# Recognition of financial Instruments

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Initial Recognition

## ① Initial Measurement

Recognise in its Balance Sheet when, and only when, the entity becomes party to the "contractual provisions" of the instrument

The following are examples of applying the above principle:-

### (1) unconditional Receivables & payables

when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash.

### (2) Firm commitment to purchase or sell goods or services

Not recognised until atleast one of the parties has performed under the agreement

For example, an entity that receives/places a firm order does not generally recognise an asset|liability at the time of commitment but, instead, delays recognition until the ordered goods or services have been shipped, delivered or rendered.

### (3) Firm commitment to buy or sell non-financial items

Ind AS109 shall be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument or by exchanging financial instruments as if they are financial instruments, that is, derivatives unless they were entered into & continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usuage requirements. However, this standard shall be applied to those contracts that an entity designates as measured at FVTPL.

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Net fair value is recognised as an asset or liability on commitment date.

### (4) forward contract

Recognised on the commitment date, instead of on the date on which settlement takes place.

When the entity becomes a party to a forward contract, the fair values of the rights & obligations are often equal, so that net fair value of the forward is zero.

If the net fair value of the right & obligation is not zero, the contract is recognised as an asset or liability.

Note:- Generally, no upfront premium is paid by one party in a forward contract to the other at the inception of contract. This is indicative of the fact that fair value of a forward contract on inception is approximately zero.

(5) option contracts

when the holder or writer becomes a party to the contract

Note :- option holder generally pays an up-front premium to the option writer at the inception of the option contract. This provides evidence that there is some fair value of the rights & obligations of the parties at the inception of an option contract.

(6) planned future transactions

Not recognised as assets & liabilities because the entity has not become a party to a contract

(II) Regular way purchase or sale of financial Assets

- Recognised & derecognised, using trade date A/cing or settlement date A/cing
  - trade date A/cing: date that an entity commits itself to purchase or sell an asset
  - settlement date A/cing: date that an asset is delivered to or by an entity.

- "Regular way purchase or sale" is
  - a purchase or sale of a financial asset
  - under a contract
  - whose terms require delivery of the asset
  - within the time frame
  - established generally by regulation or convention in the market place concerned.

- A contract that requires or permits net settlement of the change in the value of the contract is not a regular way contract. Instead, such a contract is accounted for as a derivative in the period b/w the trade date and settlement date

Illustration :-

On 30th march 2015 an entity enters into an agreement to purchase a financial asset for ₹100 which is the fair value on that date.

On Balance sheet date i.e., 31/03/2015 the fair value is 102 & on settlement date i.e., 02/04/2015 fair value is ₹103

Pass necessary journal entries on trade date & settlement date when the asset acquired is measured at

(a) Amortised cost (b) FVTPL (c) FVTOCI

Ans:-

(a) financial Asset at Amortised cost

| | Trade date A/cing | Settlement date A/cing |
|---|---|---|
| 30/03/2015 - | financial Asset A/c Dr 100<br>To payables A/c 100 | - |
| 31/03/2015 - | - | - |
| 02/04/2015 - | payables A/c Dr 100<br>To cash A/c 100 | financial Asset A/c Dr 100<br>To cash A/c 100 |

(b) financial Asset at FVTPL

| | Trade date A/cing | Settlement date A/cing |
|---|---|---|
| 30/03/2015 - | Financial Asset A/c Dr 100<br>To payables A/c 100 | - |
| 31/03/2015 - | financial Asset A/c Dr 2<br>To P&L A/c 2 | fair value change A/c Dr 2<br>To P&L A/c 2 |
| 02/04/2015 - | Financial Asset A/c Dr 1<br>To P&L A/c 1<br><br>payables A/c Dr 100<br>To cash A/c 100 | fair value change A/c Dr 1<br>To P&L A/c 1<br><br>financial Asset A/c Dr 103<br>To cash A/c 100<br>To fair value change A/c 3 |

(c) Financial Asset at FVTOCI

| | Trade date A/cing | Settlement date A/cing |
|---|---|---|
| 30/03/2015 - | Financial Asset A/c Dr 100<br>To payables A/c 100 | - |
| 31/03/2015 - | Financial Asset A/c Dr 2<br>To OCI A/c 2 | fair value change A/c Dr 2<br>To OCI A/c 2 |
| 02/04/2015 - | Financial Asset A/c Dr 1<br>To OCI A/c 1<br><br>Payables A/c Dr 100<br>To cash A/c 100 | fair value change A/c Dr 1<br>To OCI A/c 1<br><br>Financial Asset A/c Dr 103<br>To cash A/c 100<br>To fair value change A/c 3 |

# Derecognition of Financial Assets

- Derecognition refers to the timing of removing a financial asset from the balance sheet.

- Ind AS 109 provides step-by-step flow chart for making this determination.

Consolidate all subsidiaries (Note 1)

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Determine whether the derecognition principles are applied to a "**part**" or "all" of an asset (or group of similar assets) (Note 2)

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Have the rights to the cash flows from the asset "**expired**"? (Note 3) — Yes → Derecognise the asset.

↓ No

Has the entity **transferred** its right to receive cash flows? (Note 4) — Yes → (to: Has the entity transferred substantially all risks & rewards?)

↓ No

Has the entity assumed a contractual obligation to pay the cash flows in an arrangement that meets 3 conditions? (Note 5) — No → Continue to recognise the asset.

↓ Yes

Has the entity **transferred** substantially all risks & rewards? (Note 6) — Yes → Derecognise the asset

↓ No

Has the entity **retained** substantially all risks & rewards? (Note 6) — Yes → continue to recognise the asset

↓ No

Has the entity **retained** control of the asset? (Note 7) — No → Derecognise the asset

↓ Yes

Continue to recognise the asset to the extent of the entity's "<u>continuing involvement</u>"

## Note 1 - consolidate all subsidiaries

In consolidated FSs, a/cing principles for derecognition are applied at a consolidated level. Hence an entity first consolidates all subsidiaries in accordance with Ind AS 110 & then applies those requirements to the resulting group.

## Note 2 - Whether the derecognition principles are applied to "Part or all" of an asset (or group of similar assets)

- Derecognition requirements are applied to a "part" of a financial asset if that part meets ANY of the following three conditions:

  (i) The part comprises only specifically identified cash flows from a financial asset (or a group of similar financial assets)

  for example, when an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash flows, but not the principal cash flows from a debt instrument, derecognition principles are applied to the interest cash flows.

  (ii) The part comprises only a fully proportionate (prorata) share of the cash flows from a financial asset (or a group of similar financial assets).

  for example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90% share of all cash flows of a debt instrument, derecognition principles are applied to 90% of those cash flows.

  (iii) The part comprises only a fully proportionate (prorata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets).

  for example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90% share of interest cash flows from a financial asset, derecognition principles are applied to 90% of those interest cash flows.

- In all other cases, derecognition principles are applied to the financial asset in its entirety (or group of similar financial assets in their entirety)

  for example, when an entity transfers

  (i) the rights to the first or the last 90% of cash collections from a financial asset (or a group of financial assets), or

  (ii) the rights to 90% of the cash flows from a group of receivables, but provides a guarantee to compensate the buyer for any credit losses upto 8% of the principal amount of the receivables,

  derecognition principles are applied to the financial asset in its entirety.

## Illustrations

### ① sale of disproportionate interest

Entity A originates a portfolio of similar 5 year interest-bearing loans of 10,000. A then enters into an agreement with entity B. A agrees to pay to B the first 9000 of cash collected from the portfolio plus interest in an exchange for an upfront cash payment from B. A retains the rights to the last 1000 plus interest, representing a subordinated interest in the portfolio. Can the sale of the rights to the first 9000 cash collections from a group of similar financial assets be considered a part of those assets for derecognition purposes?

