

10th Capacity Building Seminar on Retirement Benefits (10th CBRB)
The PIlazio Hotel, Gurugram
8th March 2024, Friday

Overview of requirements under Ind AS 109 – Audit Perspective

Mr Lakshay Gupta

Associate Director , Deloitte , Audit & Assurance
– Accounting Advisory practice



Contents

Overview of financial instruments – Financial assets and liabilities	3-7
Financial Liability vs Equity classification	8-10
Recognition and measurement	11
Financial Assets – Classification and measurement	12-17
Financial Liabilities – Classification and measurement	18-19
Equity instruments – classification & measurement	20
Effective interest rate (EIR)	21

Financial Instruments - Context and Objective

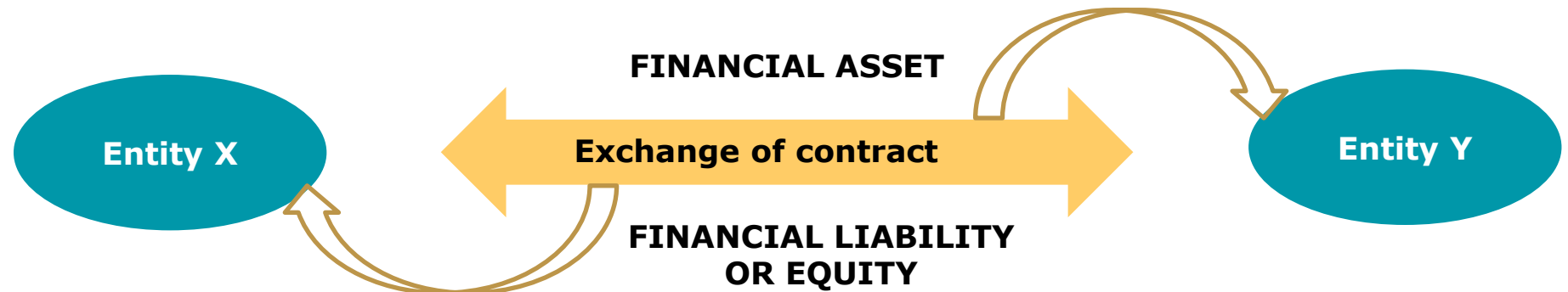


Under the Ind AS framework, detailed guidance on recognition classification measurement presentation and disclosure of financial instruments is available in three Ind AS collectively known referred to as the “Financial Instruments standards”

- **Ind AS 32: Financial Instruments: Presentation-** The objective of this standard is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities
- **Ind AS 109: Financial Instruments -** Objective of this standard is to establish principles for the financial reporting of financial assets and financial liabilities that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of the entity’s future cash flows.
- **Ind AS 107: Financial Instruments: Disclosures-** The objective of this standard is to require entities to provide disclosures in their financial statements that enable users to evaluate:
(a) the significance of financial instruments for the entity’s financial position and performance; and
(b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.

Definition

- A financial instrument is any **contract** that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.



Definition

A financial asset is any asset that is:

- (a) **cash**;
- (b) an equity instrument of another entity;
- (c) a contractual right:
 - (i) to receive **cash or another financial asset** from another entity; or
 - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity; or
- (d) a contract that will or may be settled in the entity's own equity instruments and is:
 - (i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
 - (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. For this purpose, the entity's own equity instruments do not include certain puttable and similar financial instruments classified by exception as equity instruments or instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

Represents the medium of exchange and is Therefore, the basis on which all transactions are measured and recognised in financial statements

Following are the few common financial instruments-
 (a) trade accounts receivable and payable;
 (b) notes receivable and payable;
 (c) loans receivable and payable; and
 (d) bonds receivable and payable.

Financial instruments also include derivatives such as financial options, futures and forwards, interest rate swaps and currency swaps. Derivatives normally transfer one or more of the financial risks inherent in an underlying primary instrument between the contracting parties without any need to transfer the underlying instruments themselves (either at inception of the contract or even, where cash settled, on termination).

For example, a note payable in government bonds gives the holder the contractual right to receive, and the issuer the contractual obligation to deliver, government bonds, not cash.

Definition

An equity instrument is any contract that evidences a residual interest in the assets of an Entity after deducting all of its liabilities.

An instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met:

- a) The instrument includes 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 unfavorable to the issuer.
- b) the instrument will or may be settled in the issuer's own fixed number of equity instruments.

