



VIRTUAL COACHING CLASSES ORGANISED BY BOS, ICAI

CA FINAL

TOPIC : FINANCIAL INSTRUMENTS - IND AS 109,
FINANCIAL INSTRUMENTS PRESENTATION - IND AS 32
PAPER : FINANCIAL REPORTING (FR)

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Agenda

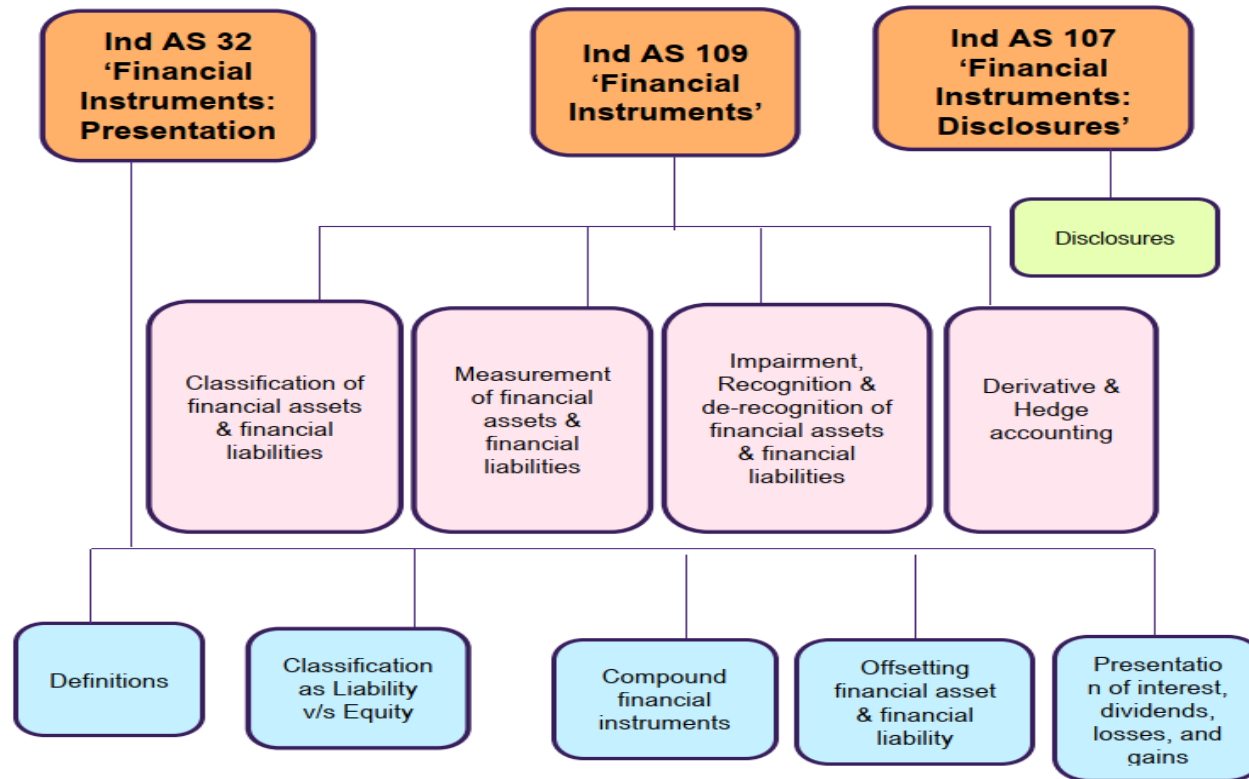


Ind AS Course ICAI

- Scope
- Definition
- Classification of financial instruments
- Recognition & Measurement
- Reclassification
- Practical case studies
- Impairment of financial instruments
- Recognition and de-recognition
- Derivatives and Embedded derivatives
- Regular way of purchase and sell
- Hedge Accounting



Structure - Ind AS 109, 32 & 107



Scope



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#	Particulars	Covered under Ind AS 109	Covered under Ind AS 32	Applicable Ind AS
1	▪ Interest in subsidiaries (At Costs)	No	No	Ind AS 27
2	▪ Interests in associates (At Costs)	No	No	Ind AS 27
3	▪ Interest in joint ventures (At Costs)	No	No	Ind AS 27
	▪ Interest in subsidiaries / Associates / Joint venture (At FV)	Yes	Yes	
4	▪ Rights and obligations under revenue for contracts with customers	No	No	Ind AS 115
5	▪ Rights and obligations under leases	No	No	Ind AS 116
6	▪ Employers' rights and obligations under employee benefit plans	No	No	Ind AS 19
7	▪ Rights and obligations under an insurance contract	No	No	Ind AS 104
8	▪ Shared based payments	No	No	Ind AS 102

Definition of Financial Instruments

Financial instrument



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

a financial asset
of one entity

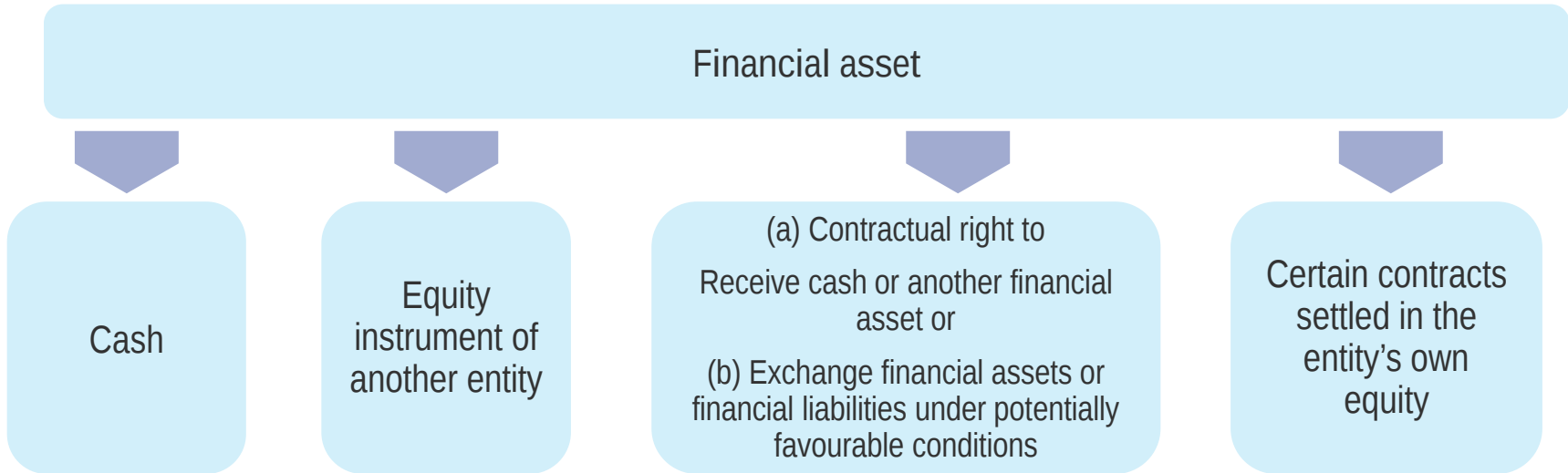
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a financial liability or equity
instrument of another entity

Financial Asset



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Exercise – Identify financial assets?



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

Exercise – Identify financial assets?



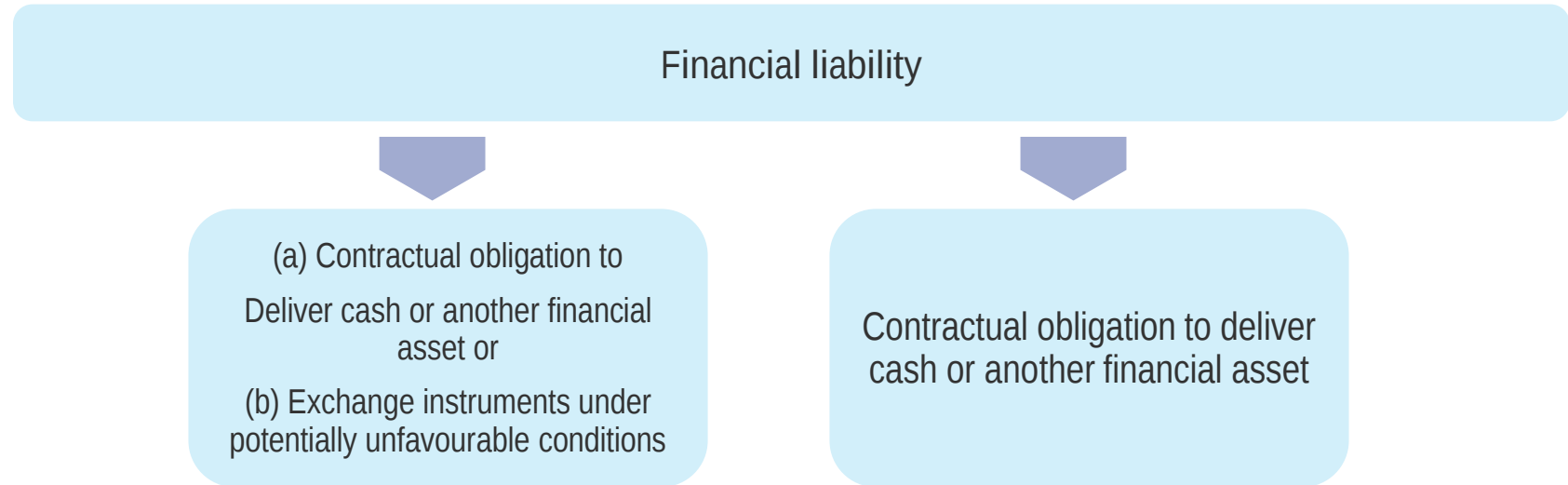
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S. No	Item	Classification	Reason
10	Inventories	Not a financial instrument	Does not fulfil definition, no contractual right to receive cash/other financial assets
11	Property, plant and equipment	Not a financial instrument	Does not fulfil definition, no contractual right to receive cash/other financial assets
12	Intangible assets	Not a financial instrument	Does not fulfil definition, no contractual right to receive cash/other financial assets
13	Prepaid expenses	Not a financial instrument	Does not fulfil definition. Right to receive service or product but no right to receive cash or financial instrument
14	Advance given for goods and services	Not a financial instrument	Does not fulfil definition. Obligation to deliver service or product but no obligation to deliver cash or financial instrument
15	Gold	Not a financial instrument	Does not fulfil definition. Though gold is a highly liquid investment, it does not present right to receive cash or another financial asset.

Financial Liability



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Exercise – Identify financial liability?



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S. No	Item	Classification	Reason
1	Deposits received	Financial liability	Contractual obligation to pay cash
2	Trade and other payables	Financial liability	Contractual obligation to pay cash
3	Mandatory redeemable preference shares	Financial liability	Contractual obligation to pay cash
4	Finance lease obligation	Financial liability	Contractual obligation to pay cash
5	Term Loan	Financial liability	Contractual obligation to pay cash
6	Deferred revenue	Not financial instrument	Does not fulfil definition. No contractual obligation to pay cash or another financial asset.
7	Warranty obligations	Not financial instrument	Does not fulfil definition. Covered under Ind AS 37.
8	Income taxes/ Deferred tax	Not financial instrument	Does not fulfil definition. Income taxes are statutory assets or liability but not contractual assets or liability

Equity

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

Examples :

- Equity shares
- Preference shares (if fixed to fixed are met)

Comparison of Financial Asset, liability & Equity



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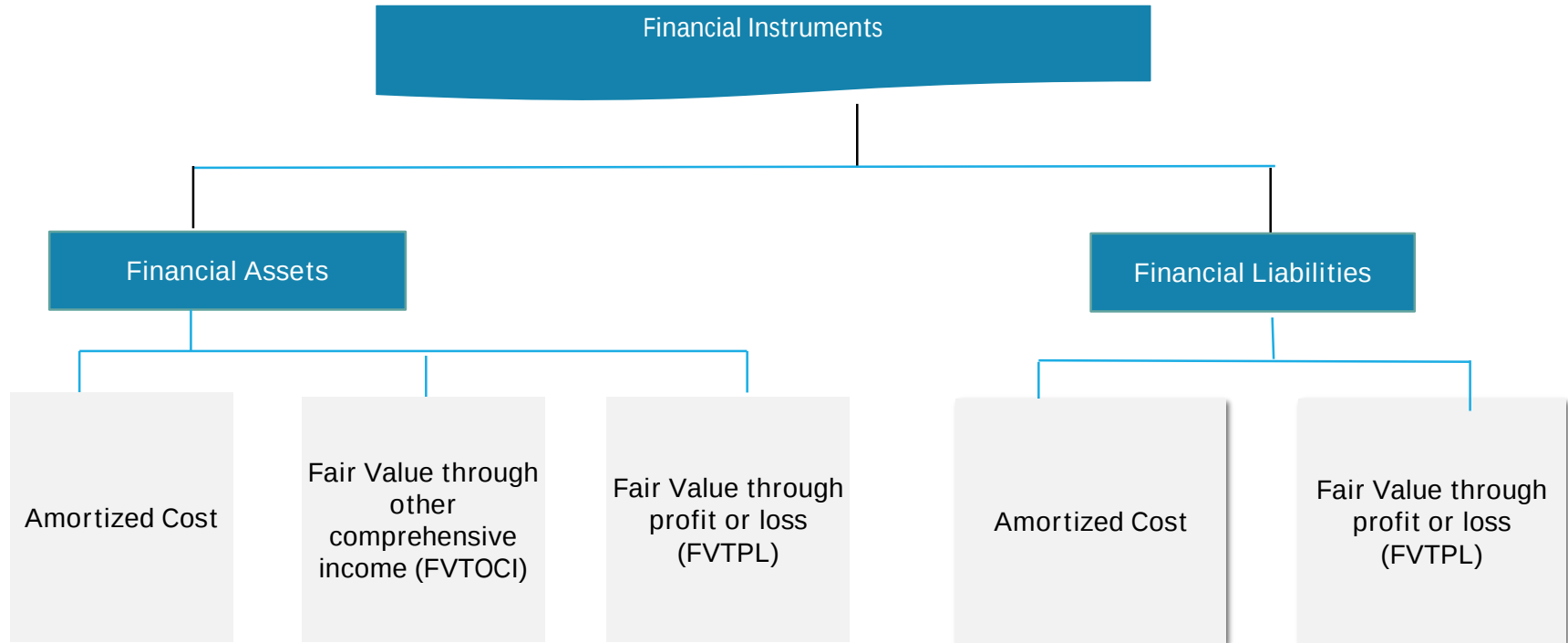
#	Financial Assets	Financial liabilities	Equity
1	Cash	-	-
2	An equity instrument of another entity.	-	-
3	A contractual right - To receive cash or another financial asset from another entity - Or - To exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity.	A contractual obligation - To deliver cash or another financial asset to another entity - Or - To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.	No contractual obligation - To deliver cash or another financial asset to another entity. - Or - To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.
4	A contract that will or may be settled in the entity's own equity instruments.	- A contract that will or may be settled in the entity's own equity instruments including derivative and non-derivative (Variable no. of shares. and not Fixed to Fixed criterion met).	A contract that will or may be settled in the entity's own equity instruments. (Fixed to Fixed criterion met).