Ans:- No. The derecognition principles should be applied to the entire portfolio of loans. The transfer of the rights to the first of any cash collections from a group of financial assets cannot be assessed for derecognition separately. The first 9000 of cash flows plus interest is not a fully proportionate share of the cash flows because any credit losses are borne in the first instance by A & are not shared proportionally b/w the parties. Also, the first 9000 of cash flows plus interest cannot be regarded as specifically identified cash flows, as it is not possible to identify which loans in the portfolio the first 9000 cash flows will arise from.

### ② Sale of asset with a guarantee

Entity C enters into an arrangement to transfer the rights to 90% of the cash flows of a group of receivables to Entity D. C also provides a guarantee to compensate D for any credit losses upto 8% of the principal amount of receivables.

Ans:- The derecognition principles should be applied to the asset in its entirety. Although the transferor has transferred 90% of all cash flows from the asset; the existence of the guarantee that the transferor bears a disproportionate share of any credit losses.

## Note 3 - Right to receive cash flows from the asset expired.

- cash flows from a financial asset expire upon payment of entire due amount or the legal release of the debtor by the creditor from the obligation to pay. In case of derivatives, this condition is considered met when, for example, contractual exercise period of an option expires & option is not exercised.
- Few circumstances wherein renegotiation does result in "expiry of right to receive cash flows":
  (a) Agreeing to a moratorium period for repayment of principal or extension of the overall tenor of the loan.
  (b) Substantial reduction in the interest rates.
  (c) Agreeing to a right to convert loan or a part thereof into equity shares after a certain period of time.

## Note 4 - Entity transferred its right to receive cash flows

An entity transfers a financial asset if, and only if, it either:

(a) transfers the contractual rights to receive the cash flows of the financial asset, or

(b) retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flow to one or more recipients in an arrangement.

For example, securitisation arrangements are a common form of transfer of financial assets in India. In these arrangements, the originator of a financial asset, say a bank or a NBFC, settle a Trust & transfer a portfolio of financial asset to that trust. Thereafter, securities of that trust are issued to unrelated parties or investors. Such arrangements are often "pass through" arrangements, in the sense that the originator or the Trust retains the rights to receive cash flows from the financial asset, but they have a simultaneous obligation to pay those cash flows to a recipient.

Note:- Assumes a contractual obligation to pay the cash flows in an arrangement that meets 3 conditions

(PASS THROUGH ARRANGEMENTS)

When the entity retains the contractual rights to receive the cash flows of a financial asset (original asset), but assumes a contractual obligation to pay those cash flows to one or more entities (eventual recipients), the entity treats the transaction as a transfer of a financial asset if, and only if, all of the following 3 conditions are met.

(a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset.

Short term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.

(b) The entity is prohibited by the terms of the transfer of contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.

(c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents during the short settlement period from the collection date to the date of required remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients.

Note:- The standard does not define the word "material" in this condition. Therefore, the same should be understood in common trade parlance.

## Illustrations

(1) Pass through arrangements

Manufacturer J enters into an arrangement with Factory K. Entity J agrees to pass on the cash flows it collects from specified trade receivables to K for an upfront payment. Entity J has to transfer the collected cash flows within 2 working days, J has no obligation to transfer cash to K unless it collects equivalent amounts from the trade receivables and is prohibited by the terms of the arrangement with J from selling or pledging the trade receivables to a third party.

Ans: The three conditions for a pass-through arrangement are met

(a) Entity J retains the contractual rights to receive the cashflows of the financial asset but it assumes an obligation to pass on the cash flows from the underlying assets without material delay

(b) Entity J cannot sell or pledge the asset

(c) Entity J also has no obligation to make payments unless it collects equivalent amounts from the asset

Entity J now assesses whether the other criteria for derecognition are met i.e, it applies the risks & rewards & control tests.

(2) Transfer of disproportionate share in pass-through arrangement

Entity M originates a 5 year interest-bearing loan of 100. M then enters into an agreement with entity N in which, in exchange for a cash payment of 85, M agrees to pass to N the first 90 of all principal & interest payments collected from the loan. M accepts no obligation to make any payments to N other than the first 90 collected. M is prohibited by the terms of the agreement from selling or pledging the loan & has to remit the first 90 of collected cash flows to N without material delay. Can the transfer of a disproportionate share of the cashflows from a loan meet the conditions for a pass-through arrangement?

Ans:
Yes. The transfer of a disproportionate share of cash flows can qualify as a pass-through arrangement. In the above arrangement, the three conditions for a pass-through arrangement are met:

(a) M has no obligation to pay cash to N unless it collects the cash from the loan

(b) M has an obligation to pay cash flows collected from the loan to the eventual recipients (i.e., N) without material delay

(c) M has no right to sell or pledge the transferred asset

(3) Transfer versus Agency Relationship

Entity K enters into an arrangement with Bank L whereby L will manage K's securities. K transfers the securities to a safe custody account of L. L will receive a management fee for its service. K can decide when & which assets should be sold & can require surrender of the securities at any time. Is the transfer of securities to a custodian a transfer of contractual rights?

Ans:
No. The transfer of securities to a custodian is not a transfer. The contractual rights to the cash flows from the financial asset to be transferred to satisfy the conditions. L does not have rights to the cash flows of the transferred securities. L acts as agent of K.

## (4) fixed payments & pass-through arrangements

Manufacturer G offers a financing scheme for the sale of its office furnishing products. A customer has the option to pay the purchase price & accrued interest in fixed monthly instalments over a maximum period of 24 months. G agrees to pay to Bank H every month a predetermined amount of cash equal to the instalments due from its customers in exchange for an upfront cash payment. Does an arrangement whereby the transferor pays a fixed amount of cash to the transferee on a monthly basis meet the requirements of a pass-through arrangement?

Ans:-

No. Payment of a fixed amount of cash does not qualify as a pass-through arrangement, as it fails the requirements of condition (a). The amounts G is obliged to pay to H are not dependent on actual cash collections from the office furnishing receivables. G is obliged to pay an amount of cash that has been determined at the outset of the contract even if it has not collected the cash from its customers.

## (5) Loan sub-participations

Bank M originates a large loan for a corporate client. M agrees with other banks that in return for an upfront cash payment, it will pass on a percentage of all payments of principal & interest collected on the original loan to the participating banks as soon as they are received from the corporate client. The arrangement is non-recourse i.e., M has no obligation to pay the other banks unless it collects equivalent amounts from the corporate loan. M also cannot sell or pledge the loan. Does a loan sub-participation meet the pass-through requirements?

Ans:-

Yes. The three conditions for a pass-through arrangement are met.

- M retains the contractual rights to receive the cash flows of the financial asset, but it assumes an obligation to pass-on the cash flows from the underlying assets without material delay.
- M cannot sell or pledge the assets
- M also has no obligation to make payments unless it collects equivalent amounts from the asset

## Note 6 - Entity transferred/retained substantially all "risks & rewards"

Ind AS 109 provides the guidance on "risk & rewards" test:

Change in exposure to the variability in the PV of future net cash flows from the financial asset

- Not significant → Entity has retained substantially all the risks & rewards of ownership of financial asset.
- Significant → Entity has transferred substantially all the risks & rewards of ownership of financial asset.

* Examples of when an entity has "transferred substantially" all the risks & rewards of ownership are:

(a) an unconditional sale of a financial asset

(b) sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase; and

(c) sale of a financial asset together with a put or call option that is deeply out of the money (i.e., an option that is so far out of the money it is highly unlikely to go into the money before expiry)

* Examples of when an entity has "retained substantially" all the risks & rewards of ownership are:

(a) sale & repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return.

(b) Securities lending arrangement

(c) Sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity

(d) sale of a financial asset together with a deep in-the-money put or call option (i.e., an option that is so far in the money that is highly unlikely to go out of the money before expiry)

(e) sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.

