Financial Instruments

Presented by:

Shrenik Baid

9820116904

Terms

Cost – transaction price (in general)

Amortised Cost (B/s)

EIR - Effective interest method (I/s)

OCI - Other Comprehensive Income

FVTPL – Fair value through profit or loss

FVOCI – Fair value through OCI

CFS – consolidated financial statements

SFS – separate (standalone) financial statements

ECL – Expected credit loss

Type of instruments in discussion

Equity – Investment in subsidiary, joint venture, associate

Equity – Other investments

Debt

Mutual funds

Money market instruments

Derivative instruments

Loans and receivables

Trade payables

Bank deposits

Standards and their scope

* This standard is being early adopted in India.
Globally, IFRS 9 is mandated from 1 January 2018

Accounting Perspective

1. Initial recognition
2. Classification and (subsequent) measurement of financial instruments
3. Presentation from issuer's perspective
4. Expected credit loss
5. Derecognition
6. Hedge accounting
7. Disclosures under Ind AS 107
8. Fair value measurement under Ind AS 113

Initial recognition

An entity shall measure a financial asset or financial liability at its **fair value** plus/minus **the transaction costs** that are <u>directly attributable</u> to the acquisition or issue of the financial asset or liability

- **Exception**:
  - *trade receivable* without financing component are recorded at the transaction price
  - transaction cost is charged to income statement for *instruments carried at FVTPL*
- **Day 1 gain/loss**: If the fair value is evidenced by a quoted price in an active market or based on valuation technique using observable market inputs, the difference between the fair value and the transaction price will be recorded as gain or loss.
- **Trade v/s settlement date**: A regular way purchase or sale of financial assets is recognised using <u>either trade date accounting or settlement date accounting</u>. *When settlement date accounting is opted for, the changes in the value between the trade date and settlement date is recorded in the same way it accounts the asset to be received during the period.*

Classification and measurement

Investment in subsidiary, joint venture and associate:

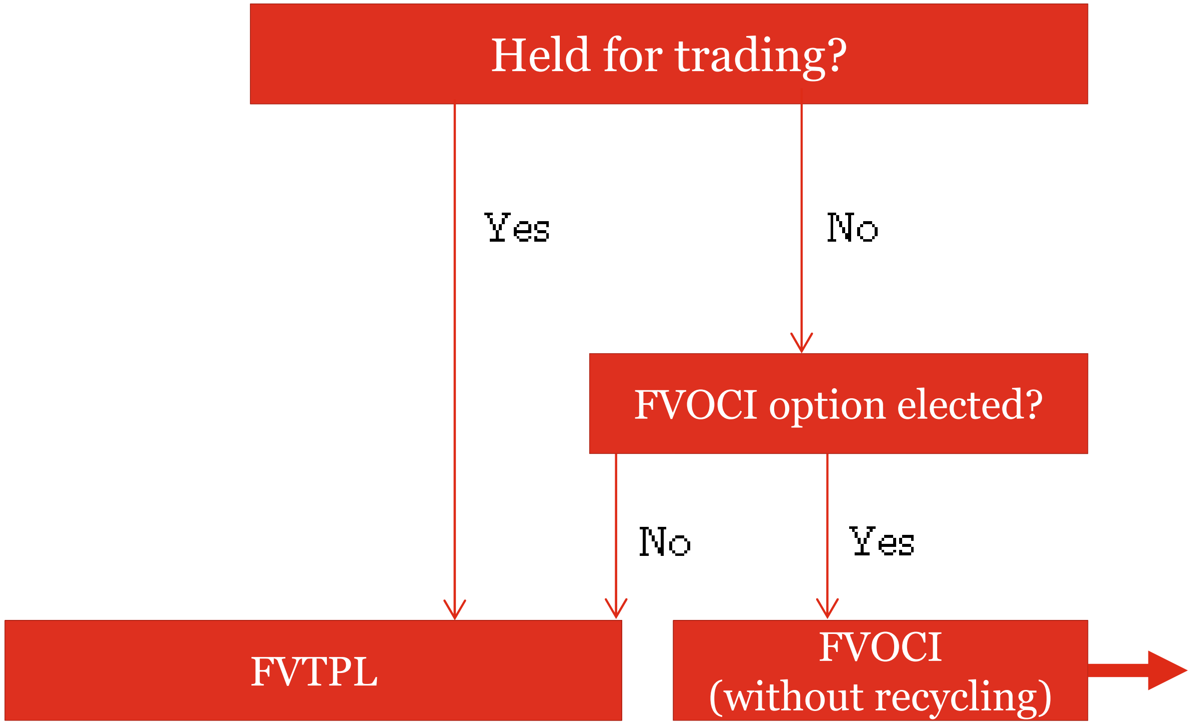
- **CFS**: subsidiary – line-by-line consolidation
- **CFS**: joint venture and associate – using equity method of accounting
- **SFS**: Cost OR in accordance with Ind AS 109

- **Exception to consolidation** for investment entities
  - <u>CFS and SFS</u>: at fair value through profit or loss (**FVTPL**) per Ind AS 109 with few exceptions

Classification and measurement

Investment in other equity instruments:

(Equity instruments are those that meet the definition of "equity" as defined in Ind AS 32)



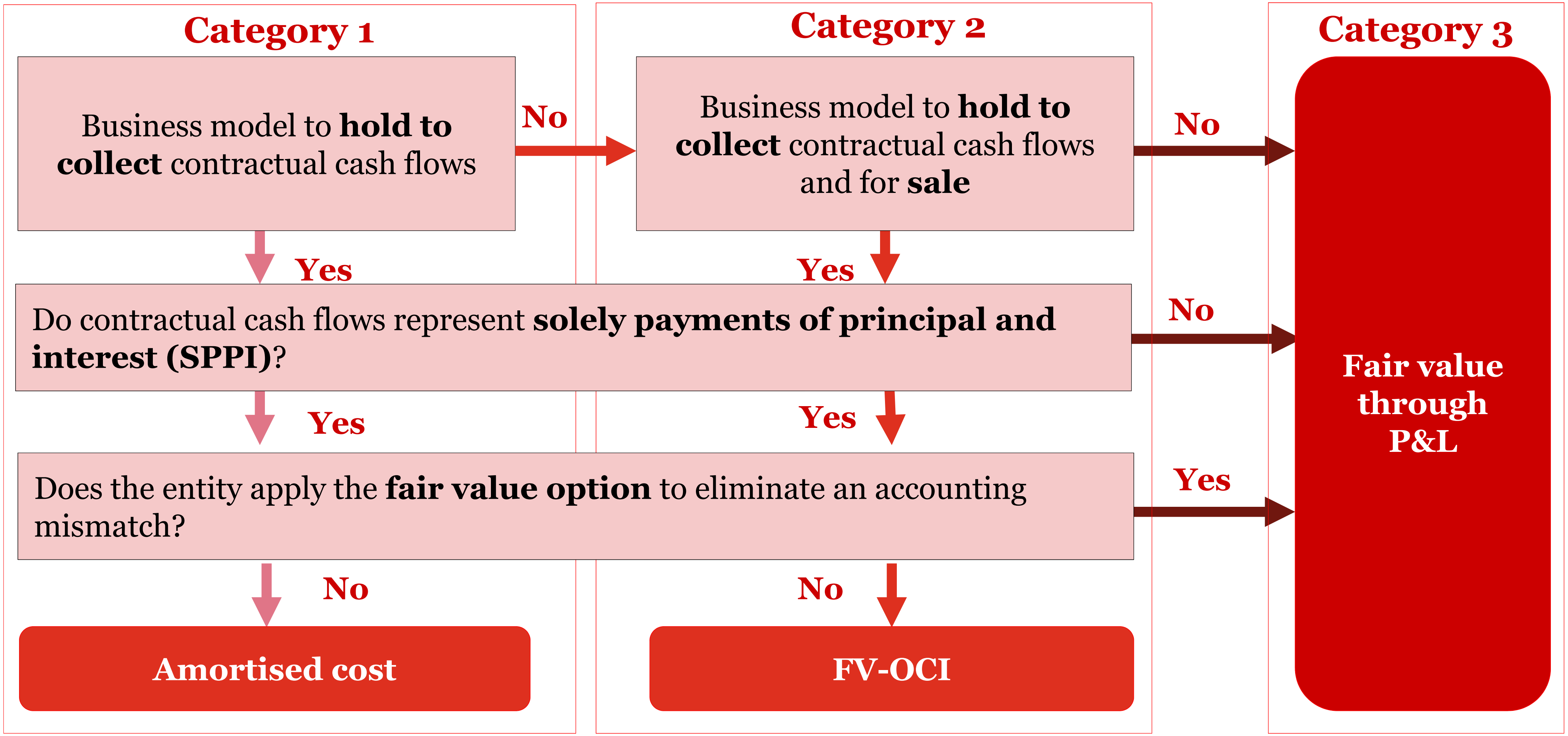
Herein all fair value changes, except dividend, will be included in OCI. No recyling into profit and loss.

** An equity instrument is defined as any contract that **evidences a residual interest** in the assets of an entity after deducting all of its liabilities (Ind AS 32)*

Classification and measurement

Investment in debt instruments:

Debt instruments are financial assets other than equity instruments. Classification under IFRS 9 is driven by the entity's business model for managing financial assets and their contractual cash flow characteristics (bifurcation of embedded derivatives is prohibited for assets)



Classification and measurement

Derivatives

- Contracts to buy or sell non-financial items are, in general, not financial instruments. However, if such contracts can be settled net in cash or by exchanging another financial instrument, they fall within the scope of Financial instruments (Derivatives) accounting under Ind AS. **Derivatives are carried at fair value.**

Embedded Derivatives

- In case of an embedded derivative, Ind AS requires for it to be accounted for separately from the host contract as a free standing derivative if all the following are met:

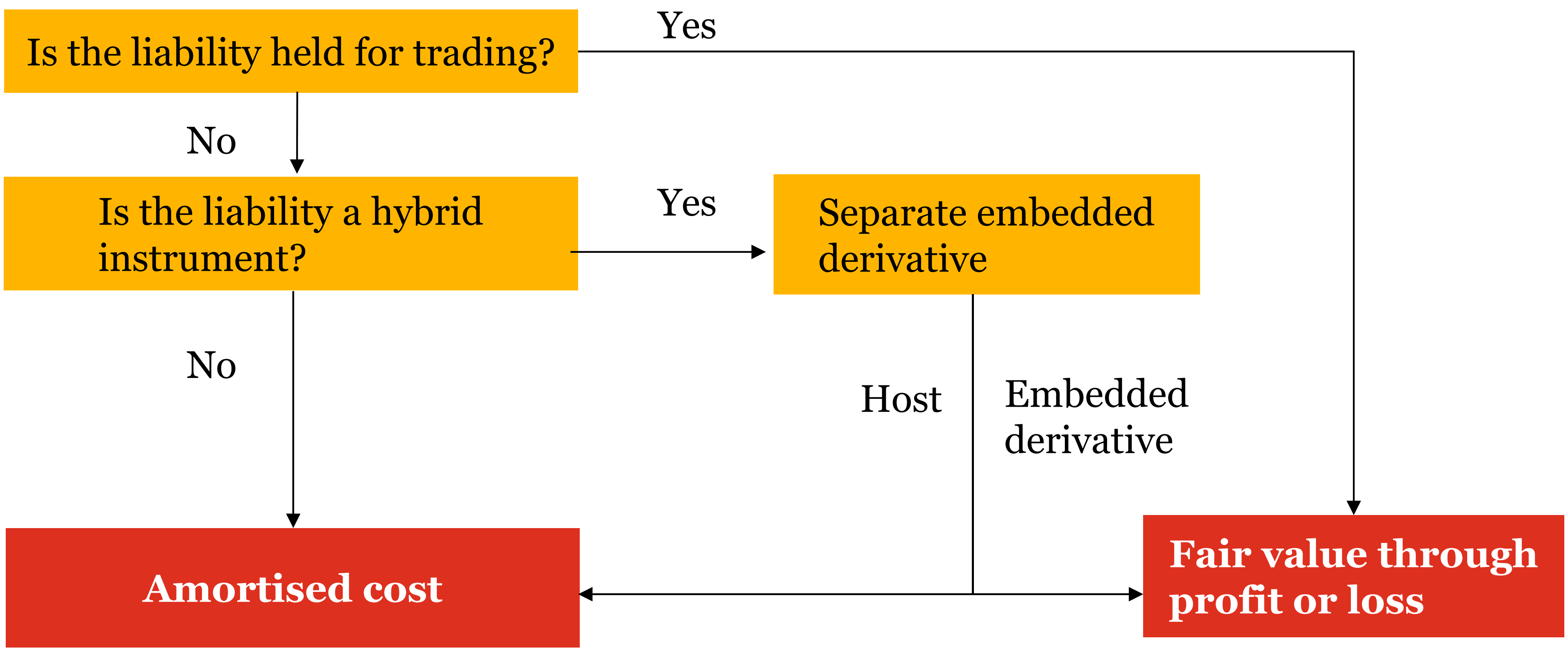
economic risks and characteristics of embedded derivative are not closely related to those of the host contract

a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative

the entire instrument is not measured at fair value with changes in fair value recognised in the income statement

Classification and measurement

Financial Liabilities



Classification and measurement

Financial Liabilities

- Under Ind AS 109, where an entity has chosen to measure a financial liability at fair value through profit or loss, changes in fair value related to changes in **own credit risk**, are presented separately in **OCI**.
- Amounts in OCI relating to own credit are **not recycled** to profit or loss even when the liability is derecognized and the amounts are realized.
- Entities are still required to **separate derivatives embedded** in financial liabilities where they are not closely related to the host contract.

Presentation from issuer's perspective (Ind AS 32)

- ***An equity instrument*** is any contract that *evidences a residual interest* in the assets of an entity after deducting all its liabilities
- ***A puttable instrument*** is a financial instruments that *gives the holder the right to put the instrument back* to the issuer for cash or another financial assets or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.

Presentation from issuer's perspective (Ind AS 32)

- Classification of financial instruments into equity or liability is based on the ***substance*** of the contractual arrangement over ***form***
- Convertible instruments which are issued to be **split into equity and debt component** depending on the terms of contractual arrangement.
- Conversion option embedded in foreign currency convertible bonds to acquire **fixed number of equity shares for fixed amount** of cash in any currency (functional or foreign) is treated as **equity** and accordingly not remeasured at fair value at every reporting date

Presentation from issuer's perspective (Ind AS 32)

- **Puttable instruments** and instruments that impose an obligation to deliver pro rata share of net assets only on liquidation should be classified as equity instruments if they:-

are subordinate to all other class of instruments

AND

meet additional criteria as laid down in the standard

- **Fixed to Fixed criteria**: Rights, options or warrants to acquire a fixed number of an entity's own equity instruments for a fixed amount of any currency are equity instruments, if the entity offers such options etc., pro rata to all its existing owners of the same class of it's non derivative equity instruments.