Classification of Financial Instruments

Classification of financial instruments



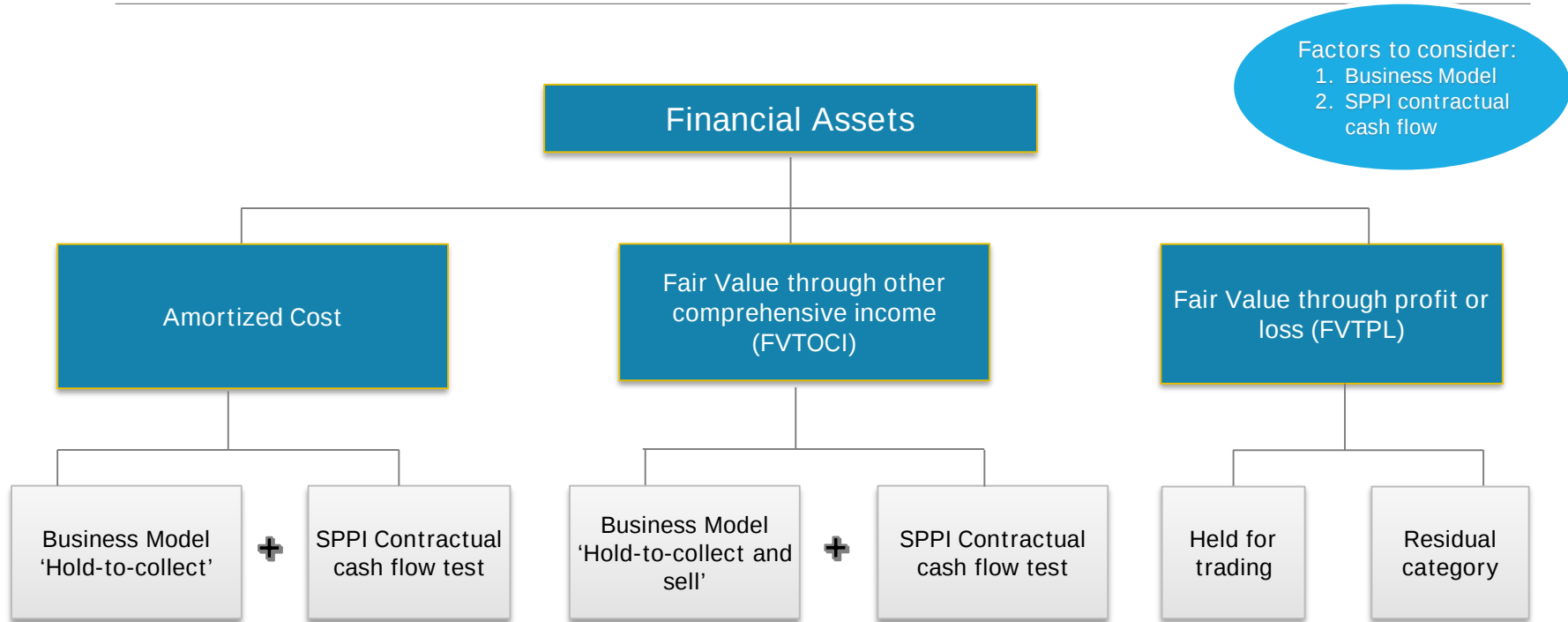
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Classification of Financial Assets



Classification of financial assets



Classification of financial assets – an overview



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- Financial assets has been classified into three categories as per Ind AS 109:
 1. Amortized Cost
 2. Fair Value through other comprehensive income (FVTOCI)
 3. Fair Value through profit or loss (FVTPL)

- Classification of Financial assets into Amortized costs, FVOCI and FVTPL shall depend on the basis of both:
 - (a) the entity's business model for managing the financial assets and
 - (b) the SPPI contractual cash flow characteristics of the financial assets

1. Financial assets classified as Amortized cost



1. What is amortized Cost

Particulars	Amount
Initial Recognition (Fair value / Transaction value)	XXXX
Less : Principal repayment	XXXX
Less : Cumulative amortization (EIR)	XXXX
Less : Impairment / un-collectability	XXXX
Amortized costs	XXXX

- Effective interest rate (EIR) method is used to calculate the amortized costs of a financial asset or a financial liability as well as the allocation & recognition of interest revenue or expense in income statement.
- EIR is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability.
The computation of EIR includes all cash flows between the parties in the contract e.g. Fees, transaction costs, premium or discounts.
- Transactions costs are the incremental costs that are directly attributable to the acquisition or issue of any financial assets or liability.



1. Amortized cost

- Financial asset (FA) will be classified as amortised cost if it meets both of following criteria:
 1. 'Hold-to-collect' business model test - Objective is to hold the financial asset in order to collect contractual cash flows; AND
 2. 'SPPI' contractual cash flow characteristics test - Contractual terms give rise to cash flows that are Solely Payments of Principal and Interest (SPPI) on the principal amount outstanding.
- Examples of FA classified and accounted for at amortised cost:
 - Trade receivables
 - Investments in government bonds (not held for trading)
 - Investments in term deposits (at standard interest rates)
 - Loan receivables with 'basic' features
- Equity instrument can never be classified at amortized costs.



Case study – Amortised costs

Case Study

Situation I

- 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

Situation II

- Nine years have passed and the entity is suffering a liquidity crisis and needs to sell the asset to raise funds.

Response:

Situation I

- Entity's objective is to hold the asset to collect the contractual cash flows and not to sell the assets.
- Thus, the debt instrument would meet the 'hold-to-collect' business model test.

Case study – Amortised costs



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Response:

Situation II

- The sale was not expected on initial classification and does not affect the classification (i.e. there is no retrospective reclassification).
- Thus, the debt instrument would still meet the 'hold-to-collect' business model test.



Business model tests

- An entity's business model refers to how an entity manages its financial assets so to generate / realise cash flows. In other words, business model is concerned with whether an entity will collect contractual cash flows by holding them to maturity or sell those financial assets or both.
- An entity is not required to perform this assessment on 'worst case' or 'stress case' scenarios. Rather, it is determined on the basis of scenarios which are reasonably expected to occur. For example, if an entity expects that it will sell a particular portfolio of financial assets only in a stress case scenario which is not likely to occur, the entity will not consider such scenario to determine its business model.
- An entity may have one of the following models for its debt instruments :
 - (a) Hold to collect contractual cash flows:
 - An entity holds financial assets to collect contractual cash flows till maturity. That is, the entity manages the assets held within the portfolio to collect those particular contractual cash flows.
 - b) Hold to collect contractual cash flows and selling financial assets:
 - In this type of business model, the entity's key management personnel have made a decision that both collecting contractual cash flows and selling financial assets are integral to achieve the objective of the business model.



Business model tests Contd..

- b) Hold to collect contractual cash flows and selling financial assets (Cont'd..) :
- Consider that an entity anticipates capital expenditure in a few years. The entity invests its excess cash in short and long—term financial assets so that it can fund the expenditure when needed. Many financial assets have contractual lives which exceed the entity's anticipated investment period. Hence, the entity will hold financial assets to collect the contractual cash flows and, when an opportunity arises, it will sell the financial assets to reinvest cash in other financial or non-financial assets with a higher return.
- c) Other business model – Actively buying & Selling :
- In this business model, an entity manages its financial assets with the objective of realising cash flows through the sale as against realizing contractual cash flows.
 - The entity makes decisions to hold / sell the investment based on an asset's fair values and manages its financial assets to realise their fair values.
 - In this case, the entity's objective will typically result in an active buying and selling. This business model results in measurement as at FVTPL.



Case study – Business model test to Collect

- ABC Ltd. sells goods to customers on credit. Entity ABC typically offers customers up to 40 days following the delivery of goods to make payment in full.
- Entity ABC collects cash in accordance with the contractual cash flows of trade receivables and has no intention to dispose of the receivables.

Evaluate the business model.

Response:

- Yes.
- Entity's ABC objective is to collect contractual cash flows from trade receivables and therefore, trade receivables meet the business model test for the purpose of classifying the financial assets at amortised cost.



Case study – Business model test to Collect & Sell

- ABC Ltd. anticipates capital expenditure in a few years. ABC invests its excess cash in short and long-term financial assets so that it can fund the expenditure when the need arises. Many of the financial assets have contractual lives that exceed the entity's anticipated investment period.
- ABC will hold financial assets to collect the contractual cash flows and, when an opportunity arises, it will sell financial assets to re-invest the cash in financial assets with a higher return. The managers responsible for the portfolio are remunerated based on the overall return generated by the portfolio.

Evaluate the business model.

Response:

- The objective of the business model is achieved by both collecting contractual cash flows and selling financial assets.

- Contractual terms give rise to cash flows that are Solely Payments of Principal and Interest on the principal amount outstanding.
- Contractual cash flows consistent with a basic lending arrangement.
- Interest element – Consider factors like:
 - Time value of money
 - Credit risk
 - Liquidity
 - Profit margin
 - Service or administrative costs.
- Interest rate can be fixed or floating, zero /any other interest rate.
- Contractual cash flows linked to features such as changes in equity or commodity prices, would not pass the SPPI test because they introduce exposure to risks or volatility.
- SPPI Test will be met if there is a prepayment penalty i.e. additional compensation for early termination or extension of contract.

SPPI Test Contd..



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Features consistent with SPPI Test	Features not consistent with SPPI Test
▪ Prepayment option	▪ Options, forward and swaps
▪ Fixed / variable rate of interest	▪ Conversion options
▪ Caps, floors, collars	



Case study – SPPI

Case Study : SPPI test for loan with zero interest and no fixed repayment terms

Parent A provides a loan to Subsidiary B. The loan is classified as a current liability in Subsidiary B's financial statements and has the following terms:

- No interest
- No fixed repayment terms
- Repayable on demand of Parent A.

Does the loan meet the 'SPPI' contractual cash flows characteristic test?

Response:

- Yes.
- The terms provide for the repayment of the principal amount of the loan on demand.

Case study – SPPI



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Case Study : SPPI test for loan with zero interest repayable in five years

Parent A provides a loan of CU10 million to Subsidiary B. The loan has the following terms:

- No interest
- Repayable in five years.

Does the loan meet the ‘SPPI’ contractual cash flows characteristic test?

Response:

- Yes.
- The principal (fair value) is CU10 million discounted to its present value using the market interest rate at initial recognition. The final repayment of CU10 million represents a payment of principal and accrued interest.

Case study – SPPI



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Case Study : SPPI test for a loan with interest rate cap

Entity B lends Entity C CU5 million for five years, subject to the following terms:

- Interest is based on the prevailing variable market interest rate
- Variable interest rate is capped at 8%
- Repayable in five years.

Does the loan meet the ‘SPPI’ contractual cash flows characteristic test?

Response:

- Yes.
- Yes. Contractual cash flows of both a fixed rate instrument and a floating rate instrument are payments of principal and interest as long as the interest reflects consideration for the time value of money and credit risk.
- Therefore, a loan that contains a combination of a fixed and variable interest rate meets the contractual cash flow characteristics test.

Case study – SPPI



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Index Linked :

- ABC Limited invested in a bond with a stated maturity date. Payments of principal and interest on the principal amount outstanding are linked to an inflation index of the currency in which the instrument is issued.
- Evaluate the Contractual cash flows characteristics test

Response:

- Contractual cash flow test will get FAIL as the interest is linked with the inflation index.

2. Financial assets classified as Fair Value through OCI

2. What is OCI



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- Other comprehensive income comprises items of income and expense that are not recognised in profit or loss as required or permitted by other Ind ASs.
- Certain examples of items in Other Comprehensive Income.

OCI Items	
To be reclassified to Profit or loss in subsequent periods	Not to be reclassified to Profit or loss in subsequent periods
1. Gain or loss on hedge of a net investment (Ind AS 109)	1. Re-measurement gains/ (losses) on defined benefit plans (Ind AS 19)
2. Net movement on cash flow hedges (Ind AS 109)	2. Revaluation of Fixed Assets & intangibles (Ind AS 16 & 38)
3. Net (loss)/gain on FVTOCI debt securities (Ind AS 109)	3. Net (loss)/gain on FVTOCI equity Securities (Ind AS 109)
4. Exchange differences on translation of foreign operations	4. Capital Reserve (common control transaction Ind AS 103)
5. Share of profit & loss in Associates & JV (Ind AS 28 & 111)	5. Share of profit & loss in Associates & JV (Ind AS 28 & 111)

- Current tax and deferred tax relating to the items recognised in OCI shall be recognised in OCI only.



2.1 FVOCI – Debt Instruments

- Financial asset (FA) is measured at fair value through OCI (FVTOCI) if it meets both of following criteria:
 - a) ‘Hold-to-collect and sell’ business model test - Objective is achieved by both holding the financial asset in order to collect contractual cash flows and selling the financial asset, AND
 - b) ‘SPPI’ contractual cash flow characteristics test - Contractual terms give rise to cash flows that are Solely Payments of Principal and Interest (SPPI) on the principal amount outstanding.
- Intention of the entity is to sell the instrument before the investment matures.
- Examples of FA classified and accounted for at FVOCI:
 - Investments in government bonds where the investment period is likely to be shorter than maturity.
 - Investments in corporate bonds where the investment period is likely to be shorter than maturity.

Case study



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Case study :

- Entity A has surplus funds – INR 10 million
- A has not yet found suitable investment opportunity so it buys medium dated (3 year maturity) high quality government bonds in order to generate interest income.
- If a suitable investment opportunity arises before the maturity date, the entity will sell the bonds and use the proceeds for the acquisition of a business operation. It is likely that a suitable business opportunity will be found before maturity date.

Whether the investment opportunity will meet the 'hold-to-collect' or 'hold-to-collect & sell business model test?

Response:

- Government bonds would not meet the 'hold-to-collect' business model test because it is considered likely that the bonds will be sold well before their contractual maturity.
- However, it is likely that such investment would meet the 'hold-to-collect and sell' business model test.

2.1 FVOCI – Debt Instruments - Accounting requirement



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- For Debt instruments classified as FVOCI, accounting requirements are as follows:

S.No	Nature of Item	Accounting treatment
1	▪ Interest income	▪ To be recognised in profit or loss using the effective interest rate method
2	▪ Other changes in the carrying amount on re-measurement to fair value	▪ To be recognized in OCI
3	▪ when the related financial asset is derecognised	▪ Cumulative fair value gain or loss recognised in OCI is recycled to profit or loss.

- For debt instruments that are classified as FVOCI, entities will need to track both the amortised cost and fair value.
- The amounts recorded in profit or loss will reflect amortised cost and the balance sheet will reflect the fair value of the financial asset.

2.2 FVOCI – Equity Instruments - Accounting requirement



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- Default Approach –
 - Ind AS 109 requires all equity investments to be measured at fair value.
 - All changes in fair value to be recognised in profit or loss.
 - New FVOCI category option – Equity investments (not held for trading)
 - Entities can make an irrevocable election at initial recognition to classify the instruments as at FVOCI.
 - Such option is available instrument by instrument i.e. (item by item)
 - All subsequent changes in fair value being recognised in OCI.
 - Dividends received on equity investments to be recognised in profit or loss.
- FVOCI category for equity investments is a new measurement category when compared to IAS 39.
 - Under this new category,
 - On disposal, cumulative change in fair value to remain in OCI and not recycled to PL
 - Entities may transfer amounts between reserves within equity (i.e. between the FVOCI reserve and retained earnings)

3. Financial assets classified as Fair Value through PL (FVTPL)



3. FVTPL

- Fair value through profit or loss (FVTPL) is the residual category in Ind AS 109.
 - Financial asset (FA) classified and measured at FVTPL if FA is:
 - A held-for-trading financial asset
 - A debt instrument that does not qualify to be measured at amortised cost or FVOCI
 - An equity investment which the entity has not elected to classify as at FVOCI
 - Examples of FA classified and accounted for at FVTPL are:
 - Derivatives that have not been designated in a hedging relationship, e.g.:
 - Interest rate swaps
 - Commodity futures/option contracts
 - Foreign exchange futures/option contracts
 - Investments in shares that the entity has not elected to account for at FVOCI.
 - Contingent consideration receivable from the sale of a business.
- Under Ind AS 109, consideration is first given to whether a financial asset is to be measured at amortised cost and FVOCI and, if it is not, it will be measured at FVTPL.



3. FVTPL – Case Study

Case study :

- Entity B owns five retail chains
- It sold one of its retail chains to Entity C.
- As part of the purchase consideration, Entity B is entitled to additional consideration of INR 3 million if the retail chain meets certain profit targets over the next 3 years.

Question: How should Entity B classify the contingent consideration receivable?

Response:

- The terms of the contingent consideration receivable fails the SPPI cash flow characteristics test because the payment is linked to the future profitability of the retail chain which has been sold.
- The contingent consideration receivable is measured at fair value through profit or loss.