## Note 7: Entity retained the control of asset

depends on the "transferee's ability to sell the asset"

- If the transferee,

  (i) has the practical ability to sell the asset in its entirety to an unrelated third party, and

  (ii) is able to exercise that ability unilaterally & without needing to impose additional restrictions on the transfer,

  the entity has not retained control.

- In all other cases, the entity has retained control.

Note: A transferee has the practical ability to sell the transferred asset if it is traded in an active market because the transferee could repurchase the transferred asset in the market if it needs to return the asset to the entity.

Whether entity has retained control of the financial asset?

"NO"

Derecognise the financial asset

AND

Recognise separately as assets or liabilities any rights & obligations created or retained in the transfer.

"Yes"

Continue to recognise the financial asset

AND

Recognise the financial asset to the extent of its continuing involvement in the financial asset.

## Transfers that Qualify for derecognition

(1) If, as a result of a transfer, a financial asset is derecognised in its entirety, but the transfer results in the entity obtaining a new financial asset or assuming a new financial liability or a servicing liability,

the entity shall recognise the new financial asset, financial liability or servicing liability at its "fair Value"

(2) On derecognition of a financial asset in its entirety, the difference b/w:

(a) carrying amount (measured at the date of derecognition) and

(b) consideration received (including any new asset obtained less any new liability assumed)

shall be recognised in "profit or loss"

(3) If an entity transfers a financial asset in a transfer that Qualifies for derecognition in its entirety & retains the right to service the financial asset for a fee,

it shall recognise either a "servicing asset" or a "servicing liability" for that servicing contract.

fee to be received is expected to be more than adequate compensation for the servicing
↓
Recognised at an amount determined on the basis of an allocation of the carrying amount of the larger financial asset.

fee to be received is not expected to compensate the entity adequately for performing the servicing

(4) If the transferred asset is part of a larger financial asset (eg., when an entity transfers interest cash flows that are part of a debt instrument) and the part transferred qualifies for derecognition in its entirety,

the previous carrying amount of the larger financial asset shall be allocated b/w the part that continues to be recognised & the part that is derecognised, on the basis of relative fair values of those parts on the date of transfer.

- for this purpose, a retained servicing asset shall be treated as a part that continues to be recognised.

- The difference b/w:

(a) carrying amount (measured at the date of derecognition) allocated to the part derecognised and

(b) consideration received for the part derecognised (including any new asset obtained less any new liability assumed)

Shall be recognised in "profit or loss"

## Transfers that do not Qualify for derecognition

- If a transfer does not result in derecognition because the entity has retained substantially all the risks & rewards of ownership of the transferred asset, the entity shall:

(a) continue to recognise the transferred asset in its entirety and

(b) Recognise a financial liability for the consideration received.

- In subsequent periods, the entity shall recognise any income on the transferred asset & any expense incurred on the financial liability.

### Illustration

① Larger financial Asset

Sea Ltd has lent a sum of ₹10 Lakhs @ 18% p.a for 10 years. The loan had a fair value of ₹12,23,960 at the EIR of 13%. To mitigate prepayment risks but at the same time retaining control over the loan, Sea Ltd transferred its right to receive the principal amount of the loan on its maturity with interest, after retaining rights over 10% of principal & 4% interest that carries fair value of ₹29,000 & ₹1,84,620 respectively. The consideration for the transaction was ₹9,90,000. The interest component retained includes a 2% fee towards collection of principal & interest that has a fair value of ₹65,160. Defaults, if any, are deductible to a maximum extent of the company's claim on principal portion. You are required to show the Journal Entries to record derecognition of the loan.

Ans:

(i) Calculation of Securitized component of Loan

| | | ₹ | ₹ |
|---|---|---|---|
| fair value | | | 12,23,960 |
| Less: principal strip receivable (f.v) | | 29,000 | |
| Interest strip receivable (fv) | 1,19,460 | | |
| Value of service asset (fair value) | 65,160 | 1,84,620 | (2,13,620) |
| | | | 10,10,340 |

(ii) Apportionment of carrying amount in the ratio of fair values

| Particulars | fair value (₹) | calculation | Apportionment (₹) |
|---|---|---|---|
| derecognised { securitized component of loan | 10,10,340 | $\frac{10,10,340 \times 10,00,000}{12,23,960}$ | 8,25,468 |
| continue to be recognised (servicing Asset): principal strip receivable | 29,000 | $\frac{29,000 \times 10,00,000}{12,23,960}$ | 23,694 |
| Interest strip receivable | 1,19,460 | $\frac{1,19,460 \times 10,00,000}{12,23,960}$ | 97,601 |
| Servicing asset | 65,160 | $\frac{65,160 \times 10,00,000}{12,23,960}$ | 53,237 |

(iii) Entries to record the derecognition of the loan

Bank A/c Dr 9,90,000
    To Loan A/c 8,25,468 → derecognised
    To profit & Loss A/c 1,64,532

(Being entry for securitization of 90% principal with 14% interest)

Interest strip A/c Dr 97,601
Servicing Asset A/c Dr 53,237 → Recognised as "asset"
Principal strip A/c Dr 23,694
    To Loan A/c 1,74,532

(Being entry for interest, servicing Asset & principal strips received)

② factoring with/without recourse

Entity A (the transferor) holds a portfolio of receivables with a carrying value of ₹1,000,000. It enters into a factoring arrangement with entity B (the transferee) under which it transfers the portfolio to entity B in exchange for ₹900,000 of cash.

Entity B will service the loans after their transfer & debtors will pay amounts due directly to entity B. Entity A has no obligations whatsoever to repay any sums received from the factor & has no rights to any additional sums regardless of the timing or the level of collection from the underlying debts.

Comment

Ans: Entity A has transferred its rights to receive the cashflows from the asset via an assignment to entity B. Furthermore, as entity B has no recourse to entity A for either late payment risk or credit risk, entity A has transferred substantially all the risks & rewards of ownership of the portfolio.

Hence, entity A derecognises the entire portfolio. The diff. b/w carrying value of ₹1,000,000 & cash received of ₹900,000 i.e., ₹100,000 is recognised immediately as loss on derecognition of assets.

Had entity A not transferred its right to receive the cashflows from the asset or there would have been any credit default guarantee given by entity A, then it would have not led to complete transfer of risk & rewards & entity A could not derecognise the portfolio due to the same. Hence, the asset is recognised to the extent of continuing involvement.

## Continuing involvement in transferred assets (Partial derecognition)

(1) If an entity neither transfers nor retains substantially all the risks & rewards of ownership of a transferred asset, & retains control of the transferred asset,

the entity continues to recognise the transferred asset to the extent of its continuing involvement.

(2) Entity also recognises an associated liability that is measured in such a way that the net carrying amount of the transferred asset & the associated liability is:

- amortised cost of the rights & obligations retained by the entity, if the transferred asset is measured at amortised cost, or
- equal to the fair value of the rights & obligations retained by the entity when measured on a stand-alone basis, if the transferred asset is measured at fair value.

Recognised changes in the fair value of the transferred asset & the associated liability are accounted for consistently with each other & shall not be offset

for example, if the transferred asset is measured at amortised cost, the option in this standard to designate a financial liability as at a FVTPL is not applicable to the associated liability.

(3) If an entity's continuing involvement is in only a part of a financial asset, the entity allocates the previous carrying amount of the financial asset b/w the part it continues to recognise under continuing involvement, and the part it no longer recognises on the basis of the relative fair values of those parts on the date of the transfer. The difference b/w:

(a) carrying amount (measured at the date of derecognition) allocated to the part that is no longer recognised and

(b) consideration received for the part no longer recognised

shall be recognised in "Profit or loss"

(4) The entity shall continue to recognise any income arising on the transferred asset to the extent of its continuing involvement & shall recognise any expense incurred on the associated liability.

