

Ind AS 109 Financial Instruments

Classification and Measurement

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Agenda

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- ▶ Classification of financial assets
- ▶ Business model test
- ▶ Contractual cash flow characteristics' test
- ▶ Classification of financial liabilities
- ▶ Reclassification
- ▶ Initial measurement
- ▶ Subsequent measurement

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Definition



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Financial instrument

- ▶ Any **contract** that gives rise to both
 - ▶ a **financial asset** of one entity, and
 - ▶ a **financial liability** or **equity instrument** of another entity

Financial asset

- ▶ An asset that is:
 - ▶ Cash
 - ▶ An equity instrument of another entity
 - ▶ A contractual right:
 - ▶ To receive cash or another financial asset; or
 - ▶ To exchange financial assets or financial liabilities under potentially favourable conditions; or

Financial asset (cont.)

- ▶ 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

Exercise – identify financial assets?

1. Shares of subsidiary companies
 2. Advance given for purchase of goods
 3. Investment in perpetual debt carrying interest at fixed rate
 4. Prepaid expense
 5. Deferred tax asset
 6. CENVAT credit receivable
 7. Lease deposit paid
 8. Shares of the entity held by consolidated ESOP Trust
 9. USD-INR option held by the entity. The entity is buyer of the option
 10. Gold bullion: Whether a financial instrument (like cash) or a commodity
-

Response

1. Yes. However, investment in subsidiary is generally not covered under Ind AS 109.
 2. No. There is no contractual right to receive cash/other financial assets
 3. Yes. Instrument contains contractual right to receive interest at stated rate
 4. No. There is no contractual right to receive cash/other financial assets
 5. No. Not arising because of contractual arrangement
 6. No. Not arising because of contractual arrangement
 7. Yes. The lessee has contractual right to receive lease deposit at the end of lease term
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Response

8. No. Own equity instruments are not financial asset for the entity
9. Yes. Financial instruments include not only primary financial instruments but also derivatives instruments. Since the entity is option buyer, it is potentially favourable to the entity
10. No. Commodity. Although gold bullion is highly liquid, there is no contractual right to receive cash or another financial asset

Financial liability

- ▶ Any liability that is
 - ▶ a contractual obligation:
 - ▶ to deliver cash or another financial asset 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

Financial liability

- ▶ 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

Exercise — identify financial liabilities?

1. Tax liability
2. Finance lease obligations
3. Non-refundable revenue received in advance
4. Non-refundable advance received against sale of government securities
5. Liability for damages under a lawsuit
6. Financial guarantees given

Response

1. No. Tax liability arises as per the requirements of law and not because of contractual arrangement
2. Yes. However, accounting for financial lease obligations, except derecognition, is not covered under IFRS 109. It is covered under IAS 17.
3. No. There is no contractual obligation to pay cash/other financial assets
4. Yes. Instrument contains contractual obligation to deliver other financial asset, viz., government securities
5. No. Not arising because of contractual arrangement

Response

6. Yes. The entity has contractual right to pay cash if the original debtor fails to pay. For an instrument to be classified as financial liability, it is not necessary that the entity should have an unconditional obligation to pay. Contractual obligation to pay which are contingent upon future events are also financial liability