EXAMPLES:

Equity Instruments Issued

Warrants to issue fixed number of shares at fixed price

Other instruments convertible into fixed number of equity shares

Definition

A financial liability is any liability that is:

(a) a contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

(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. For this purpose the entity's own equity instruments do not include certain puttable and similar financial instruments classified by exception as equity instruments, or instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments

EXAMPLES:

Loans and borrowings

Payables for purchase of goods & services

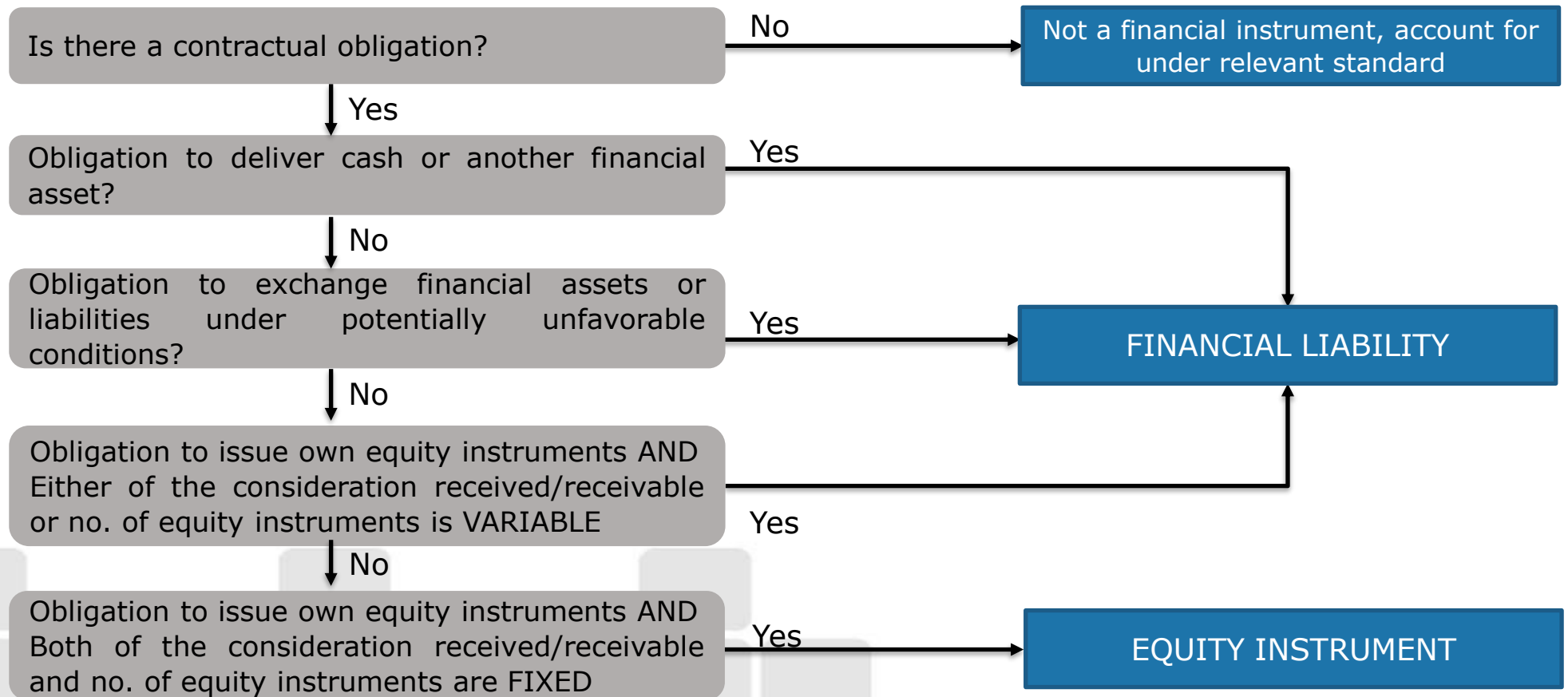
Finance Lease obligations

Redeemable instruments like preference shares with or without cumulative dividends

Debentures

Financial Liability vs Equity

Ind AS 32 establishes principles for distinguishing between liabilities and equity. The substance of the contractual terms of a financial instrument governs its classification, rather than its legal form.

