FINANCIAL INSTRUMENT IND AS 32, IND AS 107 , IND AS109

CA HAJELA

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- Under Ind AS, three Standards deal with accounting for financial instruments.

- **Ind AS 32 *Financial Instruments: Presentation*** deals with the presentation and classification of financial instruments as financial liabilities or equity and sets out the requirements regarding offset of financial assets and financial liabilities in the balance sheet.
- **Ind AS 107 *Financial Instruments: Disclosures*** sets out the disclosures required in respect of financial instruments.
- **Ind AS 109 *Financial Instruments*** contains guidance on the recognition, derecognition, classification and measurement of financial instruments, including impairment and hedge accounting.

WHAT IS?

- **<u>Financial Instrument</u> -** A contract that gives rise to Financial Asset of one entity and Financial liability or equity of other entity.

- **<u>Derivative</u>** A Contract with all the three characteristics:-
  - Value changes in response to "underlying"
  - Requires no or minimum initial investment
  - Settled on future date

  - **<u>Equity</u>-** An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

FINANCIAL ASSETS-

– CASH
– Equity instruments of other entity. (Equity shares.)
– Contractual right
    - to receive financial asset from another entity. (Preference share & Loan)
    - To exchange financial assets or financial liabilities with other entities that are potentially favourable to the entity (options)
- a contract that will or may be settled in the entity’s own equity instruments
    - a non-derivative for which the entity is or may be obliged to receive a variable (non fixed) number of entity’s own equity instruments
    - 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

CASE STUDY- NON DERIVATIVE

- P Ltd. holds some equity shares of A Ltd.
- A Ltd. enters into a contract with P Ltd. to sell chemicals for Rs.50 lakhs on 1st June 2020
- A Ltd. agreed to receive its own shares from P Ltd. towards the sale
- A Ltd. share price will be based on the NSE closing rate as on 31st August 2020.
- Whether the contract will result in a financial asset?

CASE STUDY- DERIVATIVE

- P Ltd. holds 5,000 equity shares of A Ltd.
- A Ltd. enters into a contract with P Ltd. to sell chemicals (delivery on 1st Sep 2020) on 1st June 2020 and to buyback its 5,000 shares on 1st Sep 2020
- The settlement of the contract will be based on the Share price of A. Ltd. closing rate as on 31st August 2020.
- Whether the contract will result in a financial asset?

FINANCIAL LIABILITIES-

– Contractual right
  - to deliver cash or financial asset to another entity. (Loan payable.)
  - To exchange financial assets or financial liabilities with other entities that are potentially unfavourable to the entity (options)

- a contract that will or may be settled in the entity's own equity instruments
  - a non-derivative for which the entity is or may be obliged to deliver a variable (non fixed) number of entity's own equity instruments
  - 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

- It should be noted that the equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of the entity's own equity instruments is an equity instrument if the exercise price is fixed in any currency.
- This is a deviation from IAS 32 *Financial Instruments: Presentation* where a conversion option to acquire a fixed number of equity shares for a fixed amount of cash in entity's functional currency only is treated as equity.
- Thus, a conversion option embedded in foreign currency convertible bonds is treated as embedded derivative which is not the case under Ind AS 32

CARVE OUT

FOREIGN CURRENCY CONVERTIBLE BONDS - FCCB

- Infosys India Limited issues 10% Convertible debentures (Foreign Currency Convertible Bonds - FCCB) in USA denominated in $ 500. Further, each debenture is to be converted into 2 equity instruments after 3 year period.

  However, since the value of $ changes continuously w.r. t INR, management of Infosys treats this as derivative and classifies the convertible debentures as Financial Liability (Derivative).

  Is the management contention to classify FCCB as Financial Liability correct as per Ind AS 109 ?