The following are the examples of how an entity measures a transferred asset & the associated liability:-

(1) Guarantee

- Continuing involvement asset is lower of.
  - (i) carrying amount of the asset &
  - (ii) Guarantee amount (maximum amt of consideration received that the entity could be required to pay)
- Associated liability is initiall measured at
  - Guarantee Amount
  - +
  - FV of Guarantee (which is normally the consideration received for the guarantee)
- Subsequently, the initial FV of the guarantee is recognised in profit or loss when the obligation is satisfied & the carrying value of the asset is reduced by any loss allowance.

Balance Sheet

| Liability | Asset |
|---|---|
| Lower of carrying amount & Guarantee Amount | Guaranteed Amt + FV of Guarantee |

= Net balance sheet position is the FV of Guarantee.

## (2) Assets measured at amortised cost

- If a put option obligation written by an entity or call option right held by an entity prevents a transferred asset from being derecognised & the entity measures the transferred asset at amortised cost,
  the associated liability is measured at its cost (i.e, consideration received) adjusted for the amortisation of any diff. b/w cost & gross carrying amount of the transferred asset at the expiration date of the option.
- If option is exercised, any diff. b/w carrying amount of the associated liability & the exercise price is recognised in profit or loss.

Example:-

Gross carrying amount of asset on date of transfer = ₹98

consideration received = ₹95

Gross carrying amount of asset on option exercise date = ₹100

Ans:- - Initial carrying amt of associated liability = ₹95

- Diff. b/w cost & gross CA at expirate date = ₹95 − ₹100 = (₹5) is recognised in profit or loss using the effective interest method.

## (3) Assets measured at fair value

### (i) Call option

If call option right retained by an entity prevents a transferred asset from being derecognised & the entity measures the transferred asset at fair value,

Balance sheet

| Asset | Liability |
|---|---|
| full fair value | [Lower of fair value of transferred asset (or) Strike price] − Time value of option |

option is deeply in money = Strike price − TV of option

option is deeply out money = FV − TV of option.

= Net balance sheet position is the FV of the call option.

Example:- FV of underlying asset = 80

option exercise price = 95

Time value of option = 5

Ans:- carrying amount of transferred asset = 80

carrying amount of associated liability = 80 − 5 = 75

FV of call option Right = 5

Note:- The adjustment to the measurement of the associated liability ensures that Net carrying Amount of asset & associated liability is "FV of call option Right"

(ii) put option

If a put option written by an entity prevents a transferred asset from being derecognised & the entity measures the transferred asset at fair value,

Balance sheet

| Asset | Liability | |
|---|---|---|
| Lower of strike price & fair value | Strike price + Time value of put option | = Net balance sheet position is FV of the put option. |

Example:- FV of underlying asset = 120
option exercise price = 100
Time value of option = 5

Note:- The adjustment to the measurement of the asset ensures that net carrying amount of asset & associated liability is "FV of put option"

Ans:- Associated liability = 100 + 5 = 105
Asset = 100
Time value of option (5)

(iii) Collar (Purchased call & written put)

If a collar prevents a transferred asset from being derecognised & the entity measures the asset at fair value,

Balance sheet

| Asset | Liability |
|---|---|
| full fair value | call option |

Net balance sheet position is "FV of options held & written by entity."

deeply in money = call exercise price + fv of put option - TV of call option
deep out money = FV + FV of put option - TV of call option

Note:- The adjustment to the measurement of the associated liability ensures that net carrying amount of asset & associated liability is "FV of options held & written by entity"

Example:- fv of call exercise price = 120
fv of put exercise price = 80
TV of put option = 1
TV of call option = 5
FV of asset at the date of transfer = 100

Ans:- Asset = 100
Associated liability = 100 + 1 - 5 = 96

Net Asset value = 4 (fv of options held & written by entity)

Illustrations

Debt-factoring with recourse - continuing Involvement asset

① Entity C agrees with factoring company D to enter into a debt factoring arrangement. under the terms of the arrangement, the factoring company B agrees to pay ₹91.5 crores, less a servicing charge of ₹1.5 crores (net proceeds of ₹90 crores), in exchange for 100% of the cash flows from short-term receivables. The receivables have a face value of ₹100 crores & carrying amount of ₹95 crores. The customers will be instructed to pay the amounts owed into a bank account of the factoring company. Entity C also writes a guarantee to the factoring company under which it will reimburse any credit losses upto ₹5 crores, over & above the expected credit losses of ₹5 crores & losses of upto ₹15 crores are considered reasonably possible. The guarantee is estimated to have a fair value of ₹0.5 crores. comment.

Ans:- If a guarantee provided by an entity to pay for default losses on a transferred asset prevents the transferred asset from being derecognised to the extent of the continuing involvement, the transferred asset at the date of transfer is measured at lower of

(i) carrying amount of the asset (₹95 crores) and

(ii) Guarantee amount (₹5 crores)

∴ continuing involvement Asset = ₹5 crores.

- Associated liability is initially measured at

Guarantee Amount + FV of Guarantee

= ₹5 cr + ₹0.5 crores = ₹5.5 crores.

- If an entity's continuing involvement is in only a part of a financial asset, the entity allocates the previous carrying amount of the financial asset between the part it continue to recognise under continuing involvement, & the part it no longer recognises on the basis of relative fair values of those parts on the date of transfer. The difference b/w:

(a) carrying amount (measured at the date of derecognition) allocated to the part that is no longer recognised (₹95 crores) &

(b) consideration received for the part no longer recognised (₹90 crores)

shall be recognised in profit or loss.

∴ Loss on sale of asset = ₹95 cr - ₹90 cr = ₹5 cr.

- The Entity shall continue to recognise any income arising on the transferred asset to the extent of its continuing involvement & shall recognise any expense incurred on the associated liability.

∴ Guarantee liability of ₹0.5 crores shall be amortised in profit or loss over the underlying period.

Journal Entry passed by C on date of derecognition

| | | |
|---|---|---|
| Cash A/c Dr | ₹90 cr | |
| Loss on derecognition A/c Dr | ₹5.5 cr (5+0.5) | |
| Continuing Involvement Asset A/c Dr | ₹5 cr | |
| To Receivables A/c | | ₹95 cr |
| To Associated Liability A/c | | ₹5.5 cr |

Subordinated Retained Interests - Continuing Involvement Approach

(2) An Entity has a portfolio of prepayable loans whose coupon & effective interest rate is 10% and whose principal amount & amortised cost is ₹10,000. It enters into a transaction in which, it return for a payment of ₹9115, the transferee obtains the right to ₹9000 of any collections of principal plus interest thereon at 9.5%. The entity retains rights to ₹1000 of any collections of principal plus interest thereon at 10% plus the excess spread of 0.5% on the remaining ₹9,000 of principal. Collections from prepayments are allocated b/w the entity & the transferee proportionately in the ratio of 1:9, but any defaults are deducted from the entity's interest of ₹1000 until that interest is exhausted. The FV of the loan at the date of the transaction is ₹10,100 & the FV of excess spread of 0.5% is ₹40.

Ans:

- The entity determines that it has transferred some significant risks & rewards of ownership (i.e., significant prepayment risk) but has also retained some significant risks & rewards of ownership (because of its subordinated retained interest) and has retained control. It therefore applies continuing involvement approach.

- To apply Ind AS 109, the entity analyses the transaction as

(a) retention of a fully proportionate retained interest of ₹1000

plus

(b) subordination of retained interest to provide credit enhancement to the transferee for credit losses.