Expected credit losses

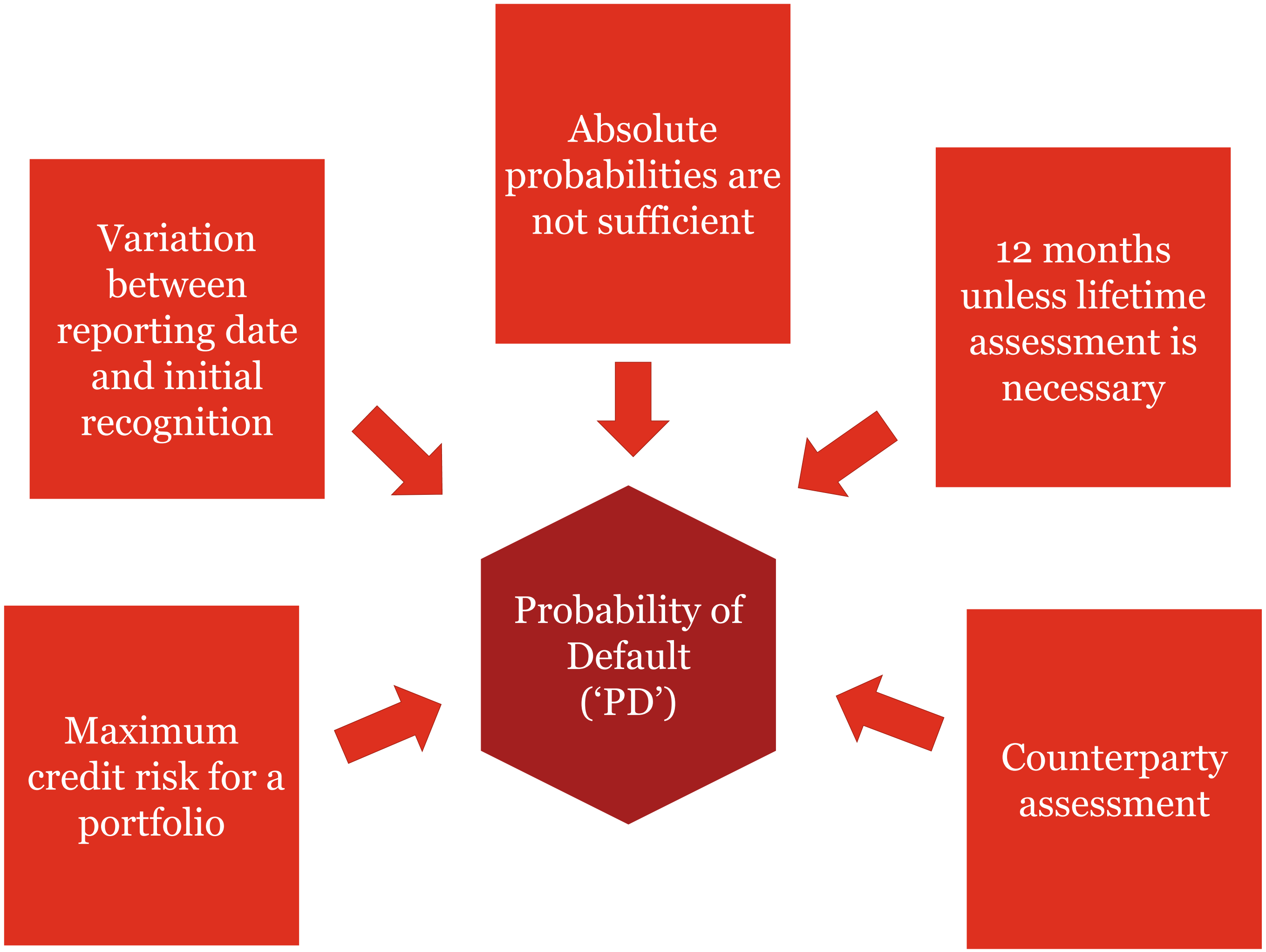
Scope: Financial assets that are not credit-impaired on initial recognition

(Stage 1) (Performing)	(Stage 2) (Under-performing)	(Stage 3) (Non-performing)
On initial recognition*	Assets with significant increase in credit risk since initial recognition (Rebuttable presumption of **30 days past due**)	Credit-impaired assets, i.e. objective evidence of impairment (Rebuttable presumption of **90 days past due**)
Interest revenue calculated on **gross** carrying amount	Interest revenue calculated on **gross** carrying amount	Interest revenue calculated on the **net** carrying amount
12-month expected losses = lifetime expected credit losses associated with the probability of a loss in the 12 months after the reporting date.	**Lifetime expected credit loss allowance**	**Lifetime expected credit loss allowance**

** Except for purchased or originated credit impaired assets*
More guidance to include asset with low credit risk and investment grade

Expected credit losses

Assessment of a significant increase in credit risk



Expected credit losses

Expected credit losses

Financial assets

ECL represent a probability-weighted estimate of the difference over the remaining life of the financial instrument, between:

Present value of cash flows according to contract	≠	Present value of cash flows the entity expects to receive

Undrawn loan commitments

ECL represent a probability-weighted estimate of the difference over the remaining life of the financial instrument, between:

Present value of cash flows if holder draws down	≠	Present value of cash flows the entity expects to receive if drawn down

Expected credit losses

Discount rate and operational simplifications

Discount rate for calculating the expected credit losses

- Effective interest rate or an approximation thereof.