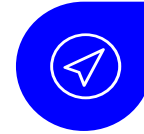


Compound Instruments - Split accounting

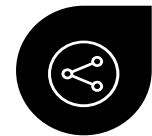
Not all instruments are either debt or equity. Some, known as compound instruments, **contain elements of both in a single contract.** These instruments, such as bonds that are convertible into equity shares either mandatorily** or at the option of the holder, are **split into liability and equity components.**



Entity first determines the fair value of the liability component (assuming there is no embedded derivative) by computing the present value of the contractually determined stream of future cash flows



These cash flows are discounted at the rate of interest applied at that time by the market to instruments of comparable credit status and providing substantially the same cash flows on the same terms but without the equity component (such as a conversion option in case of CCDs)



The residual amount is assigned to equity.

*Transaction costs are allocated between the liability and equity component on a *pro rata* basis

** i.e. For e.g.- mandatorily convertible preference shares with dividend or mandatorily redeemable bonds with interest

Compound Instruments - Split accounting

Example: An entity, whose functional currency is the Euro, issues 2,000 convertible bonds. The bonds have a three-year term and are issued at par with a face value of €1,000 per bond, giving total proceeds of €2,000,000. Interest is payable annually in arrears at a nominal annual interest rate of 6% (i.e., €120,000 per annum). Each bond is convertible at any time up to maturity into 250 ordinary shares. When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is 9% per annum.

The economic components of this instrument are:

- A liability component- a discounted fixed rate debt.
- An equity component- representing the holder's right to convert at any time before maturity.

Using Split accounting, The net present value (NPV) of the liability component is calculated as €1,848,122, using a discount rate of 9%, being the market interest rate for similar bonds having no conversion rights, as shown below.

Year	Cash Flow	€	Discount factor (at 9%)	NPV of cash flows €
1	Interest	120,000	1/1.09	110,992
2	Interest	120,000	1/1.09 ²	101,001
3	Interest and Principal	2,120,000	1/1.09 ³	1,637,029
	Total liability component			1,848,122
	Total equity component (balance)			151,878
	Total proceeds			2,000,000

Initial Recognition

An entity shall recognize a financial asset or a financial liability in **its statement of financial position** when the **entity becomes party to the contractual provisions** of the instrument.

Financial instruments are generally recognized **at fair value at inception**.

Transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability are added and reduced respectively, **unless the financial asset or financial liability is measured at fair value through profit or loss**.

Examples for applying the above principle

Nature of Contract	When to Recognize?
Unconditional Receivables and Payables	When the entity becomes party to the contract and has a legal right to receive or a legal obligation to pay cash
Firm commitment to purchase or sell goods or services	When at least one of the parties has performed under the agreement example when the services have been rendered
Forward contract	On the commitment date if the net fair value of right and obligation is not zero
Planned future transactions	Never

Fair value definition

"...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.

Classification of Financial Assets

Contractual Cash Flow

Characteristics

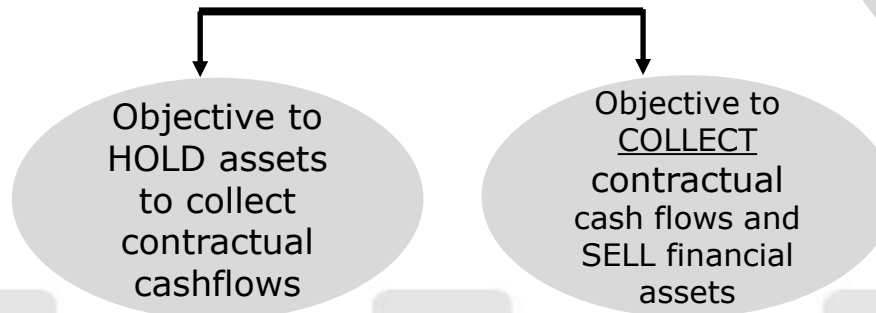
Whether the assets contractual cashflows are **solely payments of principal and interest** on the principal amount outstanding for the currency in which financial asset is denominated.





Key Elements

Business model test

An entity's business model refers to how an entity manages its financial assets in order to generate cash flows.