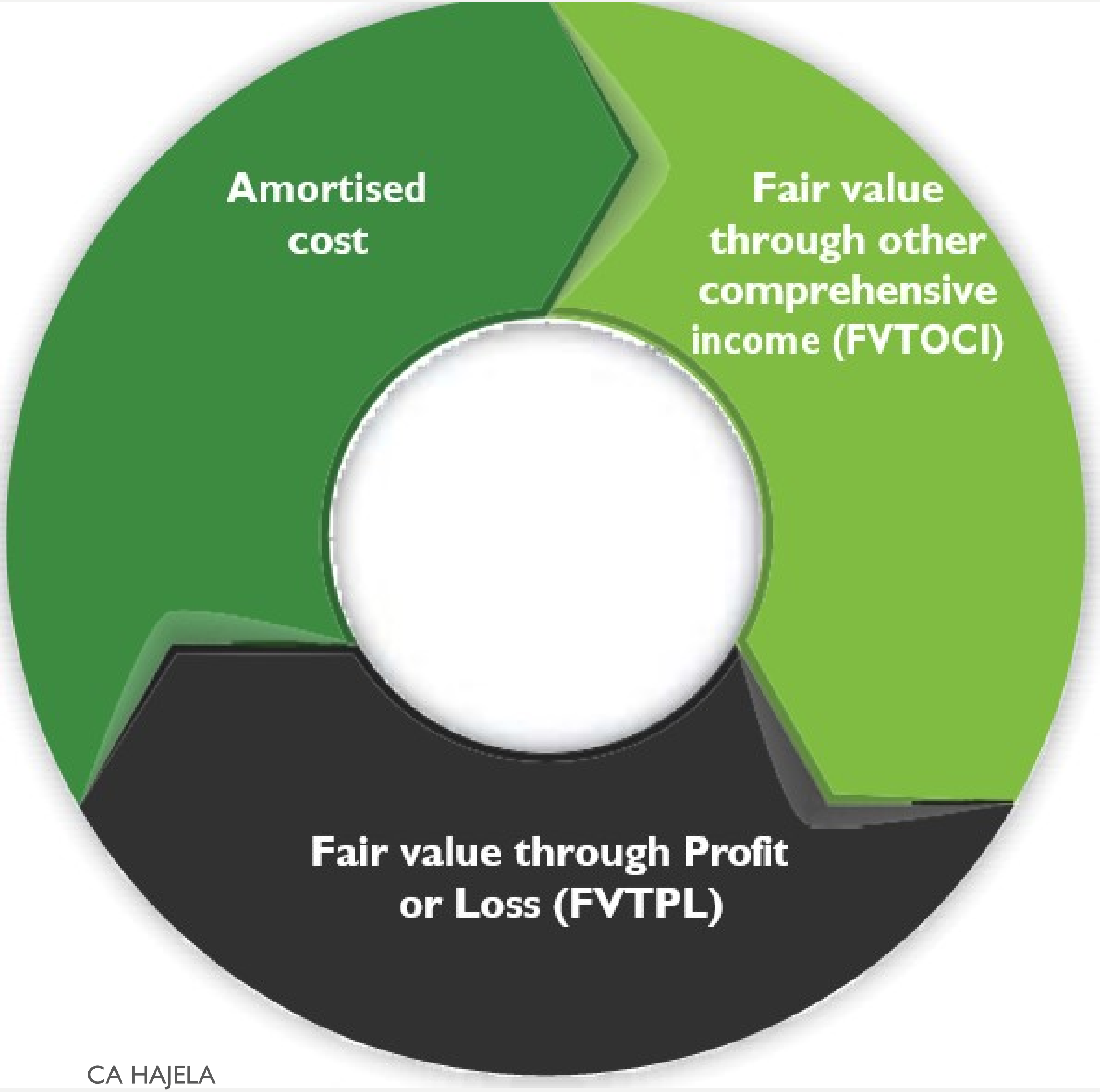
COMPOUND FINANCIAL INSTRUMENTS

- Compound instruments that have both liability and equity characteristics are split into these components.
- The split is made on initial recognition of the instruments and is not subsequently revised.
- The equity component of the compound instrument is the residual amount after deducting the fair value of the liability component from the fair value of the instrument as a whole.
- No gain / loss arises from initial recognition

FINANCIAL INSTRUMENTS

IND AS 109- RECOGNITION

- The financial instruments , on the basis of there characteristics , can be accounted through either of the three options viz :-
  - Amortised Cost.
  - Fair Value through Profit and Loss
  - Fair Value through other comprehensive income.