Equity instruments

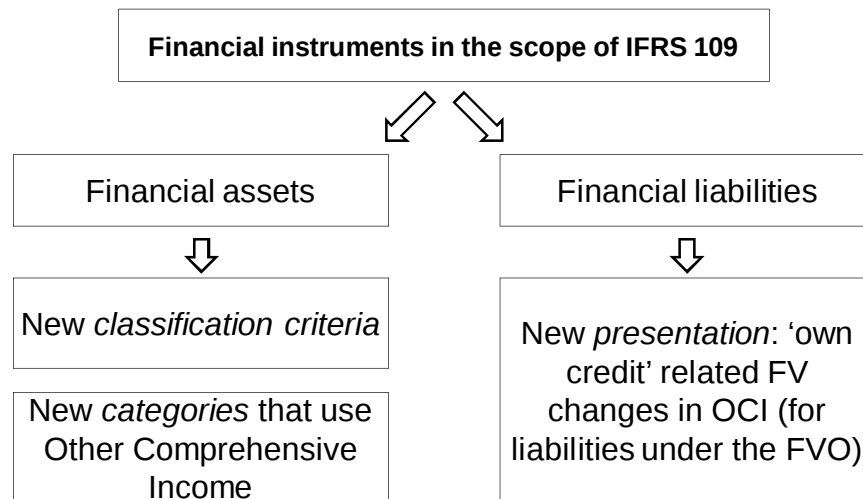
- ▶ Any contract that evidences a residual interest in the net assets of an entity
 - ▶ Examples
 - ▶ Equity shares
 - ▶ Preference shares (if certain criteria are met)
 - ▶ Warrants
 - ▶ Written call options to issue fixed number of equity shares for a fixed price

Detailed criteria for classification of instruments as liability or equity has already been covered under separate session.

Classification of Financial Assets



IFRS 9 classification and measurement model – changes from IAS 39

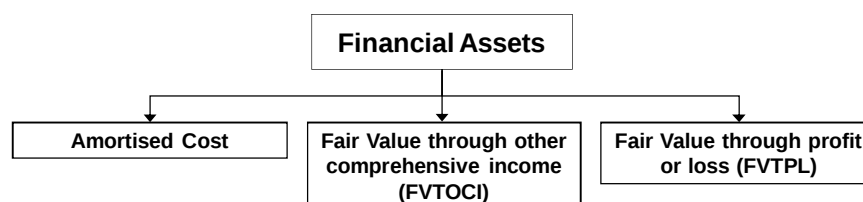


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Classification of financial assets – an overview

- Financial assets has been classified into three categories as per IFRS 9:



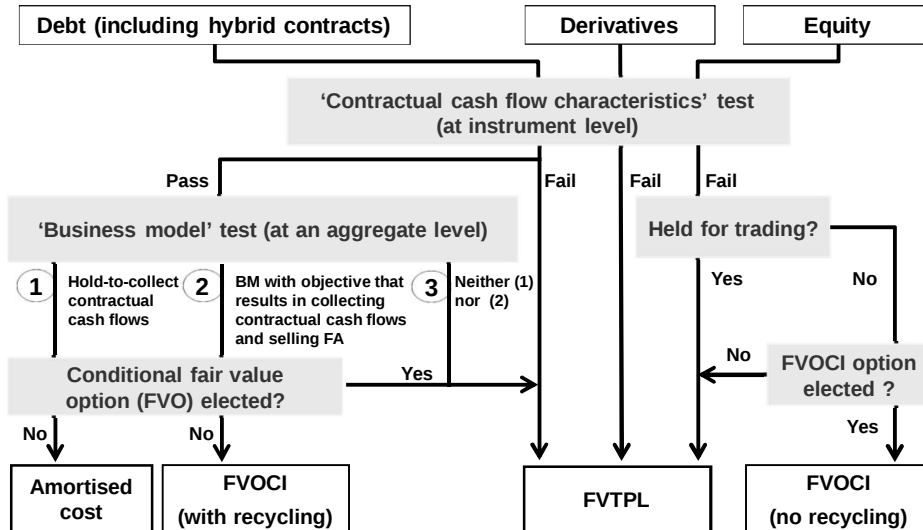
- Financial assets shall be classified on the basis of both:

- (a) the entity's **business model** for managing the financial assets and
- (b) the **contractual cash flow** characteristics of the financial assets.