Classification Summary



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	Financial Assets			Financial Liabilities		Equity
Classification	Amortised Cost	FVTOCI	FVTPL	Amortised Cost	FVTPL	-
Basis of Classification	- SPPI test - BM to hold till expiry	- SPPI test - BM to hold till expiry and sell	Held for trading (SPPI or BM test fail)	Default criterial	- If held for trading - Entity elects FVTPL (using fair value option)	-
Initial recognition	Fair Value	Fair Value	Fair Value	Fair Value	Fair Value	Fair Value
Subsequent recognition	Amortised Cost	Fair Value	Fair Value	Amortised cost	Fair Value	No Re - measure ment

Classification - Case Studies



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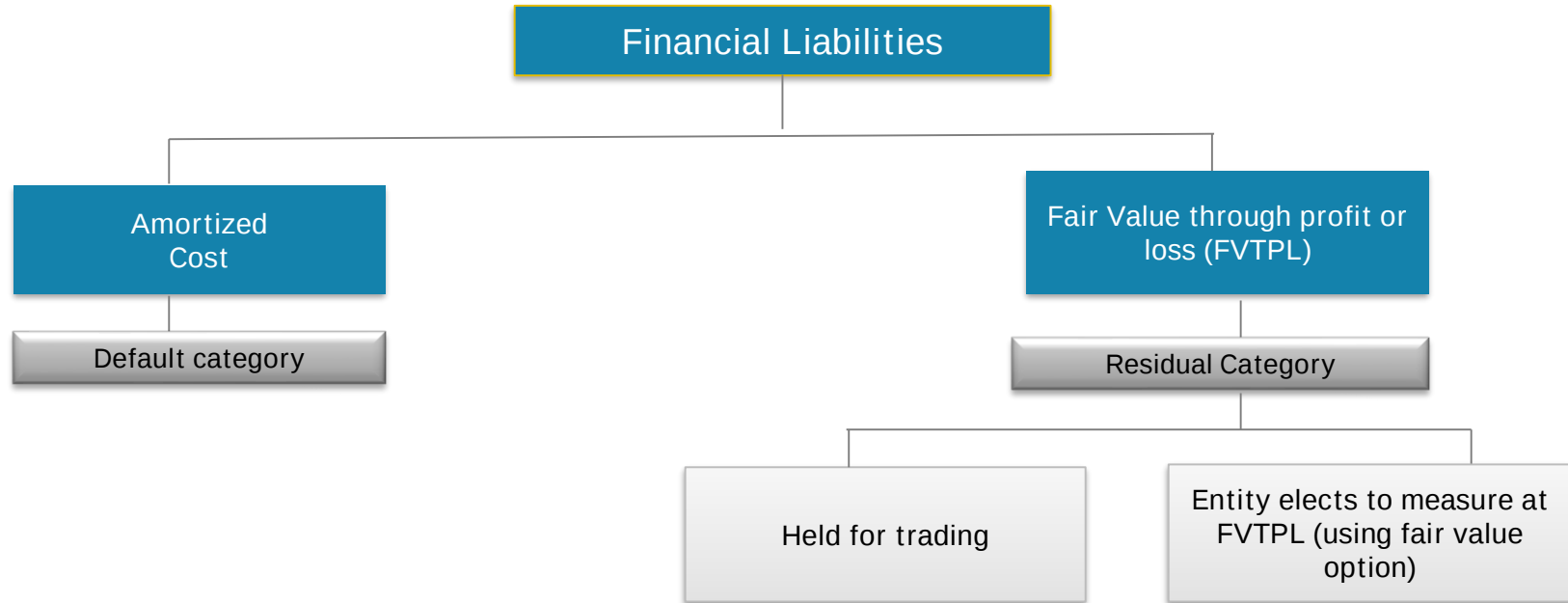
Particulars	Trade Receivable (Till Maturity)	Trade Receivable (before maturity)	Security Deposits	Cash in hand	Bank Balance	Invest in bond (Till Maturity)	Invest in bond (before maturity)	Invest in Equities (Held for trading)	Invest in Equities (Not Held for trading)
FI	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
FA	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Classification									
<u>1. Amortised Costs</u>	Yes	FAIL	Yes	Yes	Yes	Yes	FAIL	FAIL	FAIL
(a) BMT to Collect	Yes	FAIL	Yes	Yes	Yes	Yes	FAIL	-	-
(b) SPPI	Yes	Yes	Yes	Yes	Yes	Yes	Yes	FAIL	FAIL
<u>2. FVTOCI</u>	-	Yes	-	-	-	-	Yes	FAIL	Yes
(a) BMT to Collect + Sell	-	Yes	-	-	-	-	Yes	-	-
(b) SPPI	-	Yes	-	-	-	-	Yes	FAIL	-
<u>3. FVTPL</u>	-	-	-	-	-	-	-	Yes	-

Classification of financial Liabilities

Classification of financial liabilities



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Classification of financial liabilities – an overview

Financial liabilities has been classified into two categories:

Category	Main use	Examples
Amortised Cost (Default category)	▪ All liabilities not in the above category	▪ Trade payables ▪ Bank borrowings
Fair value through profit or loss	▪ Financial liabilities that are held for trading (including derivatives). ▪ Financial liabilities that are designated as FVTPL the entity on initial recognition. ▪ Contingent consideration recognised by an acquirer in a business combination	▪ Derivatives eg. Interest rate swaps, Commodity futures/option contracts ▪ Contingent consideration payable arising from one or more business combinations.

Recognition & Measurement

Initial Recognition & Measurement



Initial Recognition

Initial Recognition

- An entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes party to the contractual provisions of the instrument

- When an entity first recognises a financial asset, it must be classified as either:-
 - Amortized costs
 - Fair value through OCI
 - Fair value through PL



Initial Measurement

- On initial recognition, financial assets or financial liabilities are measured at FAIR VALUE.
- What is Fair value ?
 - Fair value of a financial instrument at initial recognition is normally the transaction price (,ie, fair value of consideration given or received).
 - Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
 - Approaches to compute Fair value (refer Ind AS 113)
 - Market Approach
 - Costs Approach
 - Income Approach or Discounted cash Flow Technique
- If the financial assets or financial liabilities are not recognized at fair value, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability are adjusted against the fair value



What is Transaction cost ?

- Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial instrument

Examples of costs that qualify as transaction costs	Examples of costs that do not qualify as transaction costs
▪ Fees and commissions paid to agents, advisers, brokers and dealers	▪ Debt premiums or discounts
▪ Levies by regulatory agencies and securities exchanges	▪ Financing costs
▪ Transfer taxes and duties	▪ Internal administration costs
▪ Credit assessment fees and registration charges	

Initial Measurement & Transaction costs – Financial Assets & Liabilities



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

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



Case study

Case study : Transaction cost

- An entity purchases a financial asset for \$1,000.
- Transaction costs of \$20 were incurred on the purchase.

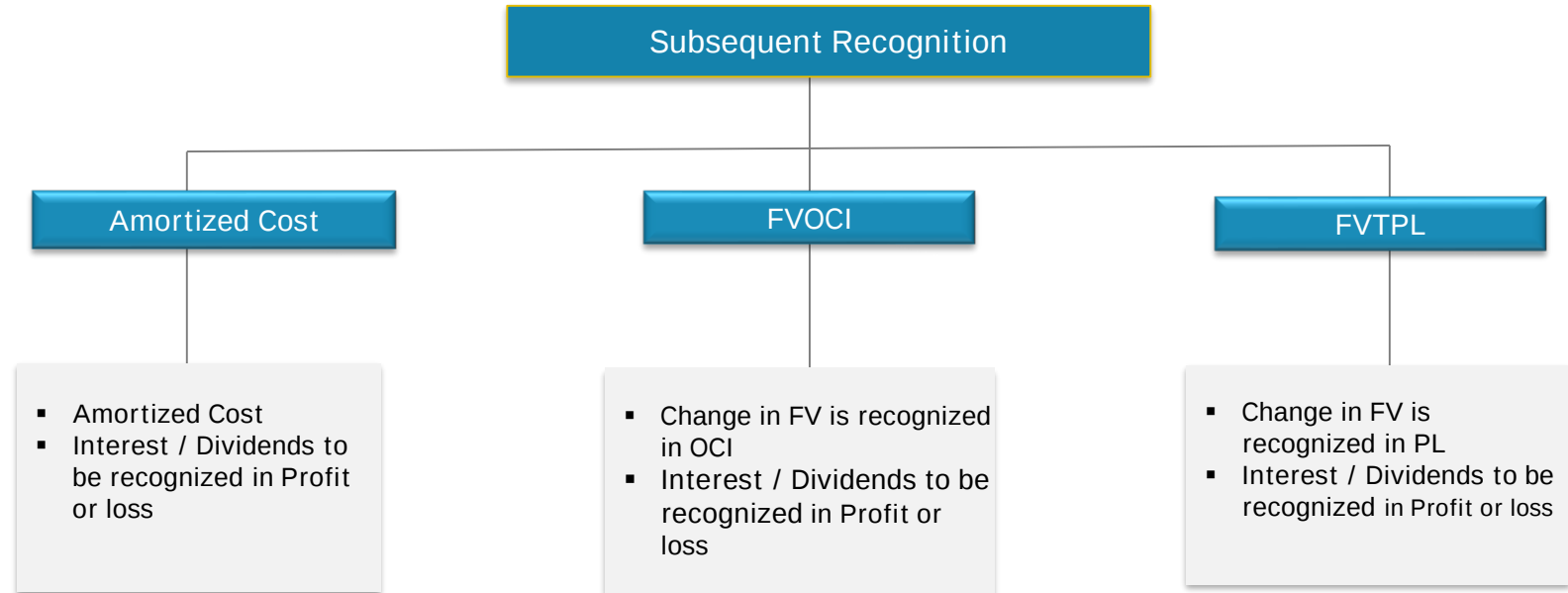
At what value, the Company should recognize the such financial assets?

Response:

- If the asset is classified as Amortised costs or FVOCI, then such financial asset is initially measured at \$980.
- If the asset is classified as FVPL, then such financial asset is initially measured at \$1,000 and the \$20 would be expensed to profit or loss immediately.

Subsequent Recognition & Measurement

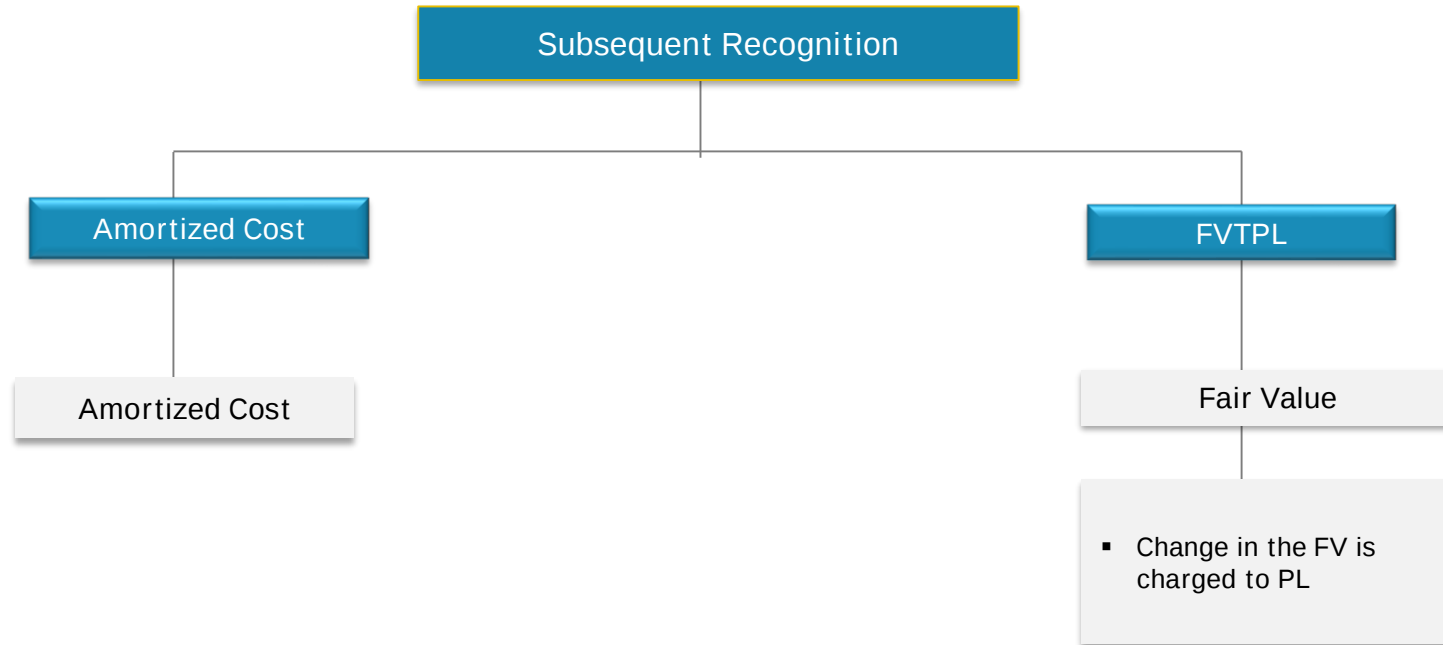
Subsequent Measurement – Financial Assets



Subsequent Measurement – Financial Liabilities



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Accounting for Instruments exchanged at Off Market Terms



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Sometimes certain type of instruments may be exchanged at off market terms (,ie, different from market terms for a similar instrument if exchanged between market participants):

- Where Market approach is applied for computing FV
 - Differential in transaction price and FV is charged to profit and loss.
- Where Discounted Cash flow technique or Income Approach is applied for computing FV
 - In the aforementioned example, the fair value of the long-term loan or receivable can be measured as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating.
 - The additional amount lent is recognized as assets if it qualifies for recognition, otherwise it will be charged to profit and loss.

Reclassification of Financial Assets and Liabilities



Reclassification of Financial Assets

An entity shall reclassify financial assets, only if the entity changes its business model for managing those financial assets.

- Such changes are determined by the entity's senior management as a result of external or internal changes and must be significant to the entity's operations and demonstrable to external parties.
- Accordingly, a change in an entity's business model will occur only when an entity either begins or ceases to perform an activity that is significant to its operations; for example, when the entity has acquired, disposed of or terminated a business line.
- Such changes are expected to be very infrequent.



Reclassification of Financial Assets

- Examples of a change in business model include the following:
 - (a) An entity has a portfolio of commercial loans that it holds to sell in the short term. The entity acquires a company that manages commercial loans and has a business model that holds the loans in order to collect the contractual cash flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and all are held to collect the contractual cash flows.
 - (b) A financial services firm decides to shut down its retail mortgage business. That business no longer accepts new business and the financial services firm is actively marketing its mortgage loan portfolio for sale.

Following are not changes in business model:

- (a) A change in intention related to particular financial assets (even in circumstances of significant changes in market conditions);
- (b) Temporary disappearance of a particular market for financial assets;
- (c) A transfer of financial assets between parts of the entity with different business models.



Reclassification of Financial Assets

- A change in the objective of the entity's business model must be effected before the reclassification date.

For example : Let us assume that an entity has 31 March year-end. It acquires a new entity on 31 May 2015 resulting in a change in business model for a portfolio of financial assets. The entity will reclassify these assets from 1 April 2016, i.e., till year end 31 March 2016, previous classification will continue.

However, any new financial asset acquired on or after 1 June 2015 will be classified from the acquisition date according to the new model.

- If an entity reclassifies financial assets, it should apply the reclassification prospectively from the reclassification date.
- The entity should not restate any previously recognised gains, losses (including impairment gains or losses) or interest.



Reclassification of Financial Assets – Accounting

Original classification	Revised classification	Accounting treatment
▪ Amortised Cost	▪ FVTPL	- Fair value is measured at reclassification cost date. - Difference between previous amortized cost and fair value is recognised in P&L.
	▪ FVTOCI	- Fair value is measured at reclassification cost date. - Difference between previous amortised cost and fair value is recognised in OCI. - No change in EIR due to reclassification.
▪ FVTPL	▪ Amortised Cost	- Fair value at reclassification date becomes its new gross carrying amount. - EIR is calculated based on the new gross carrying amount.
	▪ FVTOCI	- Fair value at reclassification date becomes its new carrying amount. - No other adjustment is required.
▪ FVTOCI	▪ Amortised Cost	- Fair value at reclassification date becomes its new amortised cost carrying amount. - However, cumulative gain or loss in OCI is adjusted against fair value. Consequently, the asset is measured as if it had always been measured at amortised cost.
	▪ FVTPL	- Assets continue to be measured at fair value. - Cumulative gain or loss previously recognized in OCI is reclassified to P&L at the reclassification date.

Reclassification of Financial liabilities



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- **Reclassification of financial liability is not allowed.**

Practical Applications

Effective interest rate method



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Case Study :-

- Company ABC has taken a loan of INR 100,000 from Bank Y and has incurred a transaction costs of INR 10,000.
- EMI payable on yearly basis is INR 12,000 for a period of 10 years.

How to compute the Amortised costs of such loan.



EIR



Effective interest rate method

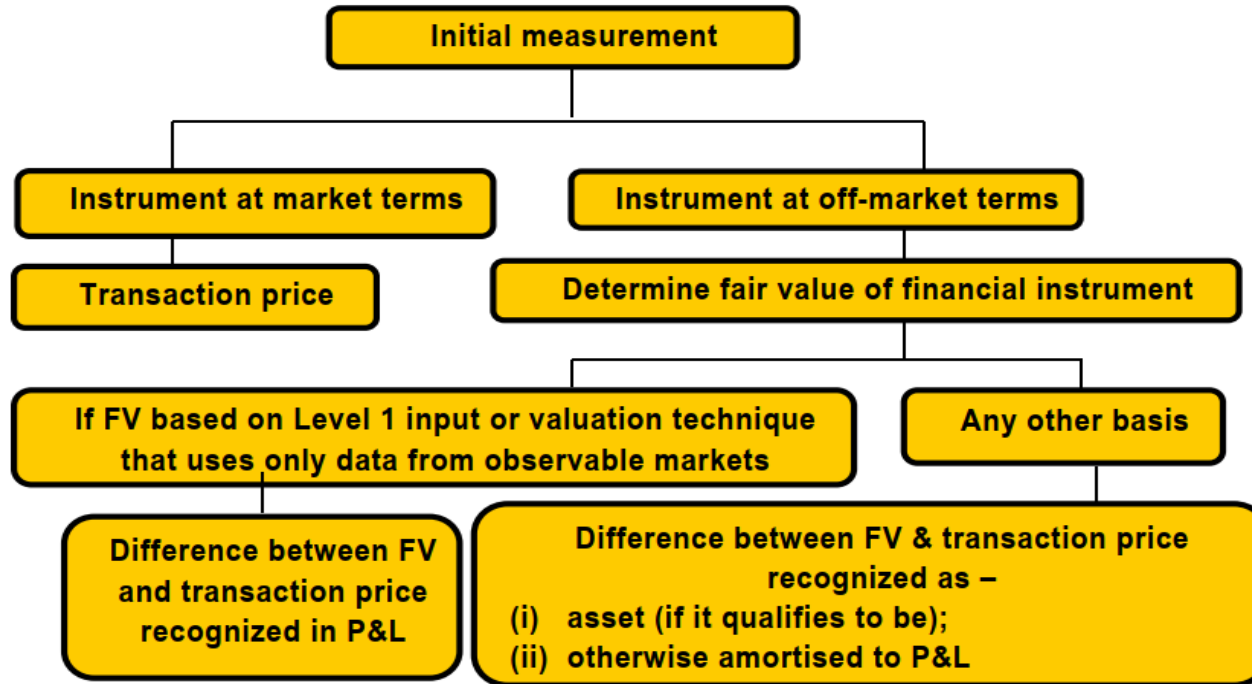
Response:

Year	Cash Flows	Opening Balance	Payment made	Interest charged (IRR)	Closing Balance (Amortised Costs)
0	-100,000				100,000
1	12,000	100,000	12,000	3,460	91,460
2	12,000	91,460	12,000	3,165	82,625
3	12,000	82,625	12,000	2,859	73,484
4	12,000	73,484	12,000	2,543	64,026
5	12,000	64,026	12,000	2,215	54,242
6	12,000	54,242	12,000	1,877	44,119
7	12,000	44,119	12,000	1,527	33,645
8	12,000	33,645	12,000	1,164	22,809
9	12,000	22,809	12,000	789	11,599
10	12,000	11,599	12,000	401	0
	20,000		120,000	20,000	

Accounting for Instruments exchanged at Off Market Terms Contd..