- Allocation of carrying amount on the basis of fair value

| | fair value | percentage | Allocated carrying Amt |
|---|---|---|---|
| portion transferred | 9090 (10,100 X 90%) | 90% | 9000 $\left[9090 \times \frac{10,000}{10,100}\right]$ |
| portion Retained | 1010 (10,100 X 10%) | 10% | 1000 $\left[1010 \times \frac{10,000}{10,1000}\right]$ |
| | 10,100 | | 10,000 |

- Continuing Involvement Asset that results from subordination of its retained interest for credit losses-

Lower of

(i) carrying amount of asset (₹1000) &

(ii) maximum amount of cash flows it would not receive under the subordination (₹1000)

∴ Continuing Involvement Asset = ₹1000

- Associated Liability

(i) maximum amt of cash-flows it would not receive under the subordination (₹1000)

plus

(ii) FV of the subordination (₹65) (working Note)

∴ Associated Liability = ₹1065

Working Note:- FV of subordination:-

| | |
|---|---|
| FV of consideration transferred | ₹9090 |
| consideration Received | ₹9115 |
| | ₹25 |

₹25 represents consideration received for subordinating its retained interest to provide credit enhancement to the transferee for credit losses

The excess spread of 0.50% represents consideration received for the credit enhancement

∴ Total consideration received for credit enhancement (fv of subordination) = ₹25 + ₹40
= ₹65

- Gain/Loss on 90% of portion transferred

| | | |
|---|---|---|
| carrying amt of consideration received | | ₹9000 |
| fv of portion transferred | | ₹9090 |
| Gain on transfer | = | ₹90 |

The entity uses all of the above information to account for the transaction as follows:-

| | Debit | Credit |
|---|---|---|
| Original Asset | | 9000 |
| Asset recognised for subordination interest | 1000 | |
| Asset for the consideration received in the forms of excess spread | 40 (Note) | |
| profit or loss (gain on transfer) | | 90 |
| Liability | | 1065 |
| cash Received | 9115 | |
| | 10,155 | 10,155 |

Immediately following the transaction, the carrying amount of asset is ₹2040

₹1000 → Allocated cost of portion retained

₹1040 → Entity's additional continuing involvement from subordination of its retained interest for credit losses.

(which includes excess spread of ₹40)

Note:- The entity shall continue to recognise any income on the transferred asset to the extent of its continuing involvement

∴ consideration of excess spread ₹40 is recognised as an continuing Involvement Asset.

## Sale of specifically identified cash flows

③ Entity A holds a portfolio of AAA-rated fixed-rate corporate bonds classified as available for sale, which all mature in approximately 5 years time. The bonds are traded in a highly liquid market. Interest rates have fallen since entity A bought the bonds; as a result, the value of the bonds, originally bought for ₹100 million, has increased to ₹111 million. Entity A assigns to entity B rights to 90% of the principal payments on the bonds for a cash payment of ₹70 million. A will continue to receive all interest payments on the whole portfolio & 10% of the principal payments. When the bonds mature in 5 year's time, A will pass on to B 90% of the principal amount that is repaid. B bears the credit risk on any defaults of its newly acquired 90% of the principal amt.

Additional information:

- FV of portfolio at date of transfer – ₹111 million
- FV of Interest only strip at date of transfer – ₹33 million
- Amt of gain previously recognised in equity – ₹11 million.

Ans:

Step 1 – consolidate all subsidiaries

This step is not applicable in this example

Step 2 – Determine whether the derecognition model should be applied to part of a financial asset or a financial asset in its entirety.

The transaction relates to a fully proportionate share (90%) of specifically identified cash flows (principal repayments) from the portfolio. The derecognition model should therefore be applied to that part of the portfolio.

Step 3 – Have the rights to the cash flows expired?

The bonds have not yet matured so the rights to the cash flows still exist

Step 4 – Is there a transfer?

Entity A has assigned 90% of the principal cash flows of these debt securities to entity B. This qualifies as a transfer as per condition (a), even though A continues to act as collection agent while A would be able to sell the remaining 10% principal strip & interest strip to a third party, it has no further rights in respect of 90% principal.

## Step5 — Risks & Rewards Analysis

Entity A has transferred the credit & late payment risks associated with the transferred asset (90% of principal cash flows). No variability in the cash flows from movements in interest rates is expected, as the transferred asset is a fixed amount that does not vary with interest rate movements. The variability in the FV of the asset from movements in interest rates has been transferred to entity B. Entity A has therefore transferred substantially all the risks & rewards in relation to the transferred asset (90% of the principal cash flows from the portfolio) & should derecognise that portion.

## Transferor's Accounting

where only part of the asset is sold, the previous carrying amount of the larger financial asset is allocated b/w the part that continues to be recognised & the part that is derecognised, based on the relative FVs of those parts on the date of transfer

FV of entire portfolio = 111

(-) FV of Interest only strip = (33)

fv of principal only → 78

FV of 90% principal = 78×90%

= 70

Gain/Loss is calculated as diff. b/w:

- carrying amount allocated to the part derecognised (70) and
- Sum of consideration received for the part derecognised (70) and any cumulative gain or loss allocated to it (on the basis of FVs) that had recognised directly in equity $\left[11 \times \frac{70}{111}\right] = 7$

∴ Gain recycled to derecognition = 7.

## A/cing Entries on date of transfer

Cash A/c Dr 270 Million

To Debt Securities A/c 270 Million

(sale of a financial asset)

Equity A/c Dr 27 Million

To profit & Loss A/c 27 Million

(Gain recycled to P&L A/c on derecognition)

# Sale of Equities subject to call option

④ ⓐ Entity C holds 0.1% shareholding in a construction company it bought one year ago for ₹58 million & that is classified as available for sale. C enters into an agreement with bank D in which, in exchange for a cash payment of ₹65 million, C agrees to sell those shares to D. The shares are subject to a call option that allows C to repurchase the shares for ₹70 million, at any time during the next 3 years. The shares are quoted in an active market.

Additional information:

- FV of shares at date of transfer - ₹68 million
- Amount of gain previously recognised in equity - ₹10 million
- FV of call option on date of transfer - ₹3 million (only time value, no intrinsic value & neither deeply in nor deeply out of money)

Ans:-

Step 1 — consolidate all subsidiaries

This step is not applicable in this example.

Step 2 — Determine whether the derecognition model should be applied to part of a financial asset or a financial asset in its entirety

The asset being transferred is the shares in their entirety.

Step 3 — Have the rights to the cash flows expired?

No, the rights to dividends continues to exist & as the shares are still outstanding.

Step 4 — Is there a transfer?

Yes, entity C has sold the shares to bank D.

Step 5 — Risks & Rewards analysis

Entity C has neither transferred nor retained substantially all the risks & rewards of the shares, as the call option is neither deeply in nor deeply out of the money.

Step 6 — Control

As the shares Quoted in an active market, D has the practical ability to sell them, and C has lost control. Hence, it should derecognise the shares & recognise the call option.

## Transferor's Accounting

Entity C derecognises the shares in their entirety & recognises a new financial asset (the purchased call option) at fair value.

C should calculate the gain or loss on sale of its shares. The gain or loss is calculated as the difference b/w:

- carrying amount of ₹68 million &
- sum of consideration received of ₹68 million (i.e. ₹65 million cash plus the new call option obtained whose FV is ₹3 million) plus any cumulative gain or loss that had been recognised directly in equity (₹10 million)

∴ Gain on derecognition = ₹10 million

### Accounting entries on the date of transfer

Cash A/c Dr ₹65 million
Purchased Call option A/c Dr ₹3 million
　　To Shares A/c ₹68 million

Equity A/c Dr ₹10 Million
　　To profit & Loss A/c ₹10 million

Subsequently, entity C will measure its call option at FVTPL. If the price of the shares never reaches ₹70 Million, the time value of the option will be recognised in profit or loss during the next three years. If the price of the shares rises above ₹70 million, C has right to exercise its call option & pay cash of ₹70 million to D to obtain back the shares.

## ⑥ Alternative Scenario & accounting consequences - No market for the shares

Assume that shares are not Quoted in an active market but are privately held & that they represent 15% of the construction entity (rather than 0.1%). As there is no market for the asset, derecognition is precluded to the extent of amount of the asset that is subject to the call option because the entity has retained control of the asset.