Operational simplifications

- Low credit risk: the loss allowance for financial instruments that are deemed low credit risk at the reporting date would continue to be recognised at 12-month ECL.

Simplified approach for lease and trade receivables

The Standard provides two operational simplifications:

- **For trade receivables or contract assets that do not contain a significant financing component**: Relief from calculating 12-month ECL and to assess when a significant increase in credit risk occurred. Lifetime ECL throughout the trade receivable's life.
- **For lease receivables and trade receivables or contract assets that contain a significant financing component**: Accounting policy choice to apply simplified approach to measure loss allowance at lifetime ECL on initial recognition.

Expected credit losses
Purchased or originated credit-impaired financial assets

- Scope.
  - Both originated and purchased credit-impaired.
  - Credit impaired = same population as IAS 39.
- Use credit-adjusted effective interest rate.
  - No day 1 allowance balance.
  - No day 1 impairment loss recognised.
- Positive or negative changes in lifetime expected credit losses are reflected in profit or loss and allowance. Allowance balance represents cumulative changes in lifetime expected losses since initial recognition.

Expected credit losses
Disclosures

Quantitative

Reconciliation of opening to closing amounts of loss allowance showing key drivers of change

Write off, recovers and modifications

Reconciliation of opening to closing amounts of gross carrying amounts showing key drivers of change

Gross carrying amounts per credit risk grade

Qualitative

Inputs, assumptions and estimation techniques for estimating ECL

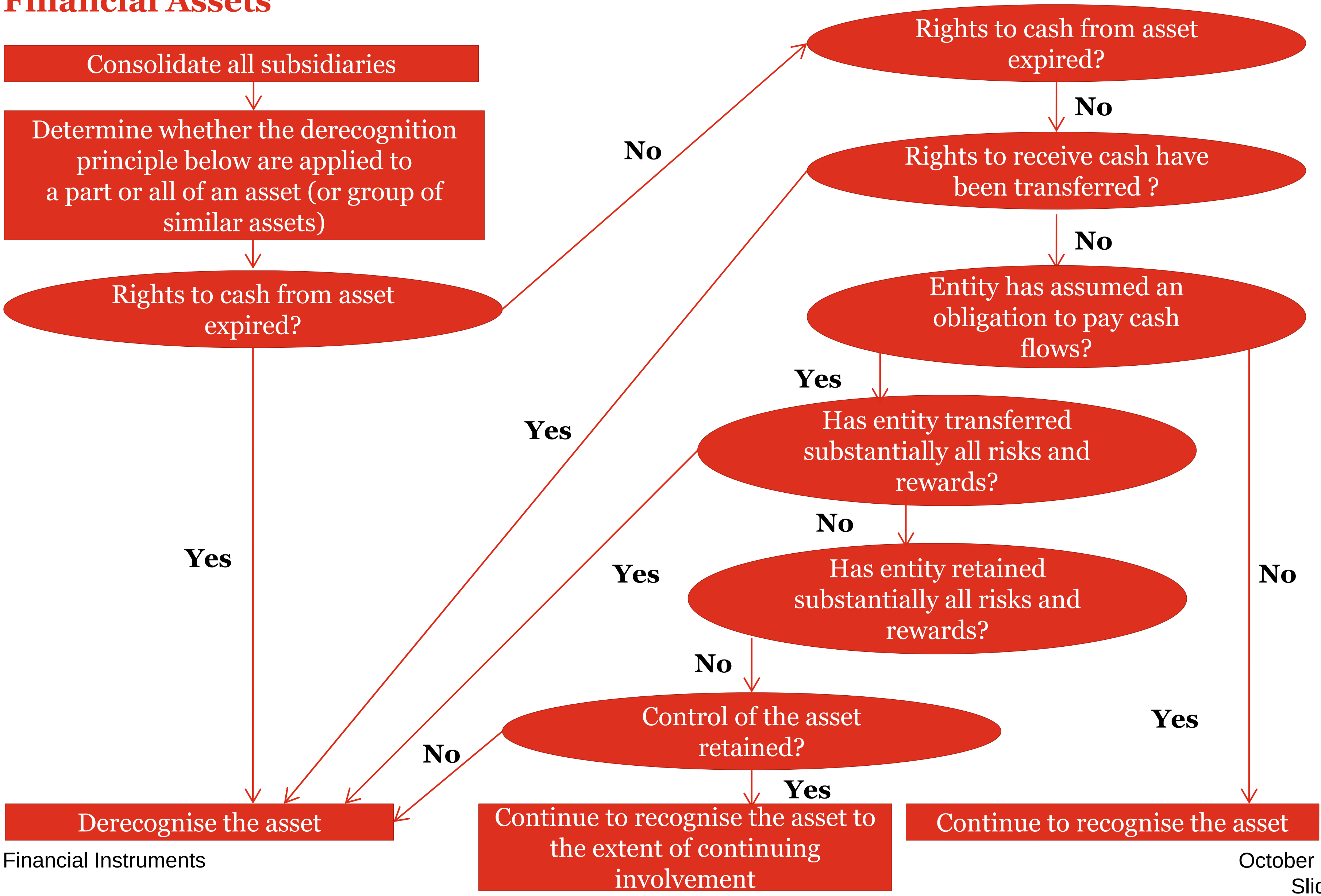
Write off policies, modification policies and collateral