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Accounting treatment of Transaction Costs / processing fees



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Case Study

Accounting treatment of processing fees belonging to undisbursed loan amount

- X Ltd., had taken 6 year term loan in April 2010 from bank and paid processing fees at the time of sanction of loan.
- The term loan is disbursed in different tranches from April 2010 to April 2016. On the date of transition to Ind AS, i.e. 1.4.2015, it has calculated the net present value of term loan disbursed upto 31.03.2015 by using effective interest rate and proportionate processing fees has been adjusted in disbursed amount while calculating net present value.

What will be the accounting treatment of processing fees belonging to undisbursed term loan amount?

Accounting treatment of Transaction Costs / processing fees



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Response :

- Assuming that the undisbursed loan amount will be disbursed in future, the accounting treatment of the processing fees will be as follows:
- Processing fee is an integral part of the effective interest rate of a financial instrument and shall be included while calculating the effective interest rate.

Accounting treatment in case future drawdown is probable

- It may be noted that to the extent there is evidence that it is probable that the undisbursed term loan will be drawn down in the future the processing fee is accounted for as a transaction cost under Ind AS 109, i.e., the fee is deferred and deducted from the carrying value of the financial liabilities when the draw down occurs and considered in the effective interest rate calculations.

Accounting treatment in case future drawdown is not probable

- If it is not probable that the undisbursed term loan will be drawn down in the future then the fees is recognised as an expense on a straight-line basis over the term of the loan.

Accounting treatment of prepayment premium and processing fees



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Case study:

Accounting treatment of prepayment premium and processing fees for obtaining new loan to prepay old loan:

- PQR Limited had obtained term loan from Bank A in 2013-14 and paid loan processing fees and commitment charges.
- In May 2017, PQR Ltd. has availed fresh loan from Bank B as take-over of facility i.e. the new loan is sanctioned to pay off the old loan taken from Bank A. The company paid prepayment premium to Bank A to clear the old term loan and paid processing fees to Bank B for the new term loan.

Whether the prepayment premium and the processing fees both will be treated as transaction cost (as per Ind AS 109, Financial Instruments) of obtaining the new loan, in the financial statements of PQR Ltd?

Accounting treatment of prepayment premium and processing fees



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Response :

Accounting treatment of prepayment premium

➤ Ind AS 109, provides that if an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment in the statement of profit and loss.

➤ Since the original loan was prepaid, the prepayment would result in extinguishment of the original loan. The difference between the CV of the financial liability extinguished and the consideration paid shall be recognised in profit or loss as per Ind AS 109. Accordingly, the prepayment premium shall be recognised as part of the gain or loss on extinguishment of the old loan.

Accounting treatment of Unamortised processing fee of old loan

➤ Unamortised processing fee related to the old loan will also be required to be charged to the statement of profit and loss.

Accounting treatment of prepayment premium and processing fees



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Response :

Accounting treatment of Processing fee for new loan

- Transaction costs are “Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.”
- It is assumed that the loan processing fees solely relates to the origination of the new loan (i.e. does not represent loan modification/renegotiation fees). Hence, the processing fees paid to avail fresh loan from Bank B will be considered as transaction cost in the nature of origination fees of the new loan and will be included while calculating effective interest rate as per Ind AS 109.

Accounting treatment of share held as stock in trade



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Case study

Accounting treatment of share held as stock in trade

➤ A share broking company is dealing in sale/purchase of shares for its own account and therefore is having inventory of shares purchased by it for trading.

How will these instruments be accounted for in the financial statements?



Accounting treatment of share held as stock in trade

Response :

- Ind AS 2, Inventories, states that this Standard applies to all inventories, except financial instruments (Ind AS 32, Financial Instruments: Presentation and Ind AS 109, Financial Instruments).
- Accordingly, the principles of recognising and measuring financial instruments are governed by Ind AS 109, its presentation is governed by Ind AS 32 and disclosures are in accordance with Ind AS 107, Financial Instruments: Disclosures, even if these instruments are held as stock-in trade by a company.
- Further Ind AS 101, First-time Adoption of Indian Accounting Standards does not provide any transitional relief from the application of the above standards.
- Accordingly, in the given case, the relevant requirements of Ind AS 109, Ind AS 32 and Ind AS 107 shall be applied retrospectively.

Accounting treatment of financial guarantee received from a director



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Case Study

Accounting treatment of financial guarantee received from a director

- Company A Ltd., applied for a term loan from Bank B for business purposes.
- As per the loan agreement, the loan required a personal guarantee of one of the directors of A Ltd. to be executed.
- In case of default by A Ltd, the director will be required to compensate for the loss that Bank B incurs.
- Mr. P, one of the director had given guarantee to the bank pursuant to which the loan was sanctioned to Company A. Company A does not pay premium or fees to its director for providing this financial guarantee.

Whether Company A is required to account for the financial guarantee received from its director?

Accounting treatment of financial guarantee received from a director



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Response :

- As per Ind AS 109, financial guarantee contract is, “A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.”
- Ind AS 109 provides principles for accounting by the issuer of the guarantee. However, it does not specifically address the accounting for financial guarantees by the beneficiary. In an arm's length transaction between unrelated parties, the beneficiary of the financial guarantee would recognise the guarantee fee or premium paid as an expense.
- In the given case, Company A Ltd, is the beneficiary of the financial guarantee and it does not pay a premium or fees to its director for providing this financial guarantee (subject to discussion above). Accordingly, Company A will not be required to account for such financial guarantee in its financial statements.
- In the given case based on the limited facts provided, Company A will be required to make necessary disclosures of such financial guarantee in accordance with Ind AS 24.



Financial guarantee

- Paragraph B2.5 of Ind AS 109 inter-alia states that, “Financial guarantee contracts may have various legal forms, such as a guarantee, some types of letter of credit, a credit default contract or an insurance contract. Their accounting treatment does not depend on their legal form.”
- In accordance with the above, it may be noted that a significant feature of a financial guarantee contract is the contractual obligation to make specified payment in case of default by the credit holder. As such, the contract may not necessarily be called as financial guarantee contract and it may take any name or legal form, however the treatment will be same as that of a financial guarantee contract.
- Accordingly, in the given case, P Ltd. will be required to evaluate as to whether it is contractually obliged to make good the loss in case S Ltd. fails to make the payment. If yes, then such comfort letter would be considered to be a financial guarantee contract and will be accounted for in accordance with Ind AS 109.

Impairment- Financial instruments

The impairment requirements would apply to:

- ▶ Debt instruments measured at amortised cost
- ▶ Debt instruments measured at fair value through other comprehensive income
- ▶ Loan commitments and financial guarantee contracts not measured at fair value through profit or loss
- ▶ Trade receivables and contract assets
- ▶ Lease receivables

Scope and variation of the expected credit loss model



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#	Scope of ECL requirements	General approach	Simplified approach
1	Ind AS 109 <i>Financial Instruments</i>		
	▪ Trade receivables that do not contain a significant financing component		✓
	▪ Trade receivables that contain a significant financing component	Policy election at entity level	
	▪ Other debt financial assets measured at AC or at FVOCI	✓	
	▪ Loan commitments and financial guarantee contracts not accounted for at FVPL	✓	
2	Ind AS 115 <i>Revenue from Contracts with Customers</i>		
	▪ Contract assets that do not contain a significant financing component		✓
	▪ Contract assets that contain a significant financing component	Policy election at entity level	
3	Ind AS 116 <i>Leases</i>		
	▪ Lease receivables	Policy election at entity level	

General Approach Vs Simplified Approach



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General Approach	Simplified Approach
➤ In General Approach, impairment loss is recognized based on either 12 month ECL or lifetime ECL. ➤ Impairment loss will be lower in 12 month ECL as it focusses only on the probability of default within next 12 months as compared to lifetime ECL as it focusses on probability of default over life the life of an instrument. ➤ This method depends whether there has been a significant increase in credit risk. ➤ One needs to track the change in credit rating / quality.	➤ This approach does not require an entity to track the changes in credit risks. ➤ Each entity recognizes the impairment loss based on lifetime ECL at each reporting date right from its initial recognition. ➤ This approach is mandatory for Trade receivables that do not contain a significant financing component.



What is Credit loss ?

What is a credit loss allowance?

For financial assets, a credit loss is the present value of the difference between:

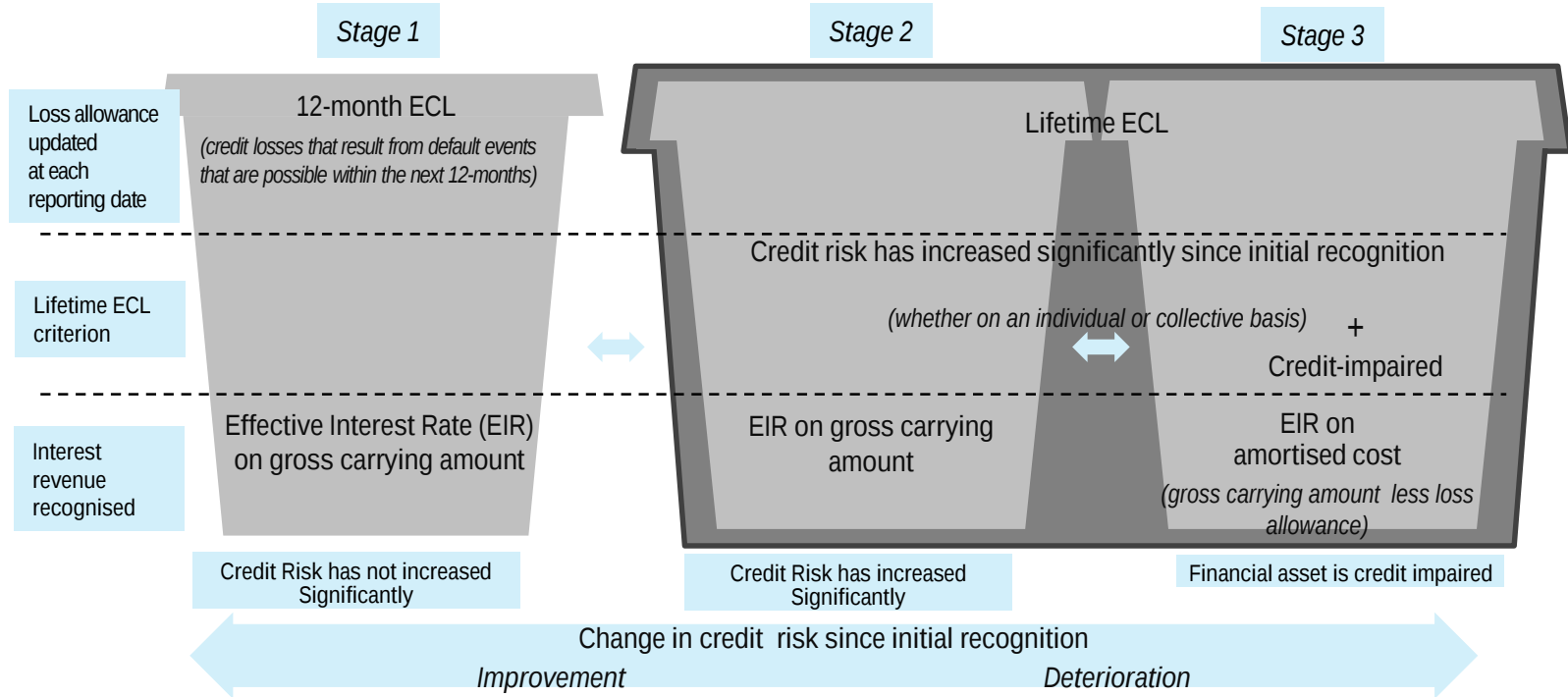
- (a) the contractual cash flows that are due to an entity under the contract; and
- (b) the cash flows that the entity expects to receive (,ie, cash short falls) discounted at original effective interest rate (or credit adjusted effective interest rate in case of purchased or originated credit-impaired financial assets).

Amount of Credit loss	=	Contractual cash flows that are due to an entity	–	Discounted value of cash flows that the entity expects to receive
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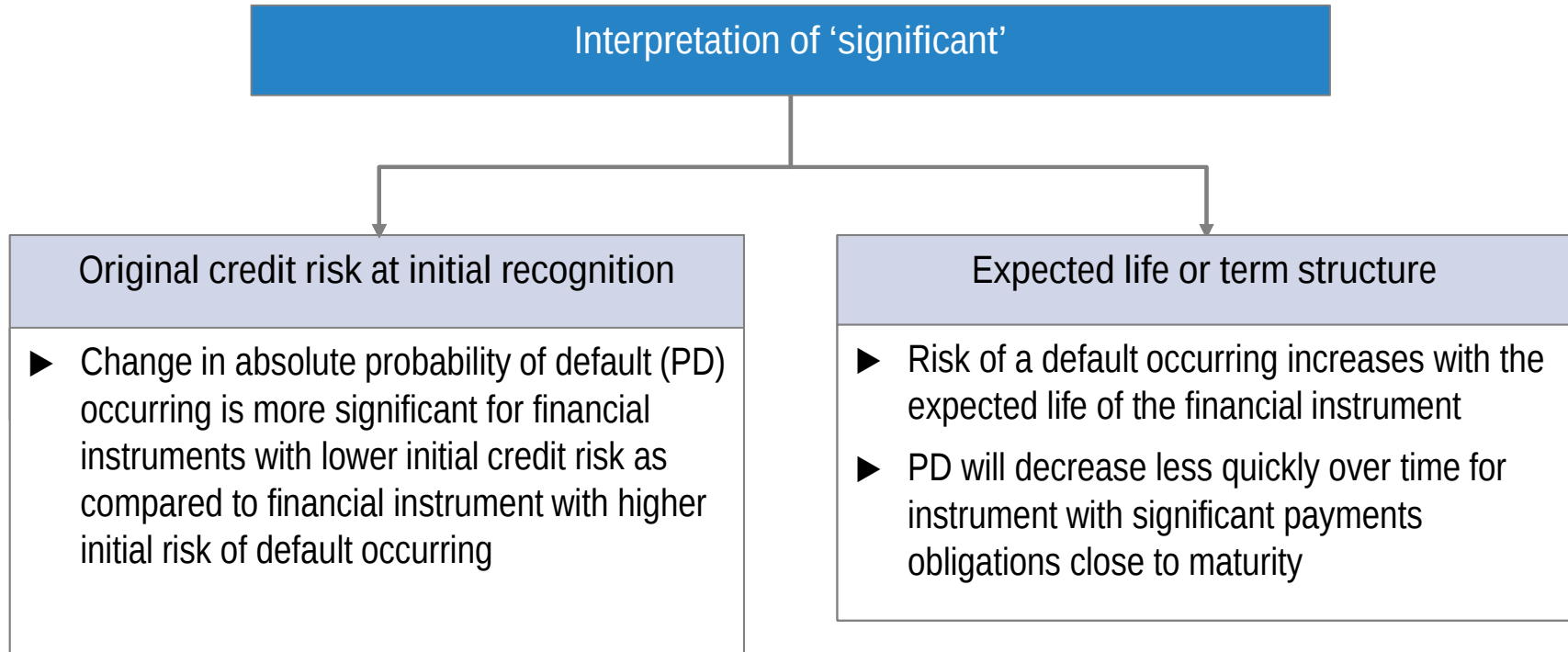
General Approach



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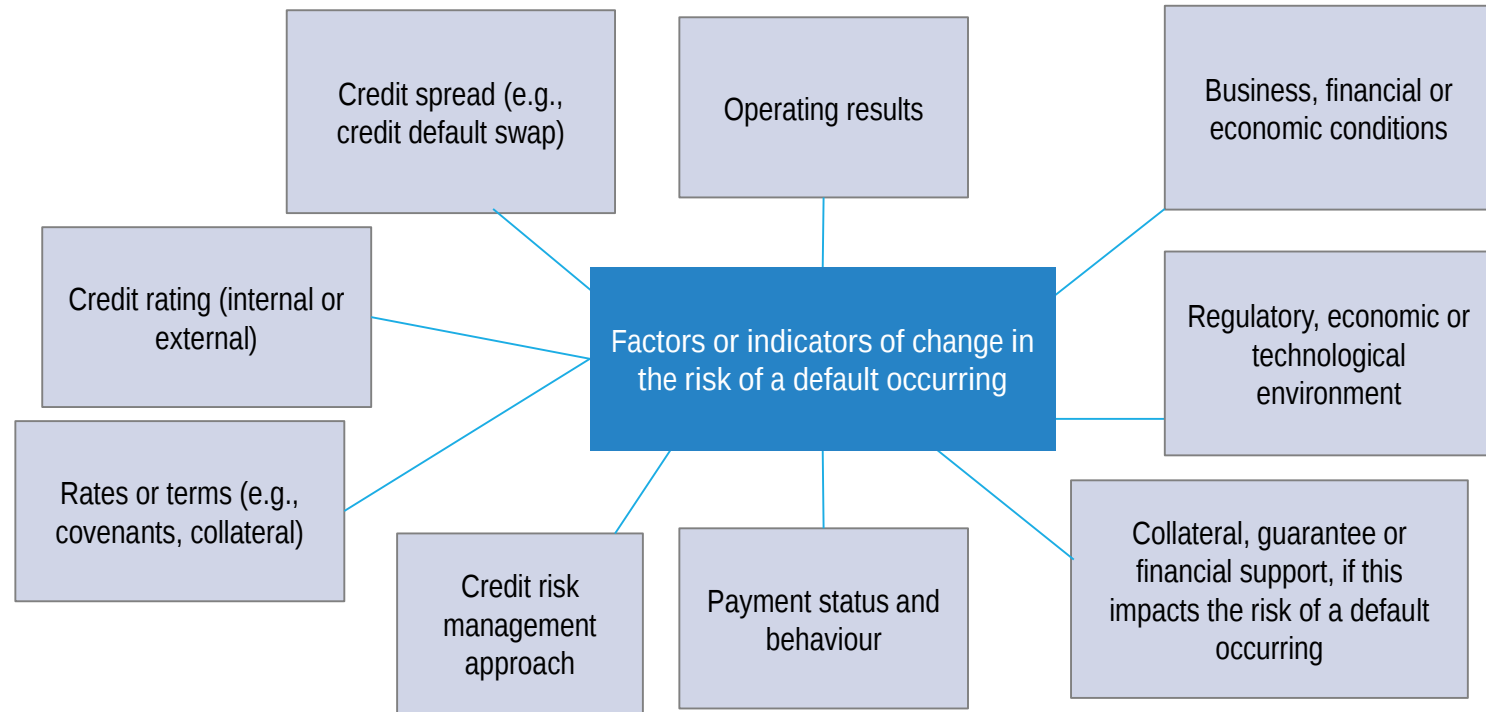
What is a 'significant' increase in credit risk?