Business model test

<p>Example 1 (Trade receivables) - Facts</p>	<ul style="list-style-type: none"> • Entity B sells goods to customers on credit. • Entity B typically offers customers up to 60 days following the delivery of goods to make payment in full. • Entity B collects the cash in accordance with the contractual cash flows of the trade receivables and has no intention to dispose of the receivables.
<p>Analysis of business model</p>	<p>Entity B's objective is to collect the  contractual cash flows from the trade receivables</p>
<p>Example 2 (Sale of financial asset close to its maturity) - Facts</p>	<ul style="list-style-type: none"> • Entity XYZ has invested in debentures, with a maturity of 5 years. • In practice, investments are sometimes sold a few weeks/months prior to maturity, and proceeds from sales approximates remaining contractual cash flows.
<p>Analysis of business model</p>	<p>Sales close to maturity are consistent with the objective of holding to collect contractual cash flows. </p> <p>**Close' and 'approximate' may be a matter of judgement specific to each entity**</p>

Business model test

<p>Example 3 (Unexpected sales) - Facts</p>	<ul style="list-style-type: none">• Entity F holds a portfolio of debt instruments with the objective of collecting the contractual cash flows from those instruments.• Entity F measures the debt instruments at amortised cost.• Entity F sells some of the debt instruments prior to their maturity to fund the settlement of a legal claim which was not previously expected to be settled.
<p>Analysis of business model</p>	<p>The sales were unexpected and [?]are not customary. The unforeseen sale of the debt instruments would not change the assessment of the business model.</p> <p>Entity F can continue to assert that its business model is to collect the contractual cash flows for its remaining debt instruments.</p>

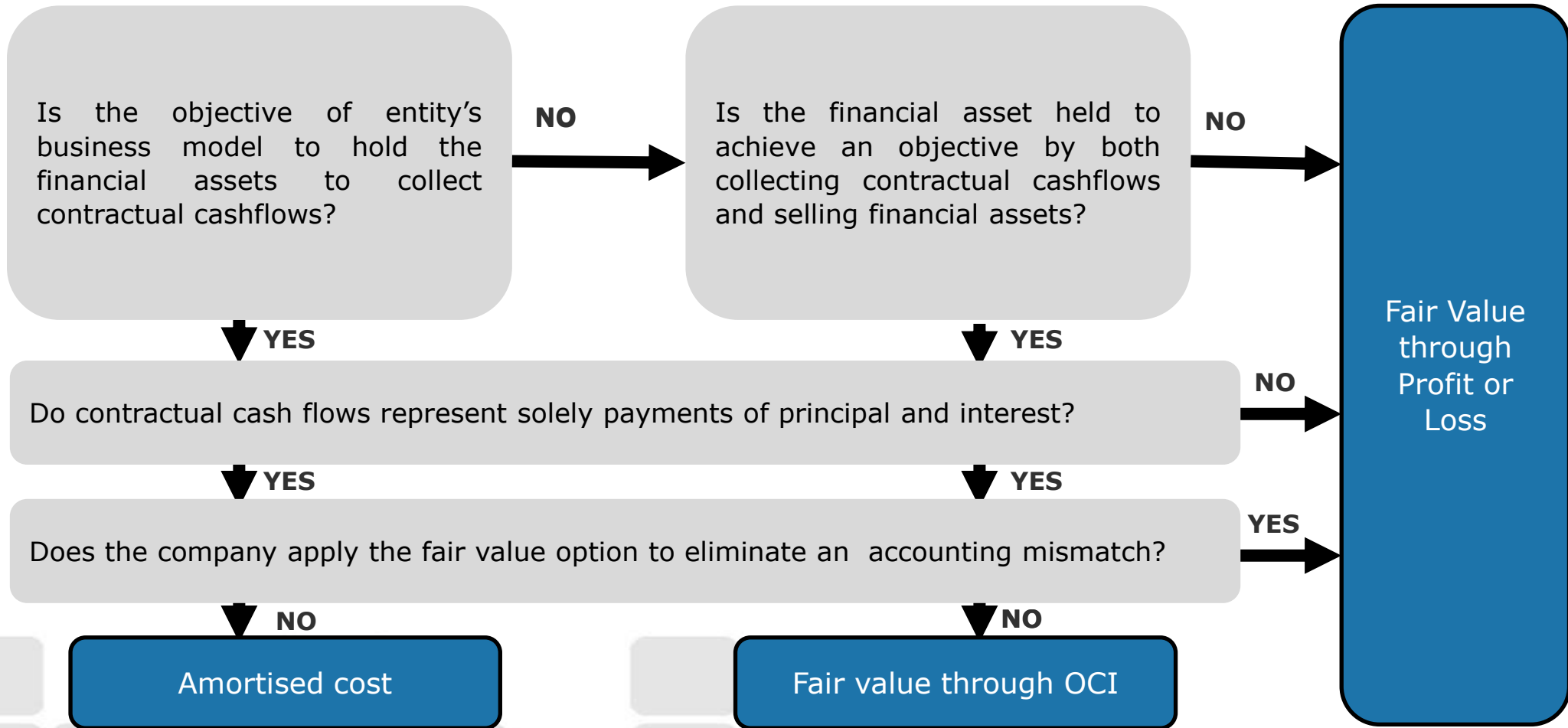
Contractual cash flows characteristics test (SPPI test)