Inputs, assumptions and estimation techniques to determine significant increases in credit risk and default

Inputs, assumptions and techniques to determine credit impaired

De-recognition

Financial Assets



De-recognition

Financial Liabilities to derecognise when:

- The obligation specified in the contract is discharged or cancelled or expires;
- An exchange between between existing borrower and lender of debt instruments with substantially different terms or substantial modification of original financial liability (extinguishment of original liability and recognition of new liability)
- Difference between carrying amount of financial liabiltiy (or a part of it) extinguished or transferred to or consideration paid (including any non-cash transfer of assets or liabilities)

Hedge accounting Qualification

Ind AS 109 qualifying criteria

1. Formal designation and documentation

2. Only eligible hedging instruments and hedged items

3. Meets the hedge effectiveness requirements

3.1 ***Economic relationship*** between hedged item and hedging instrument gives rise to offset

3.2 Effect of ***credit risk*** does not dominate the value changes

3.3 ***Hedge ratio*** results from the quantity of hedged item hedged and hedging item used to hedge

Hedge accounting
Effectiveness – Rebalancing

Change in economic relationship between underlyings

Change in risk management hedge ratio

Changes result in an imbalance that would create hedge ineffectiveness (inconsistent with the purpose of hedge accounting)

Hedge Accounting De-designation

✓ De-designation **required** if hedge accounting objective is no longer met.

✓ Voluntary de-designation **prohibited,** *i.e. if qualifying criteria continues to be met and the risk management objective is unchanged.*

Hedge Accounting
Hedging instruments

- Embedded derivatives **only allowed** if embedded in **financial liabilities** and separated from the host contract.
- Non-derivatives @FVTPL, **also for other than FX risk.**
- Options – changes in aligned time value are deferred in OCI. Reclassification to P&L depends on the nature of the hedged item:
  - ✓ Transaction related
  - ✓ Time period related
- Forward points & currency basis spreads
  - ✓ Forward points and currency basis spreads can be included in the hedging instrument; or
  - ✓ Fair value changes of forward points and currency basis spreads may be recognised in profit or loss; or
  - ✓ Forward points and currency basis spreads may be accounted in the same manner as it is applied to the time value of an option under Ind AS 109.

Hedge Accounting
Hedged Items

- Possible to hedge risk components of <u>both financial and non-financial items.</u>
- Aggregated positions <u>allowed</u>
- Net positions (including net nil positions) <u>allowed</u> as hedged item, in certain circumstances
- Equity instruments through OCI <u>can be</u> hedged items
- Layers allowed for both cash flow hedges, fair value hedges and groups of items

Risk components

- Possible to hedge risk components of both financial and non-financial items if separate identifiable and reliably measurable.
  i) Eg: contract specifies a pricing formula that references a commodity;
  ii) Eg: hedging jet fuel with crude oil derivatives. As price of jet fuel is crude oil plus a refining margin
- Risk components should be assessed in the context of the **particular market structure** to which the risk or risks relate and in which the hedging activity takes place.