Factors or indicators of change in the risk of a default occurring



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Simplified approach: Provision matrix

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



Probability of Default

$$\text{Expected credit loss (ECL)} = \text{EAD} * \text{PD} * \text{LGD}$$

- **Exposure at default (EAD)** will be the gross amount of debt financial asset or borrowing.
- **Probability of default (PD)** is the likelihood that a loan will not be repaid and will fall into default. It must be calculated for each borrower. The credit history of the borrower and the nature of the investment must be taken into consideration when calculating PD. External ratings agencies such as Standard and Poors or Moody's may be used to get a PD; however, banks can also use internal rating methods. PD can range from 0% to 100%. If a borrower has 50% PD it is considered a less risky company vs. a company with an 80% PD.
- **Loss given default (LGD)** is the fractional loss due to default.
 $\text{LGD} = 1 - \text{Recovery Rate (RR)}$
- **Recovery Rate (RR)** is defined as the proportion of a bad debt that can be recovered.



Case study : Probability of Default

Example

- A borrower (Company X) takes out a loan from Bank ABC for \$10 million (EAD). Company X pledges \$3 million collateral against this loan (for simplicity, let's say the collateral is cash). The Company's PD is determined by analysing their credit risk aspects (evaluate the financial health of the borrower, taking into account economic trends, borrower relationship with the bank, etc.) For Company X, the PD is 0.60. This means that the Company is extremely risky; the probability of them defaulting on the loan is 60%.
- **EAD = 10 million**
- **PD = 0.60**
- **LGD = 1 – Recovery Rate (RR)**
- So, LGD = $1 - 0.30 = 0.70$ or **70%**.

Expected credit loss (ECL) = EAD * PD * LGD

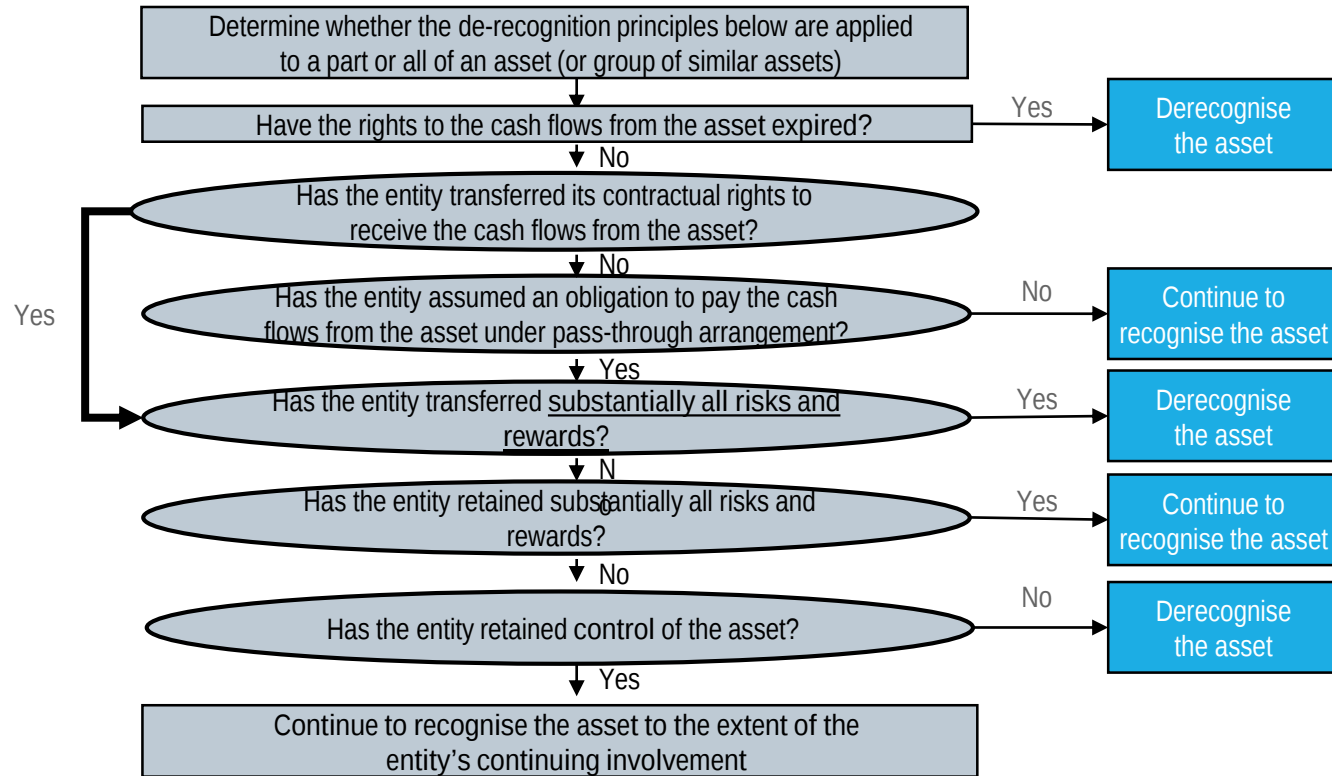
$$\begin{aligned} &= \$10 \text{ million} * 0.60 * 70\% * \\ &= \mathbf{\$4.2 \text{ million}} \end{aligned}$$

Bank ABC can expect to lose \$4.2 million

Derecognition of Financial Assets



Derecognition of Financial Asset



What is Risk & Rewards



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Examples where Risk & Reward have been transferred	Examples where Risk & Reward have not been transferred
An unconditional sale of a financial asset;	-
Sale and Repurchase at FV Sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase	Sale and Repurchase at Fixed Price or Cost + Margin Sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return;
Put / Call option - Deeply out of Money - Transferee put option or - Transferor has a call option - 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). -	Put / Call option - Deeply in the Money - Sale of a financial asset together with a deep in-the-money put or call option (ie an option that is so far in the money that it is highly unlikely to go out of the money before expiry). Guarantee for Credit loss - Sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.
-	Securities lending agreement Example : Loan.



Factoring of receivables

Case Study : An entity has receivables of \$1 million which it sells to a factor for \$940,000.

If the debtors fail to pay, or have not paid within three months of the sale, the factor can return the debt to the entity.

What will be the accounting treatment in following cases:-

- (i) Where the Factor is without Recourse
- (ii) Where the Factor is with Recourse

Response

- As the receivables have been sold “with recourse” they cannot be derecognised. Instead, a current liability loan of \$940,000 is recognised, with \$60,000 finance costs.
- If the receivables had been sold “without recourse” they would have been derecognised and \$60,000 recognised as an operating cost.

Factoring of receivables



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Factor is without Recourse (Net)				Factor is with Recourse (Gross)		
Bank	Dr	940,000		Bank	Dr	940,000
Operation Costs	Dr	60,000		Finance Costs	Dr	60,000
To Debtor	Cr	(1,000,000)		To Liability	Cr	(1,000,000)



Case Study : Repurchase Agreements

- A financial asset is sold under repurchase agreement. The repurchase price as per that agreement is (a) fixed price or (b) sale price plus a lender's return.
- Let's look at three alternate scenarios:
 - (a) Repurchase agreement is for the same financial asset.
 - (b) Repurchase agreement is for substantially the same asset
 - (c) Repurchase agreement provides the transferee a right to substitute assets that are similar and of equal fair value to the transferred asset at the repurchase date.

State whether the derecognition principles will be applied or not.

Response :

In each of these scenarios, the transferred financial asset is not derecognised because the transferor retains substantially all the risks and rewards of ownership.

- (a) Repurchase agreement is for the same financial asset – Continue to Retain.
- (b) Repurchase agreement is for substantially the same asset – Continue to Retain.
- (c) Repurchase agreement provides the transferee a right to substitute assets that are similar and of equal fair value to the transferred asset at the repurchase date – Continue to Retain.



Case Study : Put options on transferred financial assets

- A financial asset is sold and the transferee has a put option.
- Following are some scenarios:
 - (a) Put option is deeply in the money
 - (b) Put option is deeply out of the money.

State whether the derecognition principles will be applied or not.

Response :

- (a) Put option is deeply in the money :
 - Continue to retain the assets. The transferred asset does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership.
- (b) Put option is deeply out the money :
 - Derecognise the assets. The transferor has transferred substantially all the risks and rewards of ownership.



Case Study : Call options on transferred financial assets

- A financial asset is sold and the transferor has a call option. Let's look at some alternate scenarios:
 - (a) Call option is deeply in the money
 - (b) Call option is deeply out of the money.
 - (c) Call option is neither deeply in the money nor deeply out of the money

State whether the derecognition principles will be applied or not.

Response :

- (a) Call option is deeply in the money - Continue to retain the assets.
- (b) Call option is deeply out of the money – Derecognise.
- (c) Call option is neither deeply in the money nor deeply out of the money – Derecognise.

Derecognition of Financial Liabilities



Timing of derecognition of financial liability

- An entity shall remove a financial liability (or a part of a financial liability) from its statement of financial position when, and only when, it is extinguished - ie when the obligation specified in the contract is discharged or cancelled or expires. (Ind AS 109 B3.3.1(b)).
- A financial liability (or part of it) is extinguished when the debtor either:
 - (a) Discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or
 - (b) Is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor.



Timing of derecognition of financial liability

- Legal release by creditor
 - A debtor can derecognise a liability can only if the creditor legally releases the debtor from the liability.
 - For example:
 - (a) In scenario 1, the debtor pays to a third party and intimates the same to the creditor. The creditor legally releases the debtor from its liability. However, the debtor has given a guarantee for default by third party. In this case, debtor can derecognize the liability since the creditor has legally released debtor from its obligations. Further, derecognition is not precluded by the fact that debtor has given a guarantee in respect of the liability.
 - (b) Consider the scenario 2. The debtor pays to a third party and intimates the same to the creditor. Creditor does not legally release debtor from its obligation. Hence, the debtor will need to make payment if third party fails to make payment. However, in this case, debtor cannot derecognize the liability since the creditor has not legally released debtor from its obligations.



Accounting for an extinguishment

Accounting for an extinguishment :

1. The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss.
2. Any costs or fees incurred on extinguishment shall be charged to profit & loss.



Accounting for Guarantee

Further, in some cases, a creditor releases a debtor from its present obligation to make payments, but the debtor assumes a guarantee obligation to pay if the party assuming primary responsibility defaults.

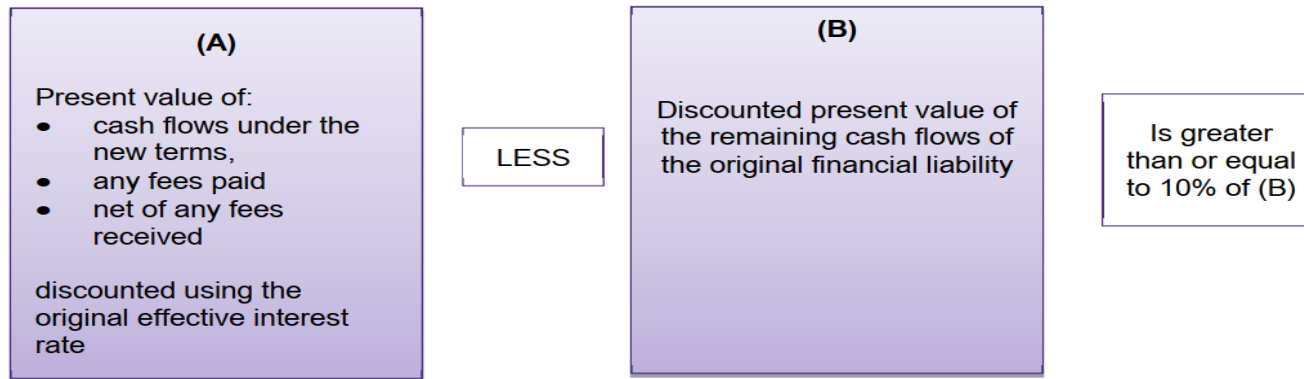
In these circumstances the debtor:

- (a) Recognises a new financial liability based on the fair value of its obligation for the guarantee, and
- (b) Recognises a gain or loss based on the difference between
 - (i) Any proceeds paid and
 - (ii) the carrying amount of the original financial liability less the fair value of the new financial liability

Exchange or Modification of Financial liability

Debt Restructuring

- An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as:
 - (a) A extinguishment of the original financial liability, and
 - (b) Recognition of a new financial liability.
- The substantially different terms are as below :



Exchange or Modification of Financial liability – Accounting treatment



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Accounting treatment – Costs of fees incurred on extinguishment or Modification

Scenario	Accounting
Where exchange of debt instruments or modification is <u>accounted for as an extinguishment</u>	Any costs or fees incurred are recognised as part of the gain or loss in PL on the extinguishment.
Where exchange of debt instruments or modification is <u>not accounted for as an extinguishment</u>	Any costs or fees incurred shall be adjusted in the carrying amount of the liability and are amortised over the remaining term of the modified liability.

Exchange or Modification of Financial liability – Accounting treatment



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If the 10% test is passed, principle of “extinguishment accounting” are applied, that is:

1. De-recognition of the existing liability.
2. Recognition of the new or modified liability at its FAIR VALUE (net of any fees incurred directly related to the new liability). Fair value of the new or modified liability is estimated based on the expected future cash flows of the modified liability, discounted using the interest rate at which the entity could raise debt with similar terms and conditions in the market.
3. Gain or loss on extinguishment : Charge to PL.
4. Recognising any incremental costs or fees incurred for modification (and not for the new liability), and any consideration paid or received, in profit or loss.
5. EIR Accounting for New Loan : Calculating a new effective interest rate for the modified liability, which is then used in future periods.



Modification of Financial liability – Accounting treatment

Ind AS 109 is not clear as to the accounting treatment if the 10% test is failed.
Two alternate approaches are therefore possible:

Approach 1: Recognition of gain or loss on date of modification

1. Under this approach, the difference between:
 - (a) discounted present value of the remaining cash flows of the original financial liability, and
 - (b) discounted present value of the remaining cash flows of the new financial liabilityboth computed using original effective interest rate, is recognized in profit or loss.
2. In addition, any fees or costs incurred will also be recognized in profit or loss.

Approach 2: Amortisation of gain or loss on date of modification

Under this approach,

1. Fees or costs incurred are netted against the existing liability;
2. the effective interest rate is recalculated. This is the rate which discounts the future cash flows as per modified contractual terms to the adjusted carrying amount mentioned above
3. the adjusted effective interest rate is used to determine the amortised cost and interest expense in future periods



Extinguishment of Financial Liability

An entity issues 1 million equity shares with face value \$20 per share with total fair value of \$100 million to extinguish the whole of a loan under restructuring package.

The carrying amount of the loans on the date of extinguishment is \$90 million.

Solution.

Accounting entries would be as follows (all figures in \$ million):

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



Case Study : Modification

Case Study:

Recognition of renegotiation gain/loss on done on financial instruments but before the approval of financial instruments

- Holding company H Ltd., which is covered under phase II of Ind AS has a subsidiary S Ltd. H Ltd. is holding 57% of equity in S Ltd. The subsidiary S Ltd., has issued 1.5% optionally convertible preference shares to its holding company, which are non-cumulative.
- Ind AS 109, Financial Instruments requires recognition of renegotiation gain/loss subject to fulfillment of certain conditions as mentioned in the standard. If there has been a renegotiation of terms of (defaulted) borrowings subsequent to the year end, but before the date of approval of financial statements.

