has significant influence over the investee
- (g) Prepaid expenses
- (h) Finance lease receivables or payables
- (i) Deferred revenue
- (j) Statutory tax liabilities
- (k) Provision for estimated litigation losses
- (l) An electricity purchase contract that can be net settled in cash
- (m) Issued debt instruments
- (n) Issued equity instruments

Required

Help Company A to determine (1) which of the above items meet the definition of a financial instrument and (2) which of the above items fall within the scope of Ind AS 32.

Introduction

- **Objective :** 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.
- **Scope :-**
 - Standard to be applied by all entities to all financial instruments except :-
 - Rights and obligations under leases to which IndAS 17 applies
 - Those interest in subsidiaries, associates and joint ventures which are accounted for in accordance with IndAS 110 , Ind AS 27 or IndAS 28.
 - Employers rights and obligations under employee benefit plan which is accounted as per IndAS 19.
 - Financial instruments issued by the entity that meet the definition of an equity instrument.
 - Rights and obligations arising under as insurance contracts as defined in IndAS 104.
 - Any forward contract between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination within the scope of Ind AS103 - Business Combinations at a future acquisition date.

Introduction continued ...

- Financial instruments , contracts and obligations under share-based payment transactions to which IndAS 102 applies.
- Rights and obligations within the scope of IndAS 115 – Revenue from contracts with customers and few others as mentioned in the standard.

Recognition of Financial instruments

Key Principle

- The principle for recognition under Ind AS 109 is that an entity should recognize a financial asset or financial liability on its balance sheet when, and only when, the entity becomes a party to the contractual provisions of the instrument.
- Further, planned future transactions and other expected transactions, no matter how likely, are not recognized as financial assets or financial liabilities because the entity has not yet become a party to a contract. Thus, a forecast transaction is not recognized in the financial statements even though it may be highly probable.

Case Study

Facts

Entity A is evaluating whether each of the next items should be recognized as a financial asset or financial liability under Ind AS 109:

- (a) An unconditional receivable
- (b) A forward contract to purchase a specified bond at a specified price at a specified date in the future
- (c) A planned purchase of a specified bond at a specified date in the future
- (d) A firm commitment to purchase a specified quantity of gold at a specified price at a specified date in the future. The contract cannot be net settled.
- (e) A firm commitment to purchase a machine that is designated as a hedged item in a fair value hedge of the associated foreign currency risk

Required

Help Entity A by indicating whether each of the above items should be recognized as an asset or liability under Ind AS 109.

Classification of financial instruments

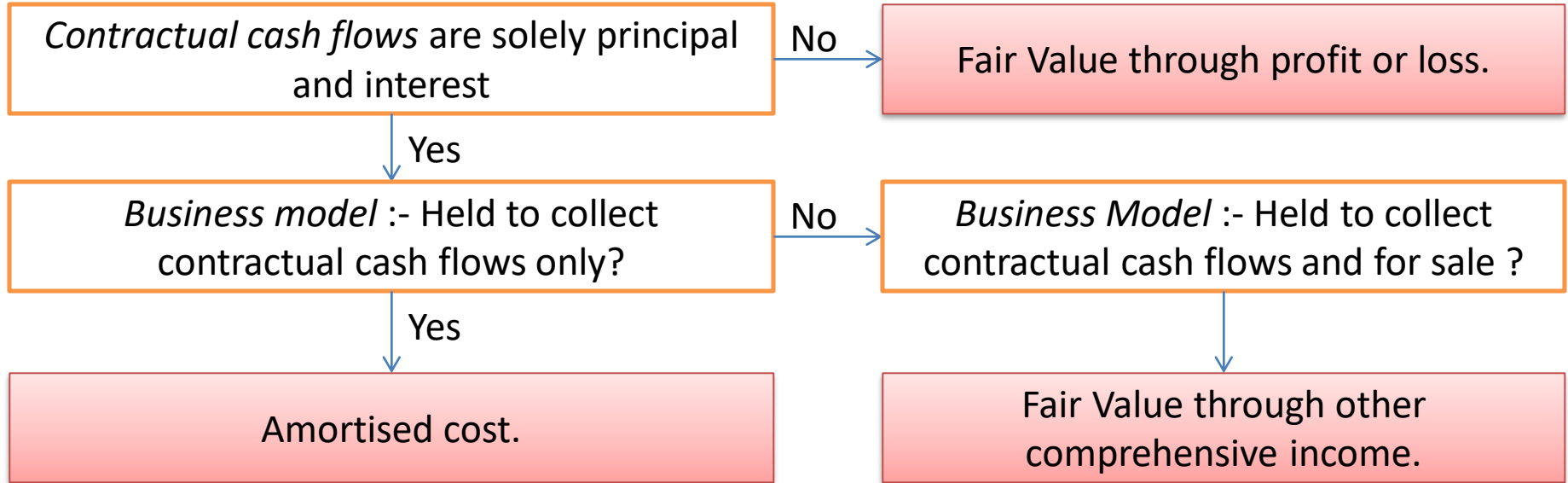
	Financial assets	Financial liabilities
Classification categories	<ol style="list-style-type: none">1) Amortised cost.2) Fair value through other comprehensive income.3) Fair value through profit or loss.	<ol style="list-style-type: none">1) Amortised cost.2) Fair value through profit or loss.3) Guidance on specific financial liabilities.