Fixed / variable rate loan

Facts (scenario 1)	<ul style="list-style-type: none">• Entity Q lends INR 10 crore to Entity P.• The terms of the loan require repayment of INR 10 crore by Entity P in 3 years and is not prepayable.• Interest rate is 7% p.a.• There are no other features that result in any variability in the contractual cash flows.
Analysis of SPPI test (scenario 1)	For Entity Q, the loan gives rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. The contractual cash flows characteristics test is met.
Facts (scenario 2)	If the rate of instrument was variable (LIBOR + 2%), would your assessment change?
Analysis of SPPI test (scenario 1)	No, the assessment will not change. Even though the interest on the loan is partly fixed and partly variable, the variable element is determined by reference to a market interest rate.

Criteria for subsequent measurement - Financial Assets



Classification of Financial Assets – Case Studies



Entity A has a retail banking business whose objective is to collect the contractual cash flows of its loan assets. Entity A also has an investment banking business whose objective is to realise fair value changes through the sale of loan assets before their maturity. Do these financial instruments qualify for amortised cost measurement?

Entity A's financial instruments held in the retail banking business qualify for amortised cost measurement even if similar financial instruments in the investment banking business do not.

Entity D lends CU10 million to Entity E; the loan is repayable in five years. The contractual return on the loan for the first three years is derived from movements in a specified equity price index. In Years 4 and 5, the contractual return is 5 per cent of par.

At initial recognition, Entity D classifies the loan as a financial asset measured as at FVTPL because the loan does not pass the contractual cash flow characteristics test. The contractual return is linked to equity prices and, therefore, is not consistent with a basic lending arrangement. Entity D is not permitted to reclassify the financial asset after Year 3, the point at which the contractual linkage to equity prices ceases, because the terms of the instrument have not changed since initial recognition and the original asset continues to be recognised.

Criteria for subsequent measurement - Financial Liabilities

All financial liabilities are required to be classified and subsequently measured at amortised cost using the effective interest rate method, except for:

1. Financial liabilities at fair value through profit or loss (FVTPL) i.e.:
 - financial liabilities classified as held for trading; and
 - financial liabilities designated by the entity as at FVTPL.
2. financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies
3. financial guarantee contracts not designated as at FVTPL that are not accounted for under IFRS 17; and
4. commitments to provide a loan at a below-market interest rate

Classification of Financial Liabilities – Case Studies



A enters into a futures contract to buy 1,000 barrels of crude oil at \$60 a barrel in one month and the contract is not entered into for the physical delivery of oil for the entity's normal business usage requirements. Do these financial instruments qualify for amortised cost measurement?

This financial instrument is a derivative and hence, needs to be classified at fair value through PL

Financial liabilities that are incurred with an intention to repurchase them in the near term, such as quoted debt instruments that the issuer may buy back in the near term depending on changes in fair value.

These are financial liabilities that qualify as held- for-trading purpose and should be classified at Fair Value through PL.

Equity instruments – classification & measurement

Equity instruments measured at FVTPL

Option to elect to measure at FVTOCI if not held for trading

No subsequent recycling if measured at FVTOCI but can be transferred within equity

Dividends continue to be recognised in P&L

Effective interest rate

Effective interest rate is the rate that exactly discounts the expected stream of future cash payments or receipts through maturity to the net carrying amount at initial recognition.

Example of Calculation of amortized cost of financial asset:

1. Loan amount \$1000
2. Loan period 3 years
3. Interest rate 12%
4. Disbursement cost \$70
5. Effective interest @15% is booked each year

Loan balance	Year 1 \$	Year 2 \$	Year 3 \$
At the beginning	930	950	973
Interest expense @15%	140	143	147
	1,070	1,093	1,120
Interest payment	(120)	(120)	(120)
At the end	950	(973)	1000

Thank you