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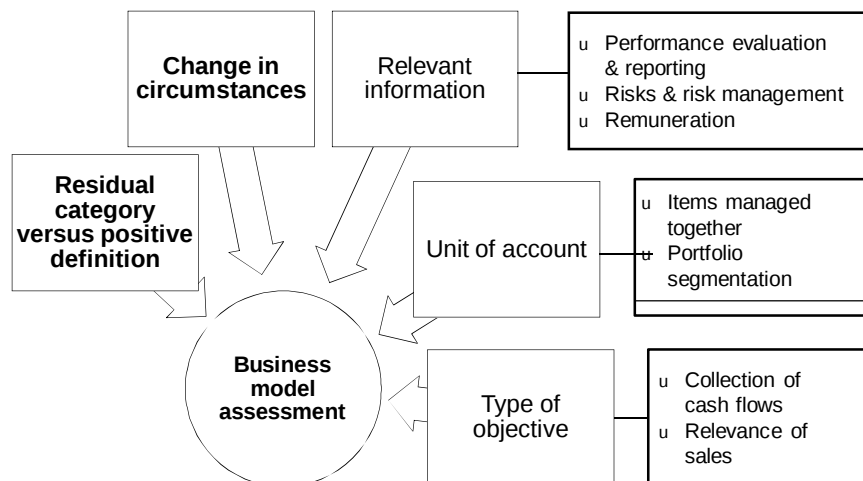
Classification and measurement model of financial assets



Business model



How to assess the business model



Overall business model assessment

- ▶ Refers to how an entity manages its financial assets in order to generate cash flows and create value for the entity.
- ▶ The entity's business model for managing financial assets is observed through particular activities undertaken to achieve the its objectives
- ▶ Sales do not drive the business model assessment and information about past sales should not be considered in isolation
- ▶ Business activities usually reflect the way in which the performance of financial assets is evaluated and reported, as well as the risks that typically affect its performance

Amortised cost business model (hold to collect)

- ▶ Examples of sales that would be consistent with a hold to collect business model:
 - ▶ Sales due to deterioration in credit quality in line with a documented investment policy
 - ▶ Infrequent sales (e.g., unanticipated stress scenarios), even if significant
 - ▶ Insignificant sales, both individually and in aggregate, even if frequent
 - ▶ Sales made close to the maturity and the proceeds approximate the collection of the remaining cash flows
 - ▶ The fact that the requirement to sell the financial asset is imposed by a third party (e.g., a regulator) is not relevant for assessment of business model.
-

Amortized cost - example

- ▶ An entity purchased a debt instrument for \$1,000. The instrument pays interest of \$60 annually and had 10 years to maturity when purchased. The entity intends to hold the asset to collect the contractual cash flows and the instrument was classified as a financial asset at amortised cost.
 - ▶ Nine years have passed and the entity is suffering a liquidity crisis and needs to sell the asset to raise funds.
 - ▶ The sale was not expected on initial classification and does not affect the classification (i.e. there is no retrospective reclassification).
-

FVOCI business model (hold to collect and sell)

- ▶ FVOCI measurement applies under a business model whose objective results in both:
 - ▶ Hold-to-collect contractual cash flows
 - ▶ Sell financial assets
- ▶ Only financial assets with contractual cash flows that are solely Principal & Interest would qualify for Fair Value through other comprehensive income
- ▶ The category is neither a free choice nor a residual category

Fair Value through other comprehensive income (FVTOCI) – example 1

- ▶ A bank holds financial assets to meet its everyday liquidity needs
- ▶ The bank seeks to minimise the costs of managing its liquidity needs and therefore **actively manages the return on the portfolio**
- ▶ The bank typically **holds some** financial assets to collect contractual cash flows and **sells others to reinvest** in higher yielding assets or to better match the duration of liabilities
- ▶ This strategy has resulted in **significant and recurring** sales activity in the past, which is expected to continue

Fair Value through other comprehensive income (FVTOCI) – example 2

- ▶ An insurer holds financial assets in order to fund insurance contract liabilities
- ▶ The insurer uses the proceeds from the contractual cash flows on the financial assets to settle insurance contract liabilities as they come due
- ▶ The insurer also undertakes **significant buying and selling** activity **to rebalance** the portfolio of financial assets **on a regular basis** as estimates of the expected cash flows needed to fulfil the insurance contract liabilities change to ensure that the contractual cash flows from the financial assets are sufficient to settle those liabilities.