Whether the modification gain/loss be recognised in the current year financial statements itself or in the next year when the terms of (defaulted) borrowings have been renegotiated in accordance with Ind AS 109?



Case Study : Modification

Response :

- As per paragraph 5.4.3 of Ind AS 109, Financial Instruments, whenever contractual cash flows of a financial instrument are renegotiated or otherwise modified and the renegotiation or modification does not result in the derecognition of that financial asset in accordance with this Standard, an entity shall recalculate the gross carrying amount of the financial asset and shall recognise a modification gain or loss in profit or loss.
- In accordance with the above, modification gain or loss should be recognised in profit or loss in the period in which the renegotiation has contractually taken place.
- Accordingly, in the given case, if the terms of the (defaulted) borrowings have been renegotiated in the next year, then the related gain/loss should also be recognised in the next year.



Financial guarantee

Case Study:

Accounting treatment of financial guarantee contract – comfort letter

- P Ltd. (parent company) has issued a comfort letter to its subsidiary company, S Ltd.
- S Ltd. was able to obtain funds from the banker on the basis of comfort letter issued by P Ltd.

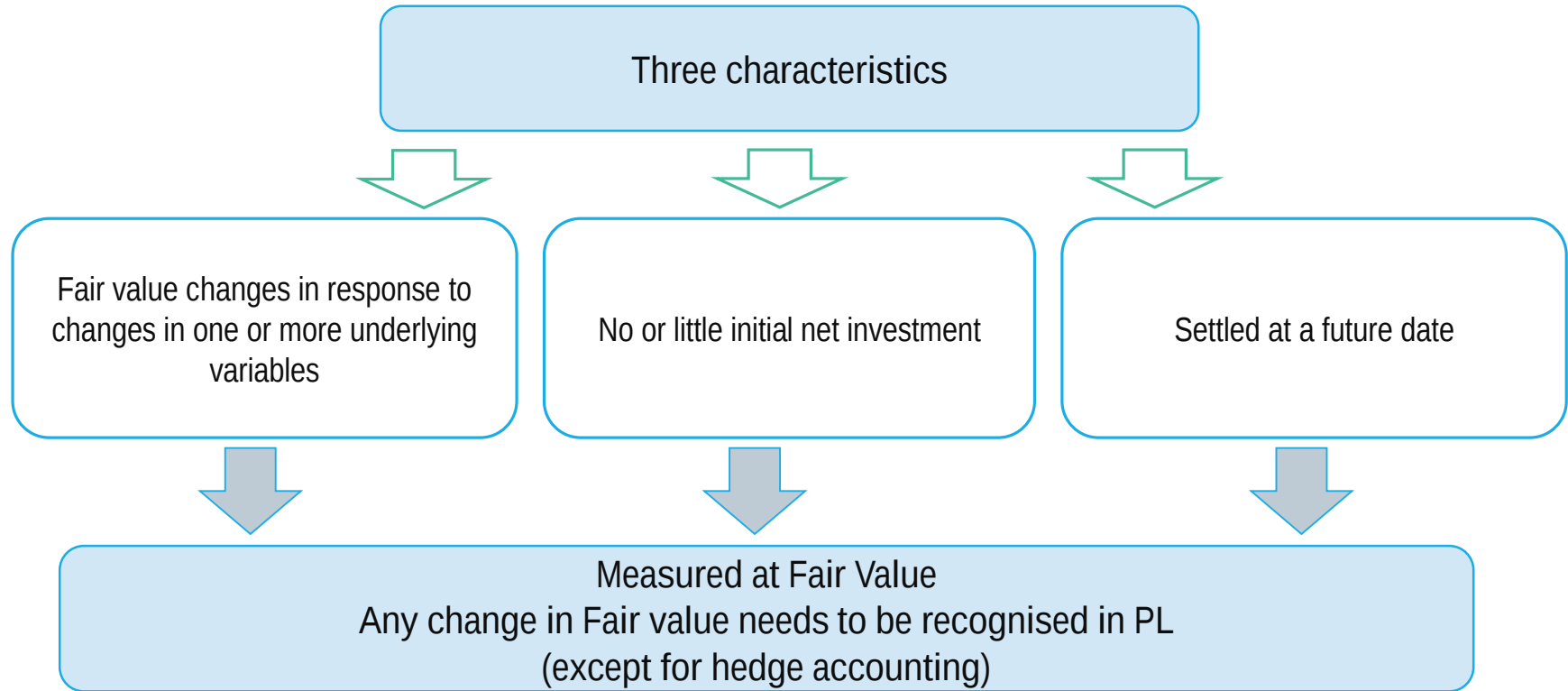
Whether the same will be accounted for as a financial guarantee contract in accordance with Ind AS 109, Financial Instruments?

Response :

- As per Ind AS 109, financial guarantee contract is, “A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.”

Derivatives and embedded derivatives

Derivative definition





Derivative definition

1. Value changes due to an underlying:
 - Value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable.
 - Derivatives give one party a contractual right to exchange financial assets or financial liabilities with another party under conditions that are potentially favourable, or a contractual obligation to exchange financial assets or financial liabilities with another party under conditions that are potentially unfavourable. Because the terms of the exchange are determined at inception, as prices in the financial markets change, those terms may become favourable or unfavourable.
 - A derivative usually has a notional amount, which can be an amount of currency, a number of shares, a number of units of weight or volume or other units specified in the contract. The changes in value of a derivative are measured corresponding to the notional amount.



Examples of derivatives and underlying

Type of contract		Main variable
Interest rate swap	➔	Interest rate
FX forward	➔	Foreign exchange rate
Commodity option	➔	Commodity price
Credit default swap	➔	Credit risk
Purchased or written stock call or put option	➔	Equity price



Derivative definition Cont'd.

2. No or little initial net investment:

- It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

3. Future settlement:

- It is settled at a future date.
- However, it is not relevant whether the derivative is settled gross or not. For example, an interest rate swap is a derivative instrument, whether the counterparties pay interest to each other or settle it on a net basis.
- Further, an option, say a call option i.e. a right to purchase shares at a fixed price at a certain date in future, may expire unexercised at maturity because it is 'out of money'. Such a contract is still a derivative contract because expiry at maturity is also a form of settlement even though there is no exchange of consideration eventually.



Liability Derivative & Equity Derivative

Financial liability

A financial instrument that fulfils **either** of (A) or (B) below:

(A)

(B) An instrument that will or may be settled in the entity's own equity instruments and is:

(i)

(ii) **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.

Equity

A financial instrument that fulfils both (A) and (B) below:

(A)

(B) An instrument that will or may be settled in the entity's own equity instruments and is:

(i)

(ii) **a derivative** that will or may be settled **only by** the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.



Accounting Treatment of Derivative

- All derivatives are measured at fair value with changes in fair value being recognized in profit or loss for the period, except derivatives that qualify as hedging instruments.
- Accounting for derivatives that qualify as hedging instruments is dealt with in the Hedge Accounting chapter.

Particulars	DR / CR	Amount
Derivative Assets (BS)	Dr	XXXX
To income on account of derivative (PL)	Cr	XXXX
(Derivative assets is recorded in case of MTM gain)		
Expense on account of derivative (PL)	Dr	XXXX
Derivative Liability (BS)	Cr	XXXX
(Derivative liability is recorded in case of MTM loss)		

Case Study



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- The definition of a derivative requires that the instrument “is settled at a future date”. Is this criterion met even if an option is expected not to be exercised, for example, because it is out of the money?
- Comments

Response :

- Yes.
- An option is settled upon exercise or at its maturity. Expiry at maturity is a form of settlement even though there is no additional exchange of consideration.



Case study : Transaction in third currency

- Entity XYZ, whose functional currency is Indian Rupees, sells products in France denominated in Euro. XYZ enters into a contract with an investment bank to convert Euro to Indian Rupees at a fixed exchange rate.
- The contract requires XYZ to remit Euro based on its sales volume in France in exchange for Indian Rupees at a fixed exchange rate of 55.00.
- Is that contract a derivative?

Response :

- Yes.
- The contract has two underlying variables (the foreign exchange rate and the volume of sales);
- No initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and a payment provision.
- Ind—AS 109 does not exclude from its scope derivatives that are based on sales volume.



Case study : Interest rate swap – Fixed rate to variable rate

- Entity A makes a **five-year fixed rate** loan to Entity B, while B at the same time makes a **five-year variable rate** loan for the same amount to A.
- There are no transfers of principal at inception of the two loans, since A and B have a netting agreement.
- Is this a derivative under Ind AS 109?

Response :

- Yes.
- This meets the definition of a derivative as
 - There is an underlying variable,
 - No initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and
 - Future settlement.



Case study : Interest rate swap – Fixed rate to variable rate

- Entity ABC enters into an interest rate swap with a counterparty (XYZ) that requires ABC to pay a fixed rate of 8% and receive a variable amount based on three month LIBOR, reset on a quarterly basis.
- The fixed and variable amounts are determined based on an INR 100 million notional amount. ABC and XYZ do not exchange the notional amount. ABC pays or receives a net cash amount each quarter based on the difference between 8% and three-month LIBOR. Alternatively, settlement may be on a gross basis.
- For the purpose of determining whether an interest rate swap is a derivative financial instrument, does it make a difference whether the parties pay the interest payments to each other (gross settlement) or settle on a net basis?

Response :

- Yes.
- The contract meets the definition of a derivative regardless of whether there is net or gross settlement because its value changes in response to changes in an underlying variable.



Case study : Interest rate swap – Pay Fixed & Receive variable

- Entity S enters into INR 100 million notional amount five-year pay— fixed, receive variable interest rate swap with Counterparty C.
- The interest rate of the variable part of the swap is reset on a quarterly basis to 3-month LIBOR. The interest rate of the fixed part of the swap is 10% per year.
- Entity S prepays its fixed obligation under the swap of INR 50 million (INR 100 million x 10% x 5 years) at inception, discounted using market interest rates, while retaining the right to receive interest payments an INR 100 million reset quarterly based on three-month LIBOR over the life of the swap.
- If a party prepays its obligation under a pay-**fixed**, receive-variable interest rate swap at inception, is the swap a derivative **financial** instrument?



Case study : Interest rate swap – Pay Fixed & Receive variable

Response :

- Yes.
- The initial net investment in the interest rate swap is significantly less than the notional amount on which the variable payments under the variable leg will be calculated. The contract requires an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, such as a variable rate bond.
- Therefore, the contract fulfils the “no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors” criteria of the standard. Even though Entity S has no future performance obligation, the ultimate settlement of the contract is at a future date and the value of the contract changes in response to changes in the LIBOR index. Accordingly, the contract is regarded as a derivative contract.



Case study : Interest rate swap – Pay variable & receive fixed

- Entity S enters into INR 100 million notional amount 5-year pay- variable, receive-fixed interest rate swap with Counterparty C.
- The variable leg of the swap is reset on a quarterly basis to three-month LIBOR. The fixed interest payments under the swap are calculated as 10% times the swap's notional amount, i.e., INR 10 million per year.
- Entity S prepays its obligation under the variable leg of the swap at inception at current market rates, while retaining the right to receive fixed interest payments of 10% an INR 100 million per year. If a party prepays its obligation under a pay-variable, receive-fixed interest rate swap at inception of the contract or subsequently.
- Is the swap a derivative financial instrument?



Case study : Interest rate swap – Pay variable & receive fixed

Response :

- No.
- A prepaid pay—variable, receive—fixed interest rate swap is not a derivative if it is prepaid at inception because it provides a return on the prepaid (invested) amount comparable to the return on a debt instrument with fixed cash flows.
- The prepaid amount fails the “no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors” criterion of a derivative.



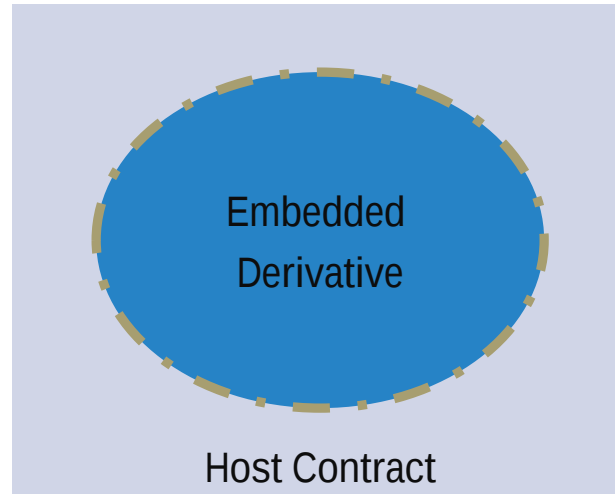
Case study : Prepaid Forward contract

- ABC Ltd enters into a forward contract to purchase 5 million equity shares of PQR in one year.
- The current market price of PQR is INR 50 per share; the one-year forward price of PQR is INR 55 per share. PQR is required to prepay the forward contract at inception with INR 50 million payment.
- The initial investment in the forward contract of INR 50 million is less than the notional amount applied to the underlying, one million shares at the forward price of INR 55 per share, i.e., INR 55 million.
- Is the forward contract a derivative?

Response :

- No.
- The initial net investment approximates the investment that would be required for other types of contracts that would be expected to have a similar response to changes in market factors because XYZ's shares could be purchased at inception for the same price of INR 50.
- Accordingly, the prepaid forward contract does not meet the initial net investment criterion of a derivative instrument.

Hybrid Instrument



Host Contract may be Debt , Equity, Executory Contract, Lease, Insurance

Embedded derivative may be Interest rate index, Commodity Index, Equity index



Embedded derivatives

- “An embedded derivative is:
 - a component of a hybrid contract
 - that also includes a non-derivative host
 - with the effect that some of the cash flows of the combined instrument vary in a way similar
 - to a stand-alone derivative.

- An embedded derivative causes:
 - Some or all of the cash flows that otherwise would be required by the contract
 - to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable,
 - provided in the case of a non-financial variable that the variable is not specific to a party to the contract.



Examples of embedded derivatives

S.No.	Particulars	Host Contract	Embedded Derivative
1	Company A holds a bond which is convertible into the ordinary shares of Company B	Bond Asset	Conversion option of Bond into shares
2	Company A enters into a lease contract with an inflation factor such that each year, rentals are adjusted for changes in Risk Price Index (RPI)	Lease contract	Adjustment to RPI
3	Company A sells PPE to Company B of USD 1 lac. Both the Companies are located in India.	Sale Contract	INR / USD foreign Exchange



Case study : Debt instrument with indexed repayments

- Entity X issues a redeemable fixed interest rate debenture to Entity Y.
- Amount of interest and principal is indexed to the value of equity instruments of Entity X
- Evaluate the instruments ?

Response :

- In the given case, the host is a fixed interest rate debt instrument. The economic characteristics and risks of a debt instrument are not closely related to those of an equity instrument.
- Hence, the exposure of this hybrid instrument to changes in value of equity instruments is an embedded derivative which is required to be separated.
- The response above will not change even if the interest payment and principal repayments are indexed to a commodity index or similar underlying.



Case study : Debt instrument with prepayment option

- Entity PQR borrows 100 crores from ABC Bank on 1 April 20X1.
- Interest is payable at 12% p.a. and there is a bullet repayment of principal at the end of the term.
- Term of the loan is 6 years. The loan includes an option to prepay the loan at 1st April each year with a prepayment penalty of 3%.
- There are no transaction costs.
- Without the prepayment option, the interest rate quoted by bank is 11% p.a.

Analyse

Response :

- Step 1: Identify the host contract and embedded derivative, if any
In the given case,
 - Host is a debt instrument comprising annual interest payment at 12% p.a. and bullet principal repayment at the end of 6 years.
 - Option to prepay the debt at INR 103 crores is an embedded derivative



Case study : Debt instrument with prepayment option (Contd..)

Response :

- Step 2: Determine the amortised cost of the host debt instrument
 - Whether the prepayment option is likely to be exercised or not, the amortised cost of the host debt instrument should be calculated as present value (PV) of expected cash flows using a fair market interest rate for a debt without the prepayment option (11% p.a. in this case). This is calculated below as 104.23 crores:

Year	Particulars	Cash Outflow	PV (11%)	Opening	Payment	Interest (12%)	Amortised value
1	Interest	12	10.81	104.23	12	11.47	103.70
2	Interest	12	9.74	103.70	12	11.41	103.10
3	Interest	12	8.77	103.10	12	11.34	102.44
4	Interest	12	7.90	102.44	12	11.27	101.71
5	Interest	12	7.12	101.71	12	11.19	100.90
6	Principal + Interest	112	59.88	100.90	112	11.10	-0.00
		172	104.23		172	67.77	



Case study : Debt instrument with prepayment option (Contd..)