Fair Value Option :- An entity may at initial recognition , designate a financial asset / liability as measured *at fair value through profit and loss* if doing so eliminates / reduces significantly any measurement or recognition inconsistency that would otherwise arise from measuring them on different bases.

Classification of financial assets

- An entity shall classify financial assets as subsequently measured at Amortised cost, FVTOCI or FVTPL on the basis of :
 - Entity's *business model* for managing the financial assets
&
 - The *contractual cash flow characteristics* of the financial assets.

Classification of financial assets



Example (For classification of financial Assets)

- ***Financial instruments that are likely to be classified and measured at amortized cost :-***
 - Investments in government bonds that are not held for trading
 - Investments in term deposits at standard interest rates
 - Trade Receivables

- ***Financial instruments that are likely to be classified and measured at FVTOCI :-***
 - Investments in government bonds that are not held for trading
 - Investments in term deposits at standard interest rates
 - Trade Receivables

Case Study

Facts

Entity A is evaluating whether each of the next items should be classified and measured at amortised cost or FVTPL as per Ind AS 109:

- (a) Investments in term deposits with standard interest rates.
- (b) Investments in Equity shares of subsidiary / associate company.
- (c) Investments in bonds of various companies.
 - Scenerio 1 :- Entity intends to hold the bonds till the date of maturity.
 - Scenerio 2 :- Entity intends to hold the bonds till the date of maturity but it may consider to sell the bonds during the tenure in case any profit opportunity arises.
 - Scenerio 3 :- Entity intends to hold the bonds purely for trading purpose.

Required

Help Entity A by indicating whether each of the above items should be classified and measured at amortized cost / FVTOCI / FVTPL as per Ind AS 109.

Classification of Financial Liabilities

Financial liabilities
at amortized cost

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

Financial liabilities at amortized cost

- IndAS 109 requires all financial liabilities to be measured at *amortized cost* unless:
 - The financial liability is required to be measured at FVTPL because it is **held for trading**.
 - The entity elects to measure the financial liability at FVTPL (**fair value option**)
 - The financial liability arise when a transfer of financial asset **does not qualify for derecognition** or when the continuing involvement approach applies .
 - The financial liability is a **financial guarantee contract**.
 - The financial liability commits to provide a loan at a **below-market interest rate**.
 - The financial liability is a **contingent consideration** recognized by an acquirer in a business combination to which IndAS 103 applies.

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

- In accordance with Ind AS 109, financial liabilities are to be measured at fair value through profit or loss if either:
 - The financial liability is required to be measured at FVTPL because it is **held for trading** (e.g. Derivatives that have not been designated in a hedging relationship)
 - The entity elects at initial recognition to measure the financial liability at FVTPL (**fair value option**) if doing so eliminates / reduces significantly any measurement or recognition inconsistency that would otherwise arise from measuring them on different bases. (Such option is irrevocable.)