CLASSIFICATION OF FINANCIAL ASSETS

- An entity shall classify financial assets as subsequently measured at:

- Amortised cost or
- Fair value through profit or loss (FVTPL)
- Fair value through other comprehensive income (FVTOCI)

BUSINESS MODEL TEST

(a) The asset is held within a **business model** whose objective is to hold assets in order to collect contractual cash flows (Solely *principal amount* and *interest*).

(b) The **contractual terms of the financial asset** give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. Interest is compensation for *time value of money* and *credit risk*.

MEASUREMENT OF FINANCIAL ASSETS

1) **At Amortised cost:**
   - **Initial measurement**: Fair value (Cash paid) + Transaction cost
   - **Subsequent measurement**: At amortised cost using effective interest rate method

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1) **At FVTOCI:**
   - **Initial measurement**: Fair value (Cash paid) + Transaction cost
   - **Subsequent measurement**: At fair value and gain/loss will be charged to OCI

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1) **At FVTPL:**
   - **Initial measurement**: Fair value (Cash paid)
     Transaction cost is charged to P&L
   - **Subsequent measurement**: At fair value and gain/loss will be charged to P&L

CLASSIFICATION OF FINANCIAL LIABILITIES

1) **At Amortised cost:**
   - **Initial measurement**: Fair value (Cash received) - Issue cost
   - **Subsequent measurement**: At amortised cost using effective interest rate method

1) **At FVTPL:**
   - **Initial measurement**: Fair value (Cash received)
     Transaction cost is charged to P&L
   - **Subsequent measurement**:
     - Fair value will be calculated by PV(FCF) by using current market interest rate
     - Any Gain or loss will be charged to P&L

FINANCIAL Instruments

FINANCIAL Asset

Debt (For issuer)

- Amortised Cost → 1 (Business Model)
- FVTOCI → 1 & 2 (Business Model)
- FVTPL → Remaining items (Derivatives)

Equity (for issuer)

- 1st Priority → F.V.T.P.L
- F.V.T.O.C.I →
  - ↳ If not held for trading
  - ↳ irrevocable decision.

Financial Liability

- 1st Priority Amortised Cost
- F.V.T.P.L
  - ↳ held for Trading
  - ↳ Matching Principle

Business Model → 1 To hold the instruments for Contractual outflow till Maturity.
→ 2 → To realise Fair Value Gain by selling.

Transaction Cost (during Initial Recog) → If recog. at F.V.T.P.L → Profit & Loss Account
→ Else → Add (Financial Asset), Less (Financial Liability).

ISSUE AND FINANCE COSTS

- Interest, dividends, loss or gains relating to a financial instrument claimed as a liability are reported in the statement of profit or loss while distributions to holders of equity instruments are debited directly to equity (in the SOCIE)
- Examples are: Issue cost of ordinary shares are deducted from share premium or retained earnings, ordinary dividends are deducted from retained earnings, issue cost of equity option is deducted from the value of equity option

IMPAIRMENT -EXPECTED CREDIT LOSS

- **The impairment requirements are applied to:**

☐ Financial assets measured at amortised cost (incl. trade receivables)

☐ Financial assets measured at fair value through OCI

☐ Loan commitments and financial guarantees contracts where losses are currently accounted for under IND AS 37 Provisions, Contingent Liabilities and Contingent Assets

☐ Lease receivables.

The impairment model follows a three-stage approach based on changes in expected credit losses of a financial instrument that determine