Hedge Accounting
Alternatives to hedge accounting

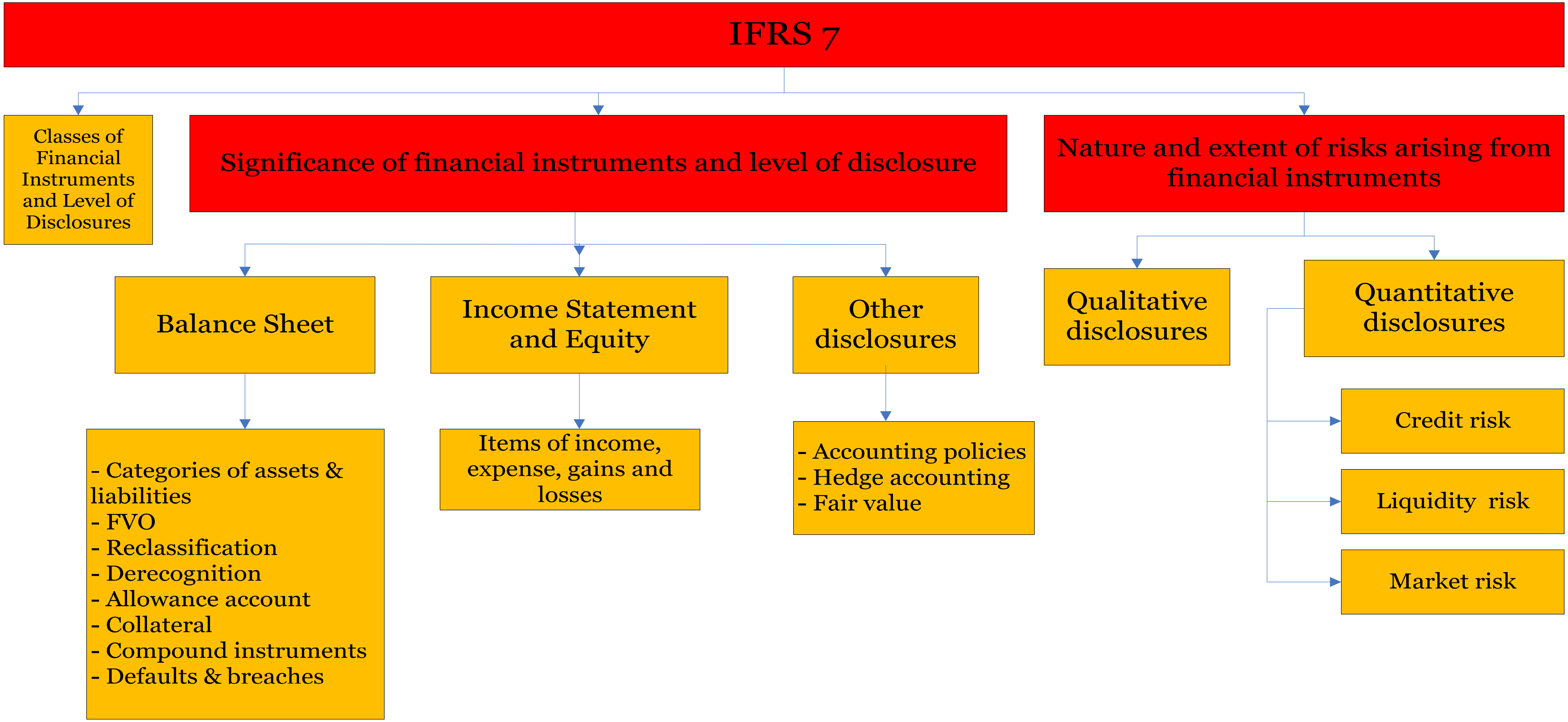
Option to designate a credit exposure at fair value through P&L

- Allows fair value through profit or loss accounting for a financial instrument (or a proportion of it) when hedged with a credit derivative.
- Certain criteria must be met.
- Not irrevocable.
- Disclosure requirements added

Extended use of fair value option for 'own use' contracts

- Fair value option extended to own use contracts managed on a fair value basis.
- Irrevocable designation.

Disclosures under Ind AS 107



Disclosures under Ind AS 107

Transfers of financial assets

An entity shall disclose information that enables users of its financial statements:

- To understand the relationship between transferred financial assets that are not derecognised in their entirety and the associated liabilities; and
- to evaluate the nature of, and risks associated with, the entity's continuing involvement in derecognised financial assets.

Disclosures under Ind AS 107

Disclosures required for transferred financial assets

Not derecognised in entirety

- Nature of transferred assets,
- Nature of risk and rewards,
- Description of nature and quantitative disclosure depicting relationship between transferred financial assets and the associated liabilities.

Derecognised in entirety

- Required Disclosures:
  - Carrying amount of the assets and liabilities recognised,
  - Fair value of the assets and liabilities,
  - Maximum exposure to loss,
  - Maturity analysis of the undiscounted cash flows to repurchase the derecognised financial assets
- Additional Disclosures:
  - Any gain or loss recognised at the date of transfer of the assets,
  - Income or expenses,
  - Details of uneven distribution of proceed from transfer activity throughout the reporting period

Fair value measurements under Ind AS 113

Definition

"Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the ***principal (or most advantageous) market*** *at the measurement date under current market conditions* ***(i.e. an exit price)*** *regardless of whether that price is directly observable or estimated using another valuation technique."*