Example (Fair value option): Issued fixed rate debt

- Entity A issues fixed rate debt. In order to economically hedge the fair value risk associated with interest payments on the fixed rate debt, Entity A concurrently enters into an interest rate swap with a bank (receive fixed, pay floating), which has the same terms and payment dates as the debt. The interest rate swap is a derivative that must be measured at FVTPL. Entity A does not wish to apply fair value hedge accounting because it does not wish to prepare any hedge documentation and it does not have the processes in place to monitor hedge effectiveness. By designating the fixed rate debt as at FVTPL on initial recognition, the entity will achieve a substantial offset in profit or loss against the fair value movements on the held for trading derivative. Because the instruments share a common risk (interest rate risk), Entity A will seek to demonstrate that applying the fair value option results in more relevant information because it significantly reduces a measurement inconsistency that would otherwise arise from measuring the derivative at FVTPL and measuring the debt at amortised cost.

Case Study

Facts

Entity Z is evaluating whether each of the next items should be classified and measured at amortised cost or FVTPL as per Ind AS 109:

- (a) Trade payables.
- (b) Convertible note liabilities.
- (c) Contingent consideration payable that arise from business combination.
- (d) Loan payable with standard interest rates (such as benchmark rate plus a margin).
- (e) Bank borrowings.
- (f) Derivatives that have not been designated in a hedging relationship viz interest rate swaps.

Required

Help Entity Z by indicating whether each of the above items should be classified and measured at amortized cost as per Ind AS 109.

Subsequent Measurement

- Amortised cost of financial liabilities is determined using the effective interest method.

- In case of financial liabilities measured at FVTPL, fair value gains and losses are recognized in profit or loss except that in the case of financial liabilities (other than loan commitments or financial guarantee contracts) that are designated at FVTPL, the gains or losses are required to be presented as follows:
 - the amount of the change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability should be presented in OCI; and
 - the remainder of the change in the fair value of the liability should be presented in profit or loss unless the treatment of the effects of changes in the liability's credit risk described above would create or enlarge an accounting mismatch in profit or loss (in which case all gains or losses are recognised in profit or loss).

Hybrid financial liability

- In the case of a hybrid financial liability containing one or more embedded derivatives, an entity may designate the entire hybrid (combined) contract as at FVTPL unless:
 - the embedded derivative does not significantly modify the cash flows that otherwise would be required by the contract; or
 - it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative is prohibited (e.g. a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost).

- **Case study 8 (Fair value option) - commodity-linked debt**
 - Entity Q issues a debt instrument that has interest payments linked to a basket of commodity prices.

The linking to commodity prices is considered to be a non-closely related embedded derivative that would require separation and measurement at FVTPL. Entity Q may choose at initial recognition to designate the whole debt instrument as at FVTPL to avoid separating out the embedded derivative.

Reclassification of financial liabilities

- Reclassifications of financial liabilities into and out of the FVTPL category are prohibited. The following changes in circumstances are not reclassifications:
 - A derivative that was previously a designated and effective hedging instrument in a cash flow hedge or net investment hedge no longer qualifies as such; and
 - A derivative becomes a designated and effective hedging instrument in a cash flow hedge or net investment hedge

De-recognition - Financial Liabilities

- The derecognition requirements for financial liabilities are different from those for financial assets. There is no requirement to assess the extent to which the entity has retained risks and rewards in order to derecognize a financial liability.
- Instead, the derecognition requirements for financial liabilities focus on whether the financial liability has been extinguished. This means that derecognition of a financial liability is appropriate when the obligation specified in the contract is discharged or is cancelled or expires
- If a financial liability is repurchased (e.g., when an entity repurchases in the market a bond that it has issued previously), derecognition is appropriate even if the entity plans to reissue the bond in the future.
- If a financial liability is repurchased or redeemed at an amount different from its carrying amount, any resulting extinguishment gain or loss is recognized in profit or loss.