Ans: Transferor's Accounting

Where a purchased call option is the cause of the continuing involvement, and the asset was previously measured at FV, the transferred asset continues to be measured at FV. The net amount of the asset & the associated liability is always the FV of the option. The associated liability is the balancing number & is measured at

(a) option exercise price less TV of option, if the option is deep in or at money,
or
(b) FV of the transferred asset less TV of option, if the option is deep out of money

Subsequently, any changes in FV of transferred asset & associated liability are accounted for consistently with each other.

Accounting entries on the date of transfer

Cash A/c Dr 265 million
To Liability A/c 265 million

The amount of liability (265 million) is the FV of the transferred asset (268 million) less TV of the option (3 million) as the option is deep out of money.

Subsequent Accounting

At the next reporting date, assume the FV of the shares increased to 269 million & the FV of option decreased to 2 million (still all time value).

Shares (Asset) A/c Dr 1 million
To Equity A/c 1 million
(continue to recognised the asset at fair value)

Equity A/c Dr 2 million (69-67)
To Liability A/c 2 million.

The liability now has a carrying value of 267 million is FV of asset (269 million) less FV of the option (2 million) as the option is still deep out of money

Assume at the next reporting date, FV of the shares has increased to 272 million & C exercises its call option.

Shares (Asset) A/c Dr 3
To Equity A/c 3
(continue to recognise the asset at FV)

Liability A/c Dr 67
Equity A/c Dr 3
To Cash A/c 70
(Record the exercise of option)

## Repurchase Agreement

⑤ Bank E Enters into an agreement with Bank F to sell a debt security classified as held to maturity. The Security is traded in an active market. At the same time, E agrees to repurchase the security from F at a specified fixed price on a fixed date. F pays E ₹1 million for the debt security, and E agrees to repurchase the security in 6 month's time for ₹1.03 million. F can sell or repledge the debt security under this agreement. The ₹0.03 million is a lender's return – that is current 6-month interest rates are 3%.

Additional information:

- FV of debt security at date of transfer – ₹1 million
- FV of forward purchase agreement on date of transfer – ₹0 million
- Carrying value at date of transfer – ₹0.95 million

**Ans:**

Step 1 — Consolidate all subsidiaries

This step is not applicable in this example

Step 2 — Determine whether the derecognition model should be applied to part of a financial asset or a financial asset in its entirety

The asset being transferred is the debt security in its entirety.

Step 3 — Have the rights to the cash flows expired?

No, the debt security has not yet reached maturity so the rights to the cash flows still exist.

Step 4 — Is there a transfer?

Yes, bank E has sold the debt security to bank F

Step 5 — Risk & Rewards Analysis

E has retained substantially all the risk & rewards of the debt security. F is receiving only a lender's return on the cash it has provided to E. Therefore, the transaction fails derecognition & E treats this transfer as a "collateralised borrowing".

### Transferor's Accounting

As a result of the failed derecognition, bank E continues to recognise the transferred asset. E also recognises a financial liability for the consideration received for the transferred asset from the F. As the F has the right to sell or repledge the debt security, E presents the asset separately in the balance sheet i.e., Loaned Asset

## Accounting entries on the date of transfer

cash A/c Dr ₹1M
To financial liability A/c ₹1M
(Recognition of consideration received)

Loaned Asset A/c Dr 1M
To Security A/c 1M
(HTM Asset)
(Recognise the transfer as collateralised borrowing)

## Subsequent Accounting

Subsequently, bank E will continue to account for the transferred asset as it previously as held to maturity; however, it will be reclassified on the balance sheet to loaned Asset. E will account for the liability at amortised cost, with the difference b/w sales & repurchase price being accrued as an expense over 6 month term of the agreement using effective interest rate method.

Interest Expense A/c Dr ₹0.03M (1.03−1)
To Financial liability A/c ₹0.03M (1.03−1)
(Accrue Interest on financial liability)

on the date the financial liability matures

Financial liability A/c Dr ₹1.03M
To cash A/c ₹1.03M
(Record the settlement of the financial liability)

## Factoring without Recourse

6. Entity G enters into an agreement to assign its portfolio of ₹20 million trade receivables without recourse to factor H. The receivables have 60-day terms & are subject to normal warranties on the existence of receivables at the date of transfer (for example, if a customer returns the goods purchased because they are faulty, the receivable does not exist. Entity G will pay Factor H the amount received from H for the receivable). H pays G ₹19 million in cash for the receivables. There is no obligation on G to make good any shortfall on the receivables to H due to either default or late payment, and G receives no compensation from H for faster than expected payments or lower than expected levels of default. As G continues to service the receivables, the debtors have not been notified that their receivables have been transferred. G also receives a fee of 0.2% of the notional amt of each receivable transferred for servicing the receivables.

Additional information:

- FV of portfolio of trade receivables on the date of transfer – ₹19 million
- Carrying value of portfolio of trade receivables on the date of transfer – ₹20 million
- Servicing fee is expected to adequately compensate entity G for servicing the receivables
- Receivables were classified as loans & receivables under Ind AS 109.

Ans:

Step 1 — Consolidate all subsidiaries

This step is not applicable in this example

Step 2 — Determine whether the derecognition model should be applied to a part of a financial asset or a financial asset in its entirety

The financial instruments being transferred have similar characteristics. They are all trade receivables, having similar credit ratings & mature at approximately the same date (60 days). They should be assessed as a group of similar financial assets.

Step 3 — Have the rights to the cash flows expired?

No, the portfolio of receivables has not yet reached maturity so the rights to the cash flows still exist.

Step 4 — Is there a transfer?

Yes, entity G has assigned the rights to the cash flows from the receivable to factor H & therefore there has been a transfer as per condition (a). Although G has provided normal warranties, these relate to business risks of the underlying transaction – which affect the existence of the receivable – rather than to the financial risks associated with the receivable itself & do not prohibit transfer of rights to cash flows. In addition, although the debtors have not been notified that their receivables have been transferred, this does not preclude this transaction meeting the definition of a transfer, as G is only servicing the receivables & has no rights to cash flows from them.

Step 5 — Risk & Rewards Analysis

Entity G has transferred the credit & late payment risk. G has therefore transferred substantially all the risks & rewards & should derecognise the receivables.

Transferor's Accounting

Entity G derecognises the receivables. The diff. b/w the carrying amt & consideration received is a gain or loss.

Accounting Entries on date of transfer

Cash A/c Dr 19M
Loss on sale A/c Dr ₹1M
TO Receivables A/c 20M

→ To recognise the sale of receivables & corresponding loss. There is no adjustment for the servicing, as it is adequate compensation.

## Factoring with recourse

(7) Entity J enters into an agreement to assign its portfolio of ₹20 million trade receivables with recourse to factor K. The receivables have 90-day terms & are subject to normal warranties on the existence of the receivables at the date of transfer (for example, if a customer returns the goods purchased because they are faulty, the receivables does not exist; J will pay to K the face amount of receivable plus interest). K agrees to pay J an initial amount of ₹16 million in cash for the rights to the cash flows from the receivables. Once the receivables have been repaid, K will pay a further sum to J calculated as the balance of ₹4 million less interest on ₹16 million initial payment until the date debtors pay & less any defaults (defined as any debts that remain unpaid after 120 days). As J continues to service the receivables, the debtors have not been notified that their receivables have been transferred. J also receives fee of 0.2% of the notional amount of each receivables transferred for servicing the receivables.

Additional information:

- FV of portfolio of trade receivables on date of transfer – ₹19.5 million
- carrying value of portfolio of trade receivables on date of transfer – ₹20 million
- servicing fee is expected to adequately compensate J for servicing the receivables
- The receivables were classified as loans & receivables as per Ind AS 109

Ans:-

Step 1 – Consolidate all subsidiaries

This step is not applicable in this example.

Step 2 – Determine whether the derecognition model should be applied to part of a financial asset (or a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety.