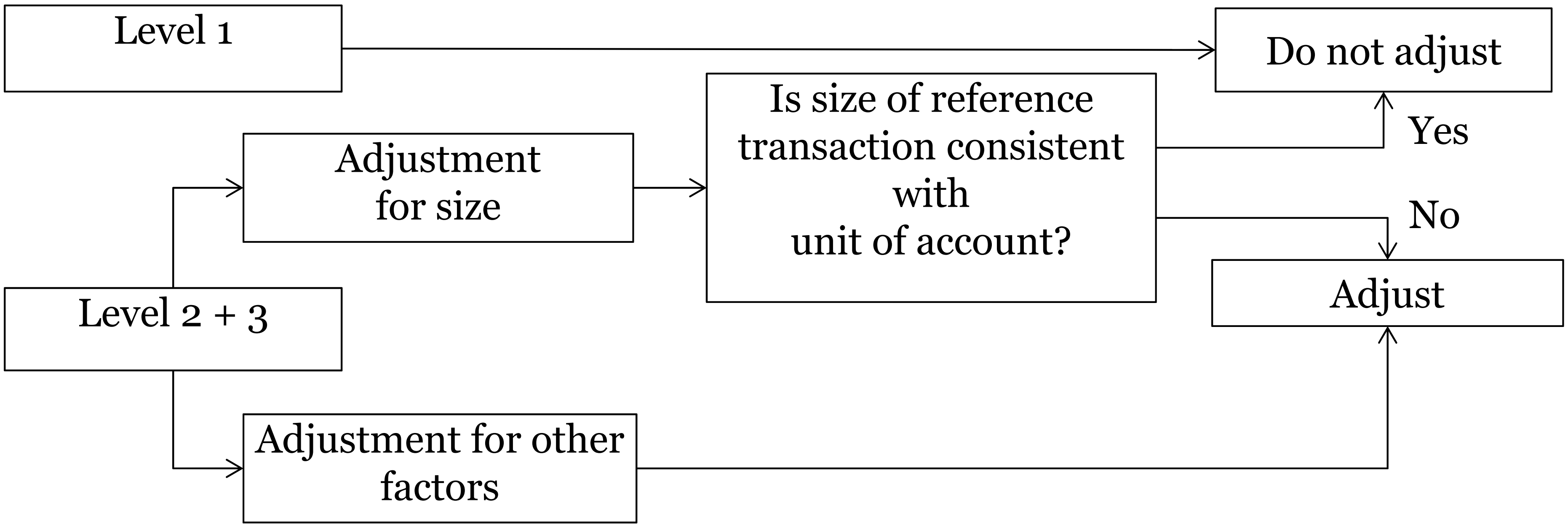
- Consider characteristics of asset/liability:
  - Condition
  - Location
  - Restrictions on sale/use
- Liability's fair value reflects own non-performance risk
- Excludes transaction costs

Valuation techniques

- Market, income or cost approach to be used appropriately based on circumstances
- Maximise observable inputs
- Change in technique acceptable if equally or more representative of fair value

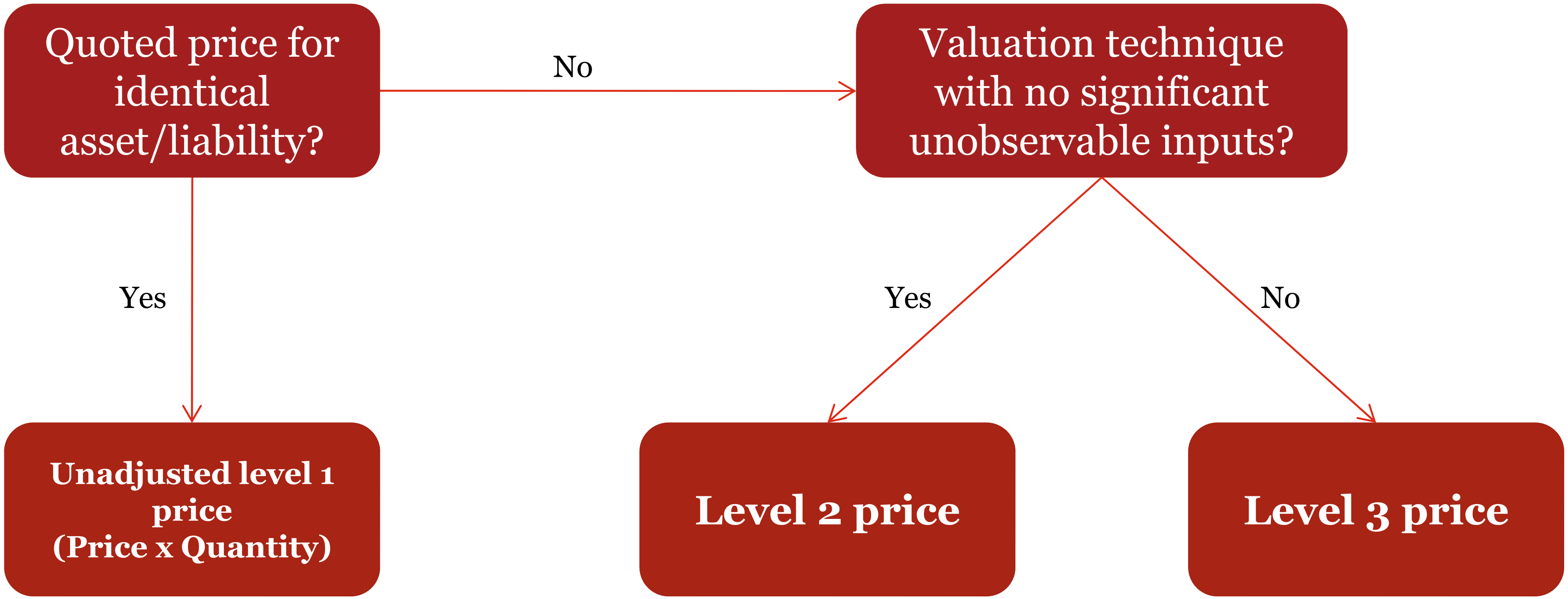
Fair value measurements under Ind AS 113

Valuation adjustments



Fair value measurements under Ind AS 113

Fair Value Hierarchy



Disclosure Requirements in addition to those of Ind AS 107:

- Disclose specific Fair value techniques and inputs
- Disclose the effect of significant unobservable inputs on P&L/OCI

Questions?

Thank you!