Fair Value through other comprehensive income (FVTOCI) – example 3

- ▶ A non-financial entity anticipates incurring capital expenditure in a few years' time. The entity invests its excess cash in financial assets in order to fund the expenditure when the need arises
- ▶ The entity's objective for managing the financial assets is **to maximise the return** on those financial assets
 - ▶ Accordingly, the entity will sell financial assets and re-invest the cash in financial assets with a higher yield when an opportunity arises
- ▶ The managers responsible for the portfolio are **remunerated based on the return** generated by the financial assets

Fair Value through other comprehensive income (FVTOCI) – example 4

- ▶ An entity anticipates the purchase of a large property in eight years' time. The entity invests cash surpluses in short and long-term financial assets. Many of the financial assets purchased have a maturity in excess of eight years.
- ▶ The entity holds the financial assets for their contractual cash flows but will sell them and re-invest the cash for a higher return as and when an opportunity arises.
- ▶ The objective of the business model is achieved by collecting contractual cash flows and selling the financial assets. The entity's decisions to hold or sell aim to maximise returns from the portfolio of financial assets.

Fair value through profit or loss business model

- ▶ Fair value through profit or loss is the residual measurement category applicable to all instruments failing either the contractual cash flow or the business model test (this includes instruments held for trading, derivatives and equity instruments)
- ▶ FVTPL also applicable for financial instruments under a Fair value through other comprehensive income business model if accounting mismatch is present

Contractual cash flow characteristics' test



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Contractual cash flow characteristics' test

- ▶ Contractual terms of the financial asset give rise, on specified dates, to cash flows that solely represent principal and interest payments
- ▶ 'Interest' is consideration for the time value of money and the credit risk associated with the principal amount outstanding during a particular period of time

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Contractual cash flow characteristics' test

- ▶ Meaning of interest
 - ▶ *De minimis* and non-genuine features to be disregarded
 - ▶ Conceptual basis for P&I is a basic lending-type relationship
 - ▶ Time value of money and credit risk as the most significant, but not the only, components of a basic lending-type return
 - ▶ Liquidity risk and profit margin as other possible components

Contractual cash flow characteristics' test

- ▶ Contractual cash flow characteristic that introduces leverage do not have the characteristics of interest e.g. option, forward and swap contracts
- ▶ An instrument that is subordinated to other instruments (e.g. to general creditors) may still have contractual cash flows that are principal and interest.

Contractual cash flow characteristics' test

Prepayment, extension options and other provisions

May be recorded at amortised cost only if several conditions are met:

Prepayment options

- ▶ the prepayment amount substantially represents unpaid principal and interest (may include early termination compensation)

Extension options

- ▶ the terms can only result in payments of principal and interest during the extension period

Contractual cash flow characteristics' test

Prepayment, extension options and other provisions

Other contractual provisions:

- ▶ All other contractual provisions that could change the timing or amount of payments do not result in contractual cash flows that are solely principal and interest unless a variable rate represents consideration for the time value of money and the credit risk associated with the principal amount outstanding

Contractual cash flow characteristics' test Examples

Instruments that will qualify	Instruments that will <u>NOT</u> qualify
A bond with a stated maturity date. Principal and interest are linked to an inflation index that is not leveraged.	A convertible bond that is convertible into equity instruments of the issuer.
A variable interest rate loan with a stated maturity date that permits the borrower to change the period of the market interest rate at each interest reset date on an ongoing basis.	A loan that pays an inverse floating rate, i.e. the interest rate has an inverse relationship to the market interest rates.
A bond with a stated maturity date and pays a variable market interest rate which is capped.	A constant maturity bond with a five-year term that pays a variable rate that is reset periodically but always reflects a five-year maturity.
A full recourse loan secured by collateral.	