Response :

- Step 3: Compare the exercise price of the prepayment option with the amortised cost of the host debt

In this case, if the management determines that a difference of more than 2% will indicate that the option's exercise price is not approximately equal to the amortised cost of the host debt instrument, it will need to separate the embedded derivative and account for it

Year	Amortised costs	Exercise price of prepayment option	Difference
1	103.70	103.00	0.7%
2	103.10	103.00	0.1%
3	102.44	103.00	-0.6%
4	101.71	103.00	-1.3%
5	100.90	103.00	-2.1%
6	0	NA	

REGULAR WAY PURCHASE OR SALE OF FINANCIAL ASSETS

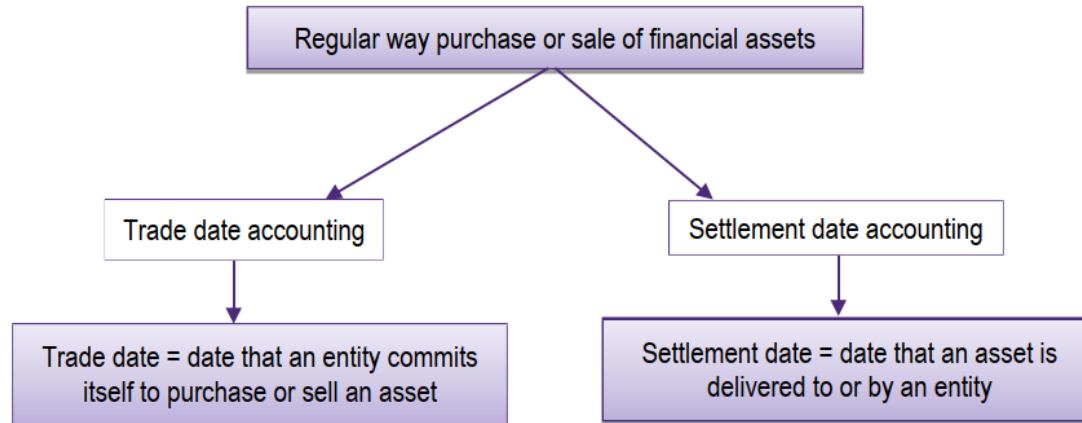
REGULAR WAY PURCHASE OR SALE OF FINANCIAL ASSETS



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Ind AS 109 defines a regular way purchase or sale as,

- 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 marketplace concerned



REGULAR WAY PURCHASE OR SALE OF FINANCIAL ASSETS – Examples



Ind AS Course ICAI

- For instance, on the Bombay Stock Exchange in India, all transactions in all groups of securities in the Equity segment, Fixed Income securities and Government securities are settled on “T+2” basis.
- In this case, “T” is the trade date and “T+2” is the settlement date i.e. exchange of monies and securities between the buyers and sellers respectively takes place on second business day (excluding Saturdays, Sundays, bank and Exchange trading holidays) after the trade date.
- It follows that if a contract is entered into with a broker for purchase or sale of securities which is normally traded on the Bombay Stock Exchange, with a settlement period that differs from the norms mentioned above, it would not be regarded as a regular way purchase or sale.



Trade date & Settlement date Accounting

Books	Trade Date	Settlement Date
In the books of buyer	Initial Recognition : • Recognises : Financial asset and Financial liability on the trade date itself. Subsequent Recognition : • Subsequently measures the financial asset in accordance with its classification category.	• Account for any change in the fair value of the asset to be received during the period between the trade date and the settlement date. • Classification wise accounting : • Amortized costs : change in value is not recognised; • FVTOCI : FV changes to be recognized in OCI . • PVTPL : FV changes to be recognized in PL.
In the books of seller	• Seller derecognises the financial asset. • Recognises any gain or loss on sale on the trade date.	• Derecognises financial asset at the settlement date. • Does not recognise any fair value changes between the trade date and settlement date.



Case Study : Regular way contracts: forward contracts

- PQR Ltd. enters into a forward contract to purchase 10 lakh shares of ABC Ltd. in a month's time for INR 50 per share. This contract is entered into with a broker, Mr. AG and not through regular trading mode in a stock exchange. The contract requires Mr. AG to deliver the shares to PQR Ltd. upon payment of agreed consideration. Shares of ABC Ltd. are traded on a stock exchange.
 - Regular way delivery is two days.
- Assess the forward contract.

Response :

- In this case, the forward contract is not a regular way transaction and hence must be accounted for as a derivative i.e. between the date of entering into the contract to the date of delivery, all fair value changes are recognised in profit or loss.
- On the other hand, if the forward contract is a regular way transaction, such fair value changes are recognised in other comprehensive income if share of ABC Ltd. are equity instruments and not held for trading.



Case Study : Regular way contracts: Option contract

- NKT Ltd. purchases a call option in a public market permitting it to purchase 100 shares of VT Ltd. at any time over the next one month at a price of INR 1,000 per share.
- If NKT Ltd. exercises its option, it has 7 days to settle the transaction according to regulation or convention in the options market. VT Ltd.'s shares are traded in an active public market that requires two-day settlement.

Assess the forward contract.

Response :

- In this case, the options contract is a regular way transaction as the settlement of the option is governed by regulation or convention in the marketplace for options.
- Fair value changes between the trade date and settlement date are recognised in other comprehensive income if share of VT Ltd. are equity instruments and not held for trading by NKT Ltd.



Case Study : Regular way purchase of financial asset

- On 1 January 20X1, X Ltd. enters into a contract to purchase a financial asset for ₹ 10 lakhs, which is its fair value on trade date. On 4 January 20X1 (settlement date), the fair value of the asset is INR 10.5 lakhs. The amounts to be recorded for the financial asset will depend on how it is classified and whether trade date or settlement date accounting is used.
- Pass necessary journal entries.

Response : Trade Date Accounting

Date	Particulars	Dr / Cr	Amortized costs	FVTPL	FVTOCI
1 Jan 2001	Financial asset	Dr	1,000,000	1,000,000	1,000,000
	Financial liability (to pay)	Cr	(1,000,000)	(1,000,000)	(1,000,000)
4 Jan 2001	Financial asset	Dr	-	50,000	50,000
	Profit & Loss	Cr	-	(50,000)	-
	Other Comprehensive income	Cr	-	-	(50,000)
4 Jan 2001	Financial liability (to pay)	Dr	1,000,000	1,000,000	1,000,000
	Bank	Cr	(1,000,000)	(1,000,000)	(1,000,000)

Case Study : Regular way purchase of financial asset (Cont'd.)



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Settlement Date Accounting

Date	Particulars	Dr / Cr	Amortized costs	FVTPL	FVTOCI
1 Jan 2001	No Entry				
4 Jan 2001	Financial asset	Dr	-	50,000	50,000
	Profit & Loss	Cr	-	(50,000)	-
	Other Comprehensive income	Cr	-	-	(50,000)
4 Jan 2001	Financial liability (to pay)	Dr	1,000,000	1,000,000	1,000,000
	Bank	Cr	(1,000,000)	(1,000,000)	(1,000,000)

Hedge Accounting

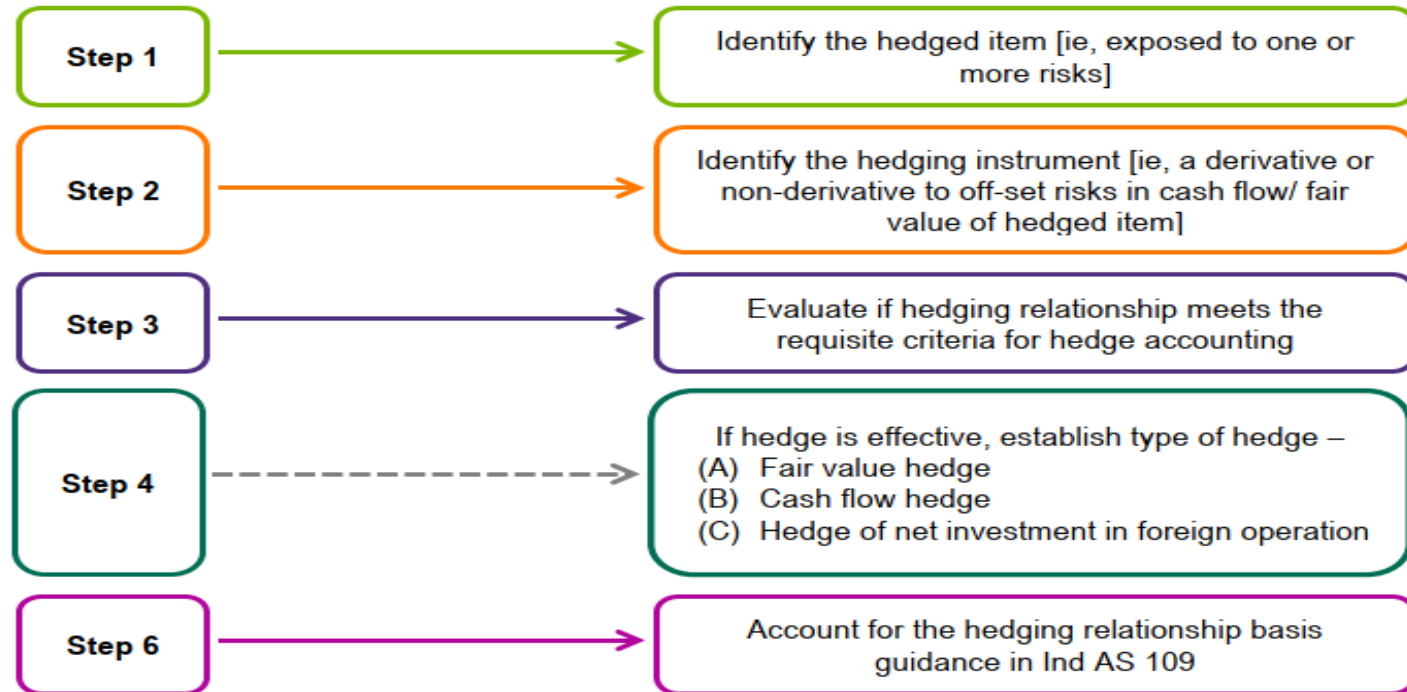
- In simple terms 'hedge accounting' is a **voluntary accounting** route that modifies the normal basis for recognising gains and losses (or revenues and expenses) on associated hedging instruments and hedged items so that both are recognised in earnings in the same accounting period.
- Hedge accounting thus allows entities the opportunity **to eliminate or reduce the P&L volatility** that otherwise would arise if the hedged items and hedging instruments were accounted for separately.
- Hedge accounting is considered **a privilege and not a right since it requires several conditions to be met including extensive documentation**



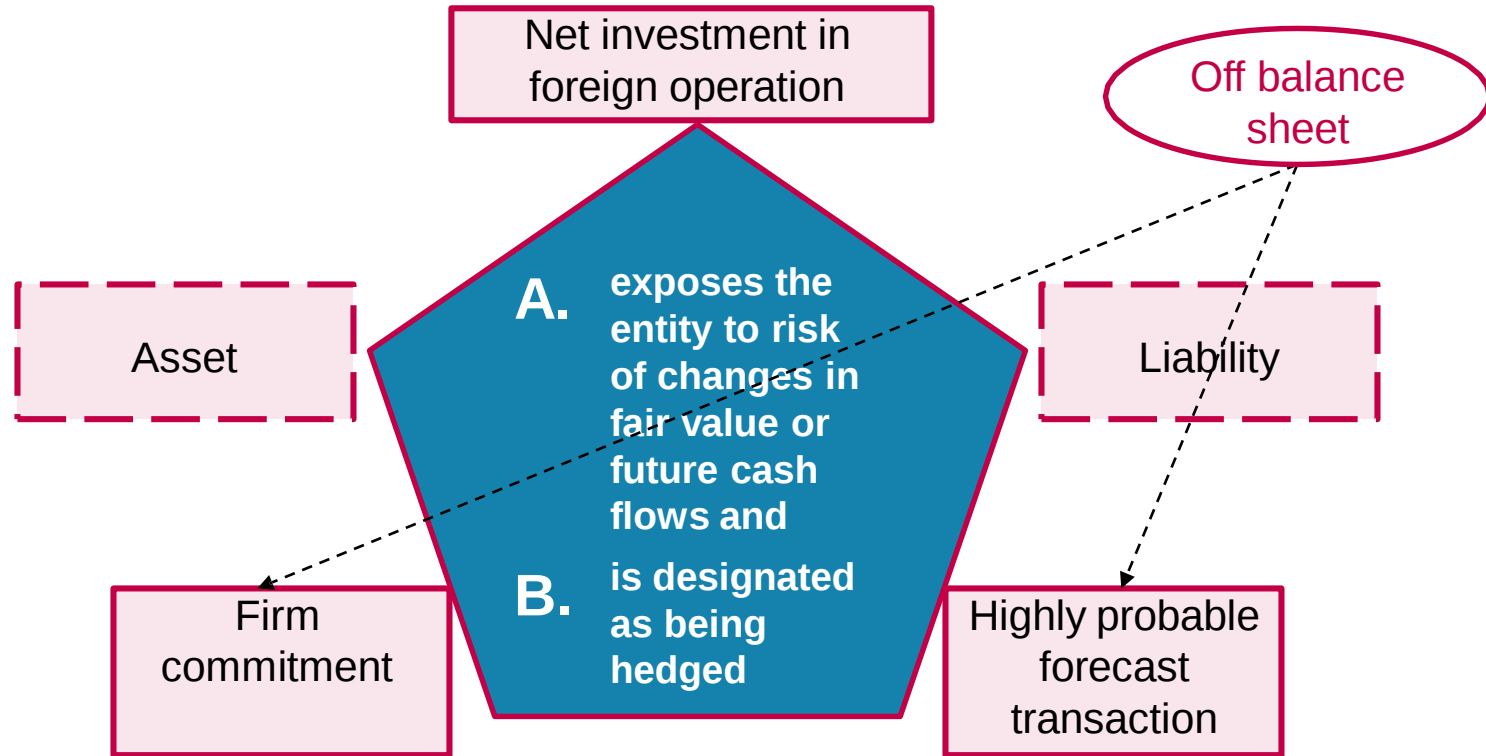
Resolves accounting mismatch in profit or loss

Approach for Hedge Accounting

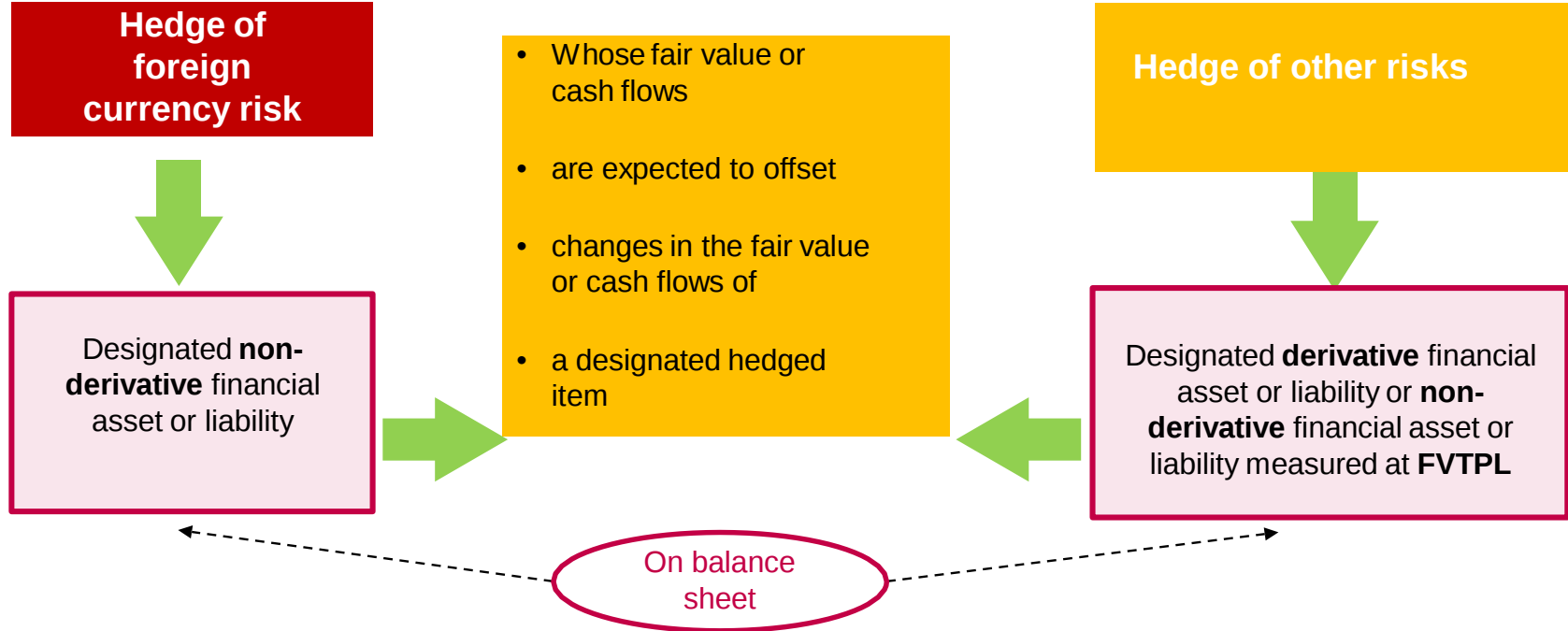
A step wise analysis has been presented using the following diagrammatic presentation –



Hedged Item



Hedged instruments



Main types of hedging relationships

Fair value Hedge

- Hedge of exposure to changes in fair value of:
 - a recognised asset or liability;
 - an unrecognised firm commitmentthat is attributable to a particular risk and could affect profit or loss or OCI.