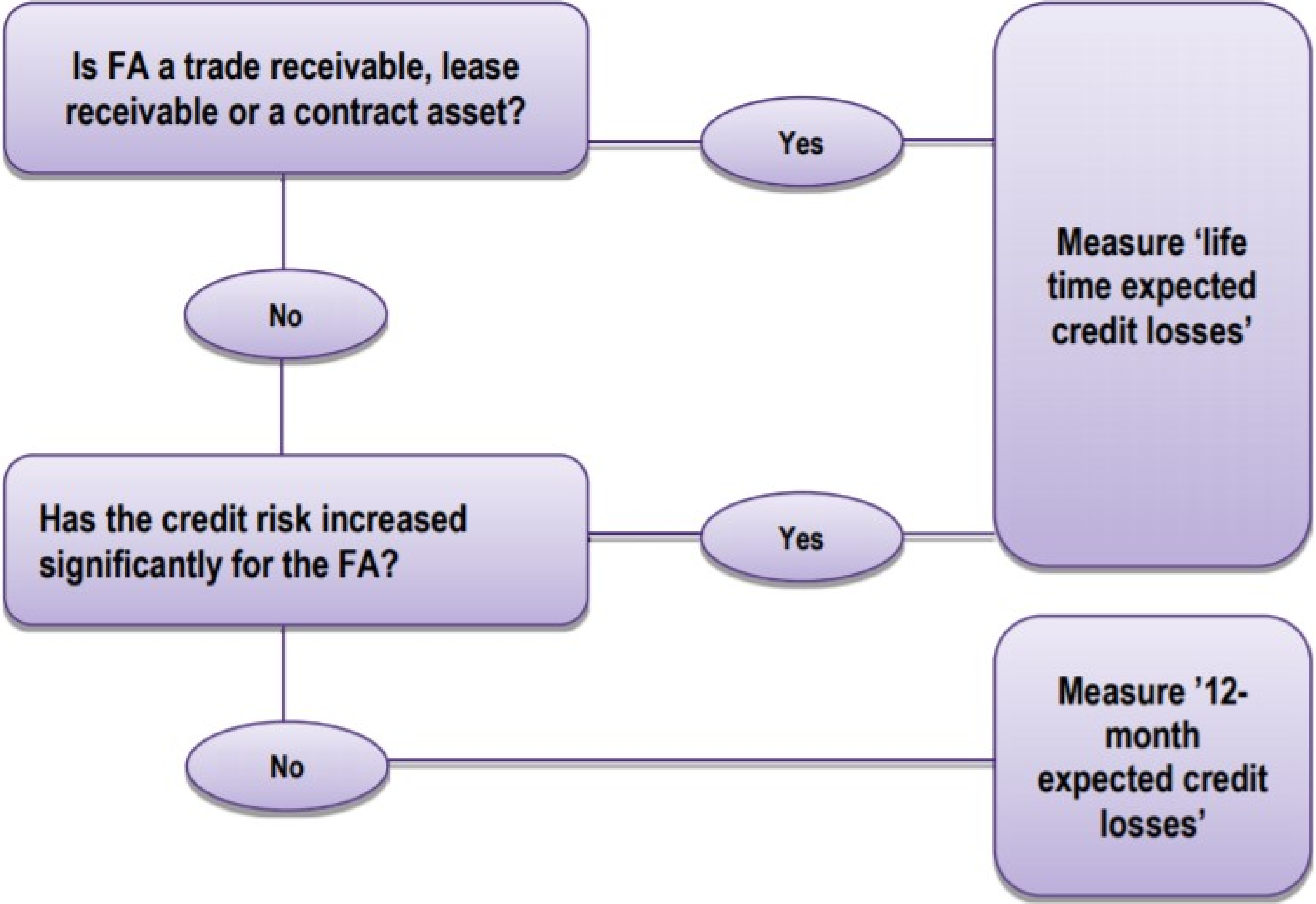
☐ the recognition of impairment, and

☐ the recognition of interest revenue

EXPECTED CREDIT LOSS.

Expected Credit Losses = Present Value of all **Cash Shortfalls**

Cash Shortfall = Contractual cash flows due to the entity − Cash flows the entity expects to receive


Is FA a trade receivable, lease receivable or a contract asset?
Yes
No
Measure 'life time expected credit losses'
Has the credit risk increased significantly for the FA?
Yes
No
Measure '12-month expected credit losses'

STAGE 1

12 month expected credit losses (gross interest)

- Applicable when **no significant increase in credit risk**
- Entities continue to recognise 12 month expected losses that are updated at each reporting date
- Presentation of interest on gross basis

STAGE 2

Lifetime expected credit losses (gross interest)

- Applicable in case of **significant increase in credit risk**
- Recognition of lifetime expected losses
- Presentation of interest on gross basis

STAGE 3

Lifetime expected credit losses (net interest)

- Applicable in case of **credit impairment**
- Recognition of lifetime expected losses
- Presentation of interest on a net basis

Reach out to me at:-
Facebook page- CA Hajela.
Email – CAHAJELA@GMAIL.COM
LinkedIn – CA Shalabh Hajela
Youtube – CA HAJELA