Case Study : Financial Guarantee

Facts

Subsidiary company S enters into a term loan arrangement with bank B on 1 April 2016 on the following terms:

Contract Terms	Details
Term	5 Years
Loan Amount & Interest	INR 10 Cr @ 11% p.a
Guarantee	Parent company P (the flagship company of the group) provides a guarantee to bank B – to make payment of the amount due if company S fails to make a payment within 30 days after it falls due.
Guarantee Fee	Nil

Company S has estimated the fair value of the guarantee (using the principles of Ind AS 113, Fair Value Measurement) as INR5 million based on the premium/fee that it would be required to pay to a market participant (e.g., a bank) to provide a similar guarantee at 1 April 2016.

Case Study : Financial Guarantee continued ...

- **Accounting issue**

- **Company P**

The parent company P is required to analyse whether the guarantee provided to bank B meets the definition of a financial guarantee contract and should be recognised at its fair value under Ind AS 109.

- **Company S**

Company S is the beneficiary of the guarantee. While Ind AS 109 does not specifically apply, company S may reflect the financial guarantee contract appropriately in its financial statements on the same principles as those applied by company P .

- **Bank B**

The holder of the financial guarantee is required to assess whether this guarantee is within the scope of Ind AS 109 or should be accounted for separately.

Presentation of liabilities and equity

A critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation that meets the definition of a financial liability. If there is an obligation to deliver cash or another financial asset, the instrument usually meets the definition of a financial liability, even though its form may be that of an equity instrument.

Examples of financial instruments that have the form of equity instruments, but in substance meet the definition of a financial liability and therefore should be accounted for as financial liabilities, are

- *A preference share that provides for mandatory redemption by the issuer for a fixed amount at a fixed or determinable future date. This is a financial liability of the issuer because the issuer has an obligation to pay cash or another financial asset.*
- *A preference share that gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed amount. This is a financial liability of the issuer because the issuer has an obligation to pay cash or another financial asset.*
- *A financial instrument that gives the holder the right to put the instrument back to the issuer for a fixed amount of cash or another financial asset. This is a financial liability of the issuer because the issuer has an obligation to pay cash or another financial asset.*

Case Study

This case illustrates the application of the principle for how to distinguish between liabilities and equity.

Facts

During 2004, Entity A has issued a number of financial instruments. It is evaluating how each of these instruments should be presented under Ind AS 32:

- (a) A perpetual bond (i.e., a bond that does not have a maturity date) that pays 5% interest each year
- (b) A mandatorily redeemable share with a fixed redemption amount (i.e., a share that will be redeemed by the entity at a future date)
- (c) A share that is redeemable at the option of the holder for a fixed amount of cash
- (d) A sold (written) call option that allows the holder to purchase a fixed number of ordinary shares from Entity A for a fixed amount of cash

Required

For each of the above instruments, discuss whether it should be classified as a financial liability and, if so, why?

Split Accounting for Compound Instruments

Compound Instruments are non-derivative financial instruments contain both liability and equity elements

Example

A bond that is convertible into a fixed number of ordinary shares of the issuer is a compound instrument. From the perspective of the issuer, a convertible bond has two components:

(1) An obligation to pay interest and principal payments on the bond as long as it is not converted.

This component meets the definition of a financial liability, because the issuer has an obligation to pay cash.

(2) A sold (written) call option that grants the holder the right to convert the bond into a fixed number of ordinary shares of the entity. This component meets the definition of an equity instrument.

Method of splitting the value

Fair value of compound instrument

– Fair value of liability component (= its initial carrying amount)

= Initial carrying amount of equity component

The accounting for the equity component is outside the scope of **Ind AS 109**. Equity is not re-measured subsequent to initial recognition.

Convertible Options

Contract Settled in own Equity Shares	Monetary Value of consideration (Amount per share)	Number of shares	Classification
Scenario 1	Fixed	Variable	Financial Liability
Scenario 2	Variable	Variable	Financial Liability
Scenario 3	Variable	Fixed	Financial Liability
Scenario 4	Fixed in a currency other than entities functional currency	Fixed	Financial Liability
Scenario 5	Fixed	Fixed	Equity

Case Study

➤ Case Study

This case illustrates the accounting for issued convertible debt instruments.