The financial instruments being transferred have similar characteristics. They are all trade receivables, have similar credit ratings & mature at approximately the same date (90 days). They should be assessed as a group of similar financial assets.

Step 3 – Have the rights to the cash flows expired?

NO, the portfolio of receivables has not yet reached maturity so the rights to the cash flows still exist

Step 4 – Is there a transfer?

Yes, entity J has assigned the rights to the cash flows from the receivables to factor K; therefore there has been a transfer as per condition (a). Although J has provided normal warranties, these related to business risks of the underlying transaction, which affect the existence of the receivable rather than to the financial risks associated with the receivables themselves & do not prohibit the transfer of rights to cash flows. In addition, although the debtors have not been notified that their receivables have been transferred, this does not preclude this transaction meeting the definition of a transfer, as J is only servicing the receivables

Step 5 – Risks & Rewards Analysis

Entity J has retained the credit & late payment risk as the expected losses/variability is such that the likelihood of losses exceeding ₹4 million withheld is remote. J has therefore retained substantially all the risks & rewards & should continue to recognise the receivables

Transferor's Accounting

As a result of the failed derecognition, entity J continues to recognise the receivables. J also recognises a financial liability for the consideration received for transferred asset from factor K.

Accounting entries on the date of transfer

Cash A/c Dr 16M

To Loan from factor K A/c 16M

(Recognise the transfer as a "collateralised borrowing")

Subsequent Accounting

Subsequently, entity J will continue to account for the transferred asset as receivables at amortised cost, subject to impairment testing. J will account for the liability to factor K at amortised cost & accrue interest until the date of receivables pay using effective interest method. Assume that ₹19 Million pay in 90 days and the other ₹1 Million remains outstanding after 120 days. Interest charged by the factor at 10%.

on day 90

Interest Expense A/c 0.4M [16M×10% × 90/360]

To loan from factor K A/c 0.4M

(Accrued interest on the loan from factor K)

on day 120

cash A/c Dr 19M

To Receivables A/c 19M

(pay cash to the factor when received)

Loans from K A/c Dr 16.4M

Receivables from K A/c Dr 2.6M (Note)

To cash A/c 19M

(Remove the liability & setup a receivable from factor for the deferred purchase consideration still to be received)

Note:- cash received from debtors = ₹19M

(-) Interest = (0.4M)

(-) upfront payment = (16M)

Additional cash received from debtor = ₹2.6M

cash A/c Dr 2.6M

Impairment A/c Dr 1M

To Receivable from K A/c 2.6M

To Receivables A/c 1M

(Record the settlement of the receivable from factor K, as at day 120 the relationship with K ceases, entity J also needs to record impairment on the remaining ₹1M of receivables if it has not already)

## Factoring with late payment risk retained

(8) Entity L enters into an agreement on 1st January 2011 to assign the portfolio of ₹220 million trade receivables to factor M. M pays L ₹219.5 million in cash for the rights to the cash flows from the receivables. As M is a banking subsidiary of an insurance company, it assumes the default risk. The receivables have 60-day terms & are subject to normal warranties on the existence of the receivables at the date of transfer (for example, if a customer returns the goods purchased because they are faulty – the receivable does not exist – L will pay M the face amount of the receivable.)

The debtors have not been notified that their receivables have been transferred. L will pay interest (at LIBOR set at date of transfer + 0.50%) to M should any of the receivables pay late for up to 210 days after their due date. After 210 days, the receivables will be considered defaulted, and the factor will suffer any further loss. Historically an average 30% of customers pay late, and an additional 1.25% of customers default. L has determined that both credit risk & slow-payment risk are significant risks of its trade receivables. L has performed an analysis that shows that some significant risk has been transferred & some significant risk has been retained.

Additional information:

- FV of portfolio of trade receivables on date of transfer – ₹19.35 million
- carrying value of portfolio of trade receivables on date of transfer – ₹220 million
- FV of late payment guarantee on date of transfer – ₹0.15 million
- 270 days LIBOR on date of transfer – 3.3%
- L continues to service the receivable & its adequately compensated for doing so.

Ans:

Step 1 – Consolidate all Subsidiaries

This step is not applicable in this example.

Step 2 – Determine whether the derecognition model should be applied to part of a financial asset (or a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety.

The financial instruments being transferred have similar characteristics. The trade receivables have similar credit ratings & mature at approximately the same date (60 days). They should be assessed as a group of similar financial assets.

Step 3 – Have the rights to the cash flows expired?

No, the portfolio of receivables has not yet reached maturity so the rights to the cash flows still exist.

Step4 – Is there a transfer?

Yes, entity L has assigned the rights to the cash flows from the receivables to factor M; therefore there has been a transfer as per condition(a). Although L has provided normal warranties, these relate to business risks of the underlying transaction, which affect the existence of the receivable rather than financial risks associated with the receivable itself & do not prohibit a transfer of rights to cash flows. In addition, although the debtors have not been notified that their receivables have been transferred, this does not preclude this transaction meeting the definition of a transfer, as L is only servicing the receivables & has no rights to cash flows from them. Therefore, L has transferred its rights to the cash flows to M.

Step5 – Risks & Rewards Analysis

Before the transaction, L was exposed to all the risks of the receivables, both credit default risk & late payment risk. After the transaction, L has only retained the late-payment risk upto 210 days. The credit risk & the slow-payment risk beyond 210 days have been transferred to the factor. Therefore, according to L's analysis, it has neither retained nor transferred substantially all the risks & rewards relating to the receivables.

Step6 – Control

Factor M does not have the practical ability to sell the receivables unilaterally. There is no market in trade receivables, and should M sell the receivables, it would have to do so with the attached late-payment guarantee. That guarantee as well as servicing is an additional restriction, hence L still controls the receivables. Therefore, L will continue to recognise the receivables to the extent of its continuing involvement.

Transferor's Accounting

The extent of L's continuing involvement is the extent to which it is exposed to changes in the value of the receivables, which in this case is the late-payment guarantee. The continuing involvement asset is the lower of the amount of the receivables & the maximum amount of consideration received that L could be required to pay. The associated liability will be amount of the continuing involvement asset plus fv of the late-payment guarantee (in this case, ₹150,000). This results in the net position on the balance sheet of the asset & liability being the fv of late payment guarantee.

## Continuing Involvement Asset

Amount of receivables = 20,000,000

Interest rate = 3.8%, No. of days = 210

Continuing Involvement Asset = $20,000,000 \times 3.8\% \times \frac{210}{360}$

= 443,333

## Accounting entries on date of transfer (1 Jan, 2011)

Cash A/c Dr 19,500,000

Continuing Involvement Asset A/c Dr 443,333

Loss on Transfer A/c Dr 650,000

To Receivables A/c 20,000,000

To Continuing Involvement A/c Liability (Associated Liability) 593,333

(Recognise entity's L continuing involvement in the form of a late-payment guarantee)

## Subsequent Accounting

Subsequently, over the next 270 days as the receivables repay, the continuing involvement asset & associated liability will decrease similarly. In addition, the initial fv of the guarantee will be amortised in profit or loss. An impairment charge on the asset will be taken if a payout is required under the guarantee.

Assume, entity L prepares an interim set of fss at 30 June, 2011 & at that time 20% of receivables still have not paid (the remaining 80% paid within 60 days).