Classification of Financial Liabilities



Classification of financial liabilities

Financial liabilities has been classified into two categories:

Category	Main use
Fair value through profit or loss	▶ Financial liabilities that are held for trading (including derivatives) ▶ Financial liabilities that are designated as FVTPL on initial recognition ▶ Contingent consideration recognised by an acquirer in a business combination
Amortised Cost	▶ All liabilities not in the above category

Reclassification of Financial assets and Liabilities



Reclassification

Financial Assets:

- ▶ When and only when entity changes its business model for managing financial assets, reclassification of financial assets is required. Such changes expected to be very rare.
- ▶ If financial asset is reclassified from amortised cost to Fair Value through profit or loss, its fair value is determined at reclassification date and gains or losses recognised in profit or loss.
- ▶ If financial asset reclassified from Fair Value through profit or loss to amortised cost, its fair value at reclassification date becomes new carrying amount.

Reclassification

Financial Liabilities:

- ▶ Reclassification of financial liabilities is not allowed.

Initial Measurement



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Initial Measurement

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

However, if part of the consideration given or received is for something other than the financial instrument or the transaction was not transacted at arm's length, the fair value is estimated using a valuation technique.

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Initial Measurement

Please advice on initial measurement of following transactions

- a) A Ltd lends to B Ltd loan of 10 million for 5 years and classify as asset under loans and receivable. The Loan carries no interest. Market rate of interest is 10%.
- b) A ltd grants interest free loan of 10 Lac to a employees for a period of two years. Market rate of interest is 10%

Interest-free lease deposit – Example 1

- Company A leases a tower site from Company B. A gives a lease deposit of INR 100,000 to Company B for five years and classifies the resulting asset within loans and receivables. The deposit carries no interest.
- On initial recognition, the market rate of interest for a five year loan with payment of interest at maturity is 10% per year.

How will the deposit be recorded in the financial statements of entity A?

Interest-free lease deposit – Example 1

Solution:

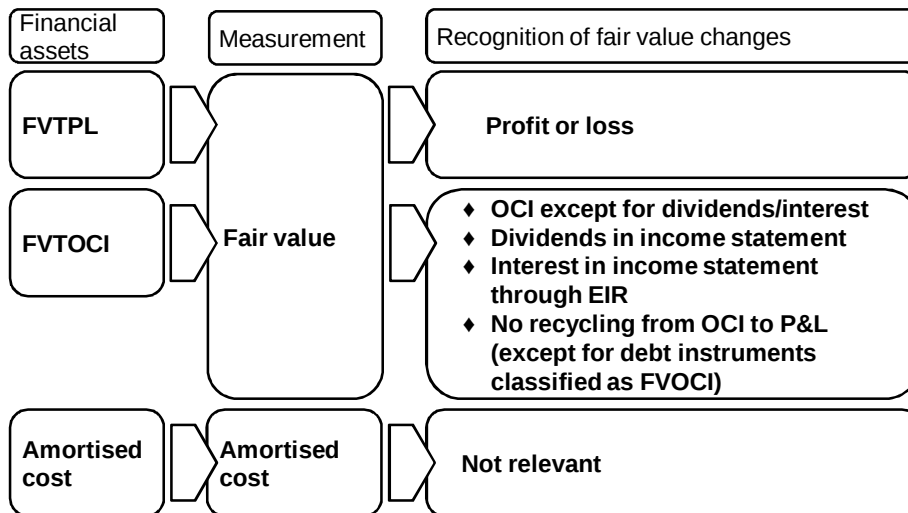
The initial fair value of the deposit is the present value of the future payment of INR 100,000, discounted using the market rate of interest for a similar loan of 10% for five years. This equates to INR 621,000.

Rationally, A would also expect to obtain other future economic benefits that have a fair value of INR 379,000 (the difference between the total consideration given of INR 100,000 and the loan's initial fair value of INR 621,000). The difference is not a financial asset, since it is paid to obtain expected future economic benefits, which here relate to the underlying lease. A recognises that amount as a pre-payment on the lease and amortises the resulting asset on a straight-line basis over the period of the lease.

Subsequent Measurement



Subsequent measurement: Financial assets



Subsequent measurement: Financial liabilities