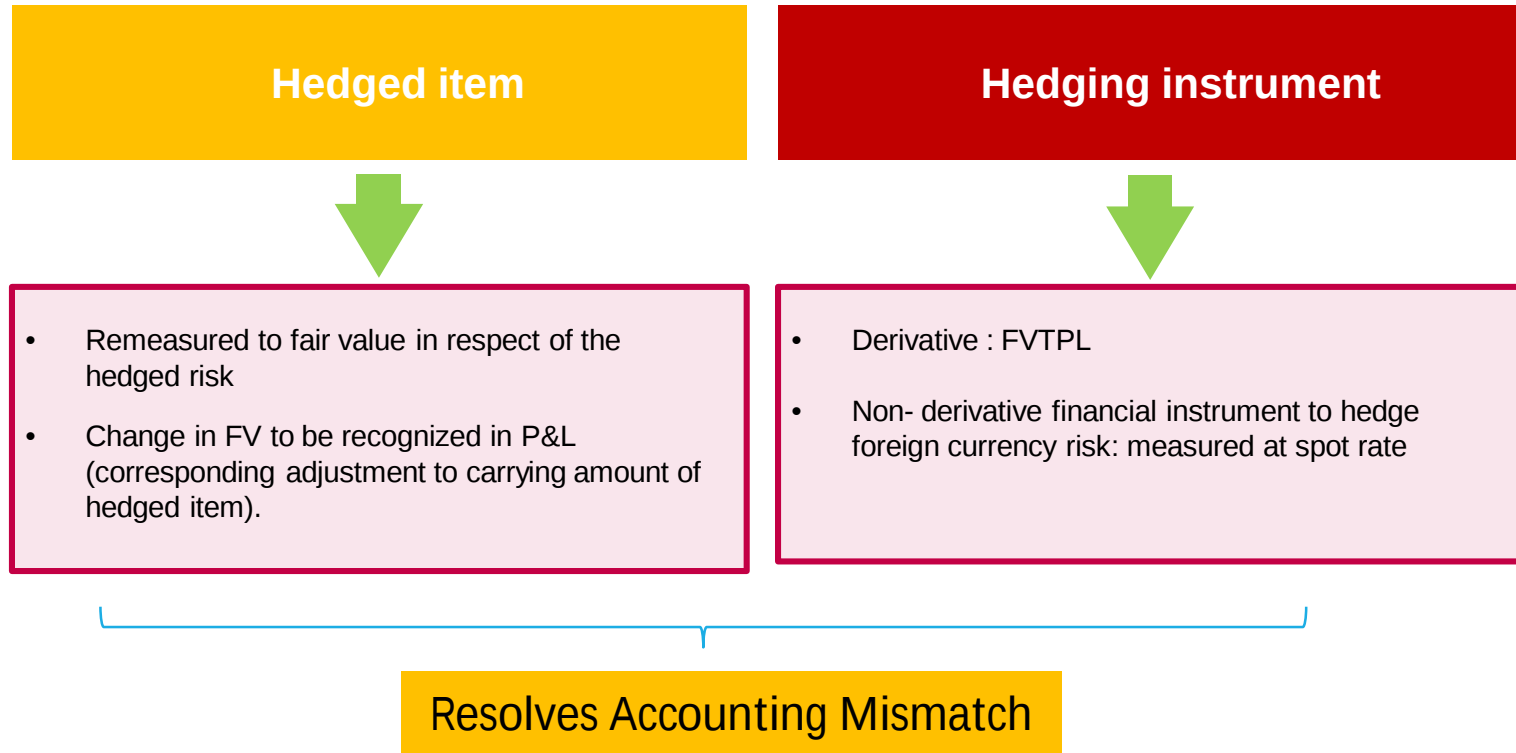
Cash Flow Hedge

- Hedge of exposure to changes in cash flows that is attributable to a particular risk associated with:
 - Recognised asset or liability
 - Highly probable forecast transaction
 - Unrecognised firm commitment (forex risk only) and could affect profit or loss.

Net Investment Hedge

- Hedge of a net investment in a foreign operation (including a hedge of a monetary item that is accounted for as part of the net investment), as defined in Ind AS 21 - 'The effect of changes in foreign exchange rates' is accounted for similar to a cash flow hedge.

Fair Value Hedge



FV Hedge – Example 1



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Particulars	Scenario
▪ Fluctuation in raw material prices hedged with a future contract	▶ ABC wants to limit the effect of fluctuation in raw material prices in its financial statements on account of anticipated fall in prices of timber ▶ ABC owns 5,000 tonnes of timber purchased for \$50,000 3 months before. Company expects price of timber to fall which would have effect on selling price of finished goods produced using timber. X enters into futures contract to sell timber at agreed price of \$60,000 on 31 March. ▶ Hedged Item : 5,000 tonnes of timber. ▶ Hedged instrument : Futures contract to sell timber ▶ Nature of Hedge : Fair value Hedge <u>Hedge Accounting :</u> ▶ Hedged Item : To be Fair valued and change in FV shall be routed through PL. ▶ Hedged instrument : FVTPL



FV Hedge – Example 2

Case Study :

- ABC Ltd. owns inventories of 5,000 tonnes of timber which it purchased three months ago for \$50,000. Management is concerned that the price of timber might fall, which would have an effect on the selling price of the products that will use the timber. It has therefore entered into a futures contract to sell the timber at an agreed price of \$60,000 on 31 March 2016.
- At 31 December 2015, ABC Ltd. year end, the fair value of the timber has fallen to \$48,000 and the futures price for delivery on 31 March 2016 is now \$58,000. Management has designated the timber as a hedged item and the futures contract as the hedging instrument and the hedge is deemed to be effective.
- What will be the accounting impact if
- (a) Hedge accounting is not adopted.
- (b) Hedge accounting is adopted.



FV Hedge – Example 2 Contd..

Response :

(a) If hedge accounting is not used

The futures contract will be recognised as a derivative asset at a value of \$2,000 (60,000 - 58,000) and the inventory will still be measured at cost of \$50,000. The accounting entries would be:

Particulars	Dr./Cr	Amount (\$)
Derivative asset	Dr.	2,000
Profit or loss	Cr.	2,000

The gain on the futures contract is recognised immediately in profit or loss but no loss would be recognised on the value of inventory, causing a mis-match.



FV Hedge – Example 2 Contd..

Response :

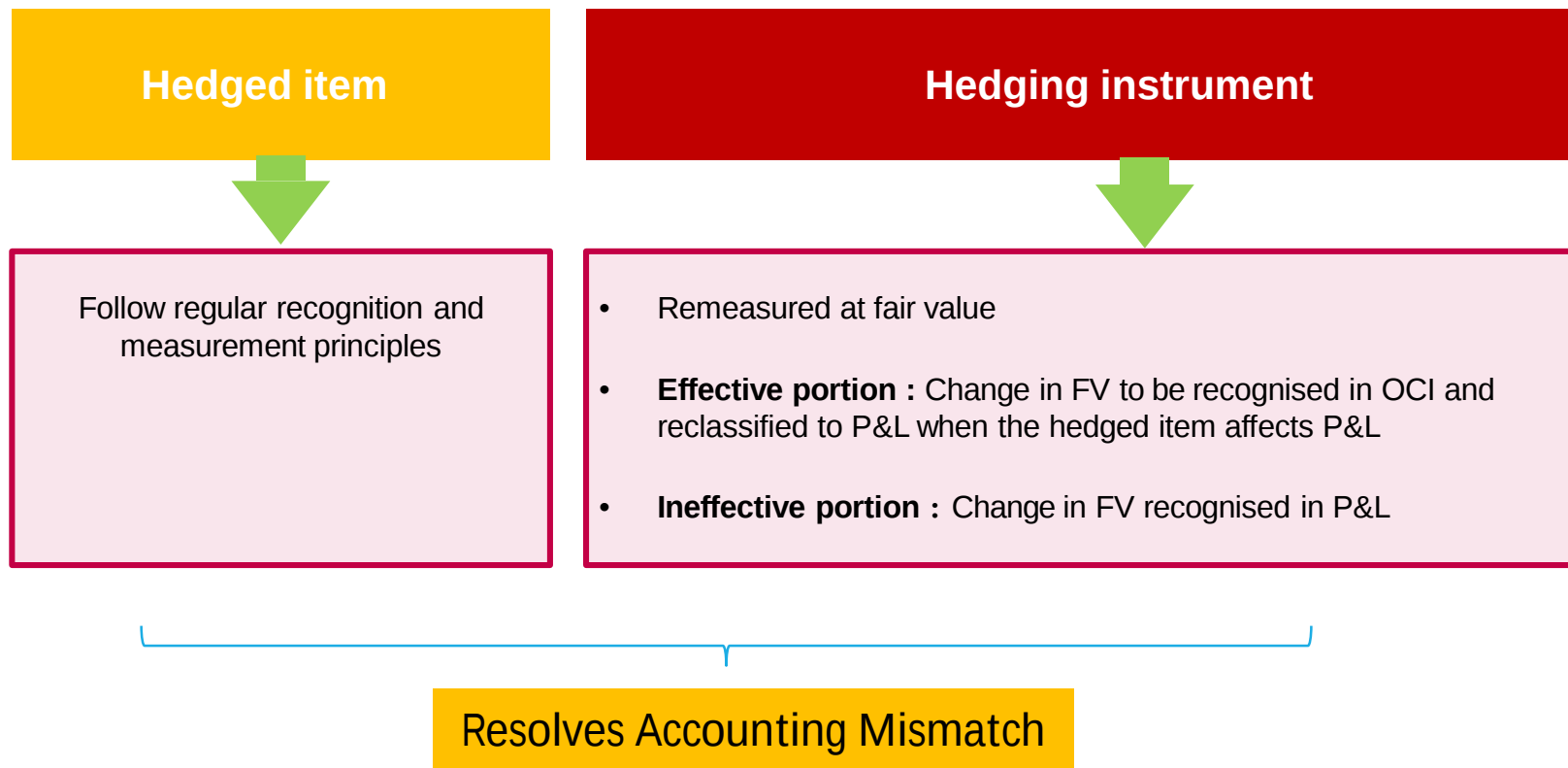
(b) If hedge accounting is used

The futures contract will still be recognised as a derivative asset of \$2,000 but the value of inventory will now be measured at fair value of \$48,000, so matching the gain and loss in the profit or loss in the same period. The accounting entries would be:

Particulars	Dr./Cr	Amount (\$)
Derivative asset	Dr.	2,000
Profit or loss	Cr.	2,000
Profit or loss	Dr.	2,000
Inventory	Cr.	2,000

This time both the gain and the loss affect profit or loss in the same period; hedge accounting has facilitated matching the upside with the downside.

Cash Flow Hedge



Cash Flow Hedge – Example 1



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Particulars	Scenario
▪ Anticipated foreign currency sales hedged with a forward contract ▪ (Highly probable forecasted)	▶ ABC Ltd. wants to limit the effect of currency fluctuations in its financial statements, by hedging highly probable forecasted USD dominated sales. ▶ ABC Ltd. expects to sell the goods in USD denominated and receive payment on 30 June 2018. Therefore, on 1 January 2018, it enters into a 6 month forward contract to sell USD and receive equivalent INR on 30 June 2018. ▶ Hedged Item : Highly probable forecasted USD dominated sales. ▶ Hedged instrument : Forward contract ▶ Nature of Hedge : Cash Flow Hedge <u>Hedge Accounting :</u> ▶ Hedged Item : To be recognized when the transaction occurs ▶ Hedged instrument : FVTOCI (if hedge is effective)

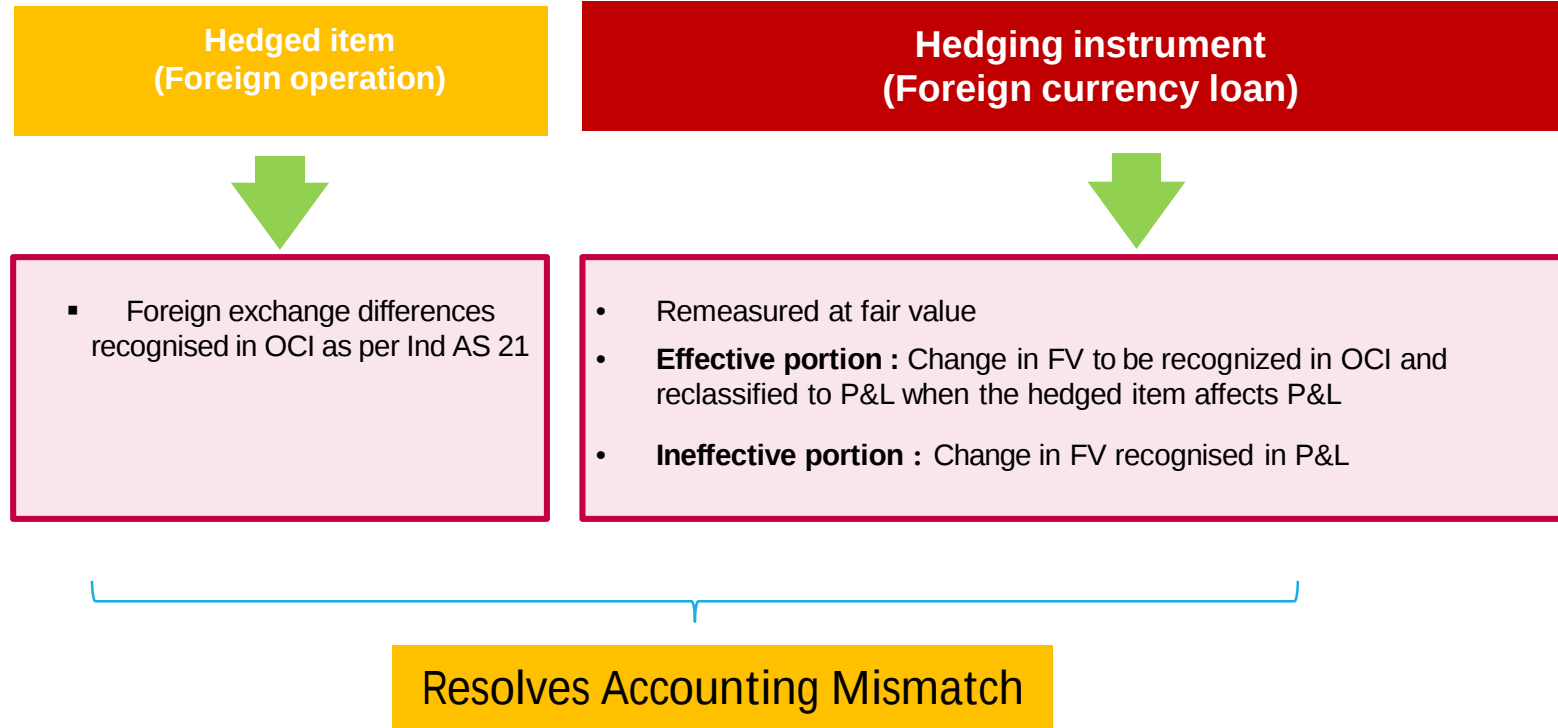
Cash Flow Hedge – Example 2



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Particulars	Scenario
▪ Anticipated foreign currency sales and future receivables hedged with a forward contract ▪ (Highly probable forecasted)	▶ XYZ Ltd. wants to limit the effect of currency fluctuations in its financial statements, by hedging highly probable forecasted USD dominated sales and resulting receivables. ▶ XYZ Ltd. expects to sell goods in USD denominated on 30 June 2018 which will be realized on 31 October 2018. To hedge the foreign currency risk of anticipated sales, it enters a forward contract on 1 January 2018 to sell USD and receive equivalent INR on 31 October 2018. ▶ Hedged Item : Highly probable forecasted USD dominated sales and receivables ▶ Hedged instrument : Forward contract ▶ Nature of Hedge : Cash Flow Hedge <u>Hedge Accounting :</u> ▶ Hedged Item : To be recognized when the transaction occurs ▶ Hedged instrument : FVTOCI (if hedge is effective)

Net Investment Hedge





What is hedge effectiveness?

- **Hedge effectiveness** is the extent to which changes in the fair value or the cash flows of the hedging instrument offset changes in the fair value or the cash flows of the hedged item
- In contrast, **hedge ineffectiveness** is the extent to which the changes in the fair value or the cash flows of the hedging instrument are greater or less than those on the hedged item.



Hedge effectiveness assessment: overview

Hedge effectiveness test

1. Economic relationship

- ▶ Between hedged item and hedging instrument
- ▶ Systematic change (opposite direction) in response to same or economically related underlying.

2. Credit risk does not dominate

- ▶ Credit risk does not frustrate economic relationship
- ▶ Credit risk can arise from hedging instrument and hedged item

3. Hedge ratio

- ▶ Consistent with actual ratio used by entity
- ▶ Different ratio only if accounting outcome would be inconsistent with purpose of hedge accounting



Key pointers to be considered in hedge documentation

- Risk management strategy
- Risk management objective and nature of risk being hedged
- Date of designation
- Hedging period
- Hedging instrument
- Hedged item
- Hedge ratio
- How hedge effectiveness will be assessed
- How hedge effectiveness will be Measured

Thank you