(1) Continuing Involvement Liability A/c (Associated Liability) 354,666 [443,333 × 80%]

To Continuing Involvement Asset A/c 354,666

(Decrease the continuing involvement asset & liability to reflect 80% paid on time; that therefore no payment will be required under the late payment guarantee)

(2) (Continuing Involvement Liability) Associated liability A/c Dr 50,666 $\left[20,000,000 \times 20\% \times 3.8\% \times \frac{120}{360}\right]$

To Cash A/c 50,666

(Recognise the payment made under late payment guarantee)

(3) Continuing Involvement Liability A/c (Associated Liability) 137,143

To Other Income A/c 137,143

(Amortise the guarantee fee) $\left[(150,000 \times 20\% \times \frac{4M}{7M}) + (150,000 \times 80\%)\right]$

= 17,143 + 120,000 = 137,143

(4) Impairment Loss A/c Dr 50,666

To continuing Involvement Asset A/c 50,666

(Impair the asset to reflect the pay out under the late payment guarantee)

After these entries have been made, the resulting continuing involvement asset is ₹38,000. This represents the maximum remaining payout on the 20% that has not yet paid. The resulting involvement liability is ₹50,858. This represents ₹38,000 for the 20% that has not yet paid + remaining fee of ₹12,858 yet to be amortised.

## Sale of loans – Guarantee retained

(9) Entity P has originated a group of similar 5-year fixed rate corporate loans for ₹9,980,000 with the intention of selling them to a bank in the near future. It is therefore accounting for these loans at FVTPL before the loan. Subsequently. Subsequently, P assigns the loans to a third party bank for ₹10.1 million but guarantees one-third of any default losses associated with the loans (under the terms of the guarantee, if a payment on a loan is 180 days overdue, the loan is considered to have defaulted & a payment becomes due under the guarantee). There is no active market in these loans. Credit risk is the only significant risk. There is no late-payment risk, as interest is charged on late payments.

Additional information:

- FV of loans ₹10 million (FV = Book value, originated for ₹9,980,000, so the FV has increased by ₹20,000 since origination)
- FV of guarantee obligation ₹100,000
- FV of guarantee fee ₹57,000
- The servicing fee is expected to adequately compensate entity P for servicing the loans
- The debtors have not been notified that their loans are being transferred.

Ans:

Step 1 – Consolidate all subsidiaries

This step is not applicable in this case.

Step 2 – Determine whether the derecognition model should be applied to part of a financial asset (or a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety

The financial instruments being transferred have similar characteristics. They are all fixed-rate loans to similar counterparties that mature at approximately the same time (5 years). They may be assessed as a group of similar financial assets in their entirety.

step3 – Have the rights to the cash flows expired?

No, portfolio of loans has not yet reached maturity so the rights to the cash flows still exist.

step4 – Is there a transfer?

Yes, P has assigned the loans to the bank. In addition, although the debtors have not been notified that their loans have been transferred, this does not preclude this transaction meeting the definition of a transfer, as P is only servicing the loans & has no rights to cash flows

step5 – Risks & Rewards Analysis

P has retained 1/3rd of any credit losses that are incurred by the bank on these loans. P has not retained any other risk on these loans. Therefore, P has retained some risks & rewards, as credit risk is the only significant risk, but not substantially all risks & rewards & should ask the control question.

step6 – Control

The bank does not have the ability to sell the loans ultimately. There is no market in the loans & as the loans are subject to the guarantee, the bank would want to also sell the loans subject to that guarantee. That additional restriction means that P still controls the loans. Therefore, P will continue to recognise the loans to the extent of its continuing involvement

Transferor's Accounting

P has neither retained nor transferred substantially all the risks & rewards relating to the loans & has retained control; it should therefore account for the transfer using continuing involvement. The continuing involvement is the lower of

(a) amount of the asset (₹10 million)

(b) maximum amount of the consideration received (₹10-1 million) that the entity could be required to repay – the guaranteed amount – is 1/3rd of the principal balance & amounts to ₹3,333,333.

The continuing involvement asset is ₹3,333,333.

The associated liability is measured in such a way that the net carrying amount of the transferred asset & the associated liability is equal to the FV of the rights & obligations retained by the entity when measured on a stand-alone basis.

The entity has the obligation to provide a guarantee for 1/3rd of credit losses. The fair value of the guarantee obligation is ₹100,000. Accordingly, the liability is ₹3,433,333, being the aggregate of the amount of the continuing involvement asset above (₹3,333,333) & the guarantee (₹100,000)

Loans A/c 9,980,000
To cash A/c 9,980,000
(Record the cash lent at origination of the loan)

Loans A/c 20,000
To profit & loss A/c 20,000
(fv of the loan increased)

Accounting entries on date of transfer

continuing Involvement Asset A/c 3,333,333
Cash A/c 10,100,000
To Loans A/c 10,000,000
To continuing Involvement 3,433,333
Liability A/c

(Record the cash received on sale of loans & continuing Involvement Asset & Liability)

Subsequent Accounting

Subsequently, the asset will be measured at FVTPL. To the extent there is an expected payout under the guarantee, this will be reflected by a negative FV change in the asset & so net of the asset & liability will reflect the FV of the guarantee. In addition, as amounts are collected on the loans, both the asset & liability are similarly reduced.

Assume we are one year later, & the FV of the loans has decreased by ₹384,000 of which we still have continuing involvement in 1/3rd, & the FV of the guarantee is now ₹174,000

continuing Involvement Liability A/c Dr 54,000 (128,000−74,000)
Net profit & Loss A/c Dr 74,000
To continuing Involvement Asset A/c 128,000 (1/3rd of 384,000)
(reflecting the change in fv of assets)

(Record the fall in fv of the asset & increase in fv of the liability)

# Derecognition principles regarding "swaps"

(1) Total Return swaps :-

An entity may sell a financial asset to a transferee and enter into an total return swap with the transferee, whereby all of the parties interest payment cash flows from the underlying asset are remitted to the entity in exchange for a fixed payment or a variable payment and any increases or declines in the FV of the underlying asset are absorbed by the entity. In such a case, derecognition of all the asset is prohibited.

(2) Interest Rate Swaps :-

An entity may transfer to a transferee a fixed rate financial asset & enter into an interest rate swap with the transferee to receive a fixed interest rate & pay a variable interest rate based on a notional amount that is equal to the principal amount of the transferred financial asset. The interest rate swap does not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on payments being made on the transferred asset.

(3) Amortising Interest rate swaps :-

An entity may transfer to a transferee a fixed rate financial asset that is paid off over time, and enter into an amortising interest rate swap with the transferee to receive a fixed interest rate & pay a variable interest rate based on a notional amount.

Swap is linked to principal amount o/sing

If the notional amount of the swap amortises so that it equals the principal amount of the transferred financial asset o/sing at any point in time, the swap would generally result in the entity retaining substantial prepayment risk, in which case the entity either continues to recognise all of the transferred asset or continues to recognise the transferred asset to the extent of its continuing involvement.

Swap is not linked to principal amount o/sing

If the amortisation of the notional amount of the swap is not linked to the principal amt o/sing of the transferred asset, such a swap would not result in the entity retaining prepayment risk on the asset. Hence, it would not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on interest payments being made on the transferred asset & the swap does not result in the entity retaining any other significant risks & rewards of ownership on the transferred asset.

## Collateral Accounting ÷ (Refer Illustration÷ 5,7)

- If a transferor provides non-cash collateral (such as debt or equity instruments) to the transferee, the accounting for the collateral by the transferor & the transferee depends on whether the transferee has the right to sell or repledge the collateral & on whether the transferor has defaulted.
- The transferor & transferee shall account for the collateral as follows:

(a) If the transferee has the "right" by contract or custom to sell or repledge the collateral,

then the transferor shall "reclassify" that asset in its balance sheet (e.g., as a loaned asset, pledged equity instruments or repurchase receivable) separately from other assets.

(b) If the transferee "sells" collateral pledged to it,

then the transferee shall recognise the proceeds from the sale & a liability measured at "FAIR VALUE" for its obligation to return the collateral

(c) If the "transferor defaults" under the terms of the contract & is no longer entitled to redeem the collateral,

then the transferor shall derecognise the collateral & the transferee shall recognise the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognise its obligation to return the collateral.

(d) Except as provided in (c), the transferor shall continue to carry the collateral as its asset, and the transferee shall not recognise the collateral as an asset