Facts

On October 31, 20X5, Entity A issues convertible bonds with a maturity of five years. The issue is for a total of 1,000 convertible bonds. Each bond has a par value of \$100,000, a stated interest rate is 5% per year, and is convertible into 5,000 ordinary shares of Entity A. The convertible bonds are issued at par.

The per-share price for an Entity A share is \$15. Quotes for similar bonds issued by Entity A without a conversion option (i.e., bonds with similar principal and interest cash flows) suggest that they can be sold for \$90,000.

Required

(a) Indicate how Entity A should account for the compound instrument on initial recognition.

(b) Determine whether the effective interest rate will be higher, lower, or equal to 5%.

Treasury Shares

Treasury shares are shares that are not currently outstanding. When an entity reacquires an outstanding share or other equity instrument, the consideration paid is deducted from equity. No gain or loss is recognized in profit or loss even if the reacquisition price differs from the amount at which the equity instrument was originally issued. Similarly, if the entity subsequently resells the treasury share, no gain or loss is recognized in profit or loss even if the proceeds at reissuance differ from the consideration paid when the treasury shares were reacquired previously.

The amount of treasury shares is disclosed separately either in the notes or on the face of the balance sheet.

Example

On January 15, 20X5, Entity A issues 100 shares at a price of \$50 per share, resulting in total proceeds of \$5,000. It makes this journal entry:

Dr Cash \$5,000

Cr Equity \$5,000

On August 15, 20X5, Entity A reacquires 20 of the shares at a price of \$100 per share, resulting in a total price paid of \$2,000. It makes this journal entry:

Dr Equity \$2,000

Cr Cash \$2,000

On December 15, 20X5, Entity A reissues 15 of the 20 shares it reacquired on August 15, 20X5, at a price of \$200 per share, resulting in total proceeds of \$3,000. It makes this journal entry:

Dr Cash \$3,000

Cr Equity \$3,000

Case Study

This case illustrates the effect on equity of treasury share transactions.

Facts

At the beginning of 20X4, the amount of equity is \$534,000.

These transactions occur during 20X4:

- February 15: Dividends of \$10,000 are paid.
- March 14: 10,000 shares are sold for \$14 per share.
- June 6: 2,000 shares are repurchased for \$16 per share.
- October 8: 2,000 shares previously repurchased are resold for \$18 per share.
- Profit or loss for the year 20X4 is \$103,000.
- No other transactions affect the amount of equity during the year.

Required

Indicate the effect of these transactions on the amount of equity and determine the amount of equity outstanding at the end of the year.

Presentation of interest, dividends, losses, and gains

The classification of an issued financial instrument as either a financial liability or an equity instrument determines whether interest, dividends, gains, and losses relating to that instrument are recognized in profit or loss or directly in equity.

- Dividends to holders of outstanding shares that are classified as equity - directly to equity.
- Dividends to holders of outstanding shares that are classified as financial liabilities - same way as interest expense on a bond.
- Gains and losses associated with redemptions of financial liabilities – profit or loss.
- Changes in the fair value of equity instruments of the entity - not recognized in the financial statements.
- costs incurred in issuing or acquiring own equity instruments are not expensed but accounted for as a deduction from equity. Such costs include regulatory fees, legal fees, advisory fees, and other transaction costs.

Offsetting of a Financial Asset and a Financial Liability

Ind AS 32 requires a financial asset and a financial liability to be offset with the net amount presented as an asset or liability in the balance sheet when, and only when, these two conditions are met:

- (1) A right of set-off. The entity currently has a legally enforceable right to set off the recognized amounts. This means that the entity has an unconditional legal right, supported by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to another party by applying an amount due from that other party.
- (2) Intention to settle net or simultaneously. The entity intends either to settle on a net basis or to realize the asset and settle the liability simultaneously.

Presentation and disclosure

➤ ***Balance Sheet Presentation***

No change as compared to Ind AS 107 except ;

Entities that have designated a financial liability at fair value through profit or loss have new disclosures in addition to the requirement to present changes in own credit risk for liabilities separately in OCI. The following new information should now be provided ;

- details of transfers of cumulative gains/losses within equity and the reasons for the transfer; and
- the amount presented in OCI that was realised on derecognition of liabilities during the period.

Questions

