Ind AS – Financial Instruments

12 March 2016

Ram Iyer

Agenda

Ind AS

Financial Instruments

Bonus Topic: Fair Value Concepts of Ind AS 113

Financial Instruments

Financial Instruments

Ind AS
Map of Financial Instruments Standards
Key Topics in Financial Instruments
Rapid Quiz – Financial Instruments
Accounting Map for Financial Instruments
Impairment: Loans by Financial Institutions
Impairment: Trade Receivables
Investments
Trade Payables
Derivatives
Embedded Derivatives
Hedge Accounting
Presentation of Financial Instruments
Disclosures
Transition Requirements
GAAP Differences – Common Examples

Map of Financial Instruments Standards

Ind AS 32	Ind AS 109	Ind AS 113	Ind AS 107
Presentation	Classification and Measurement	Fair Value Measurement	Disclosures

Key Topics in Financial Instruments

Rapid Quiz

What is a financial instrument?

Rapid Quiz

What is a financial instrument?

A contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity


Rapid Quiz

What are common financial assets?

Rapid Quiz

What are common financial assets?

Cash, equity instrument, contractual right to receive cash or exchange financial instruments under conditions that are potentially favourable

Rapid Quiz

What are common financial liabilities?

Rapid Quiz

What are common financial liabilities?

Contractual obligation to deliver cash or exchange financial instruments under conditions that are potentially unfavourable

Rapid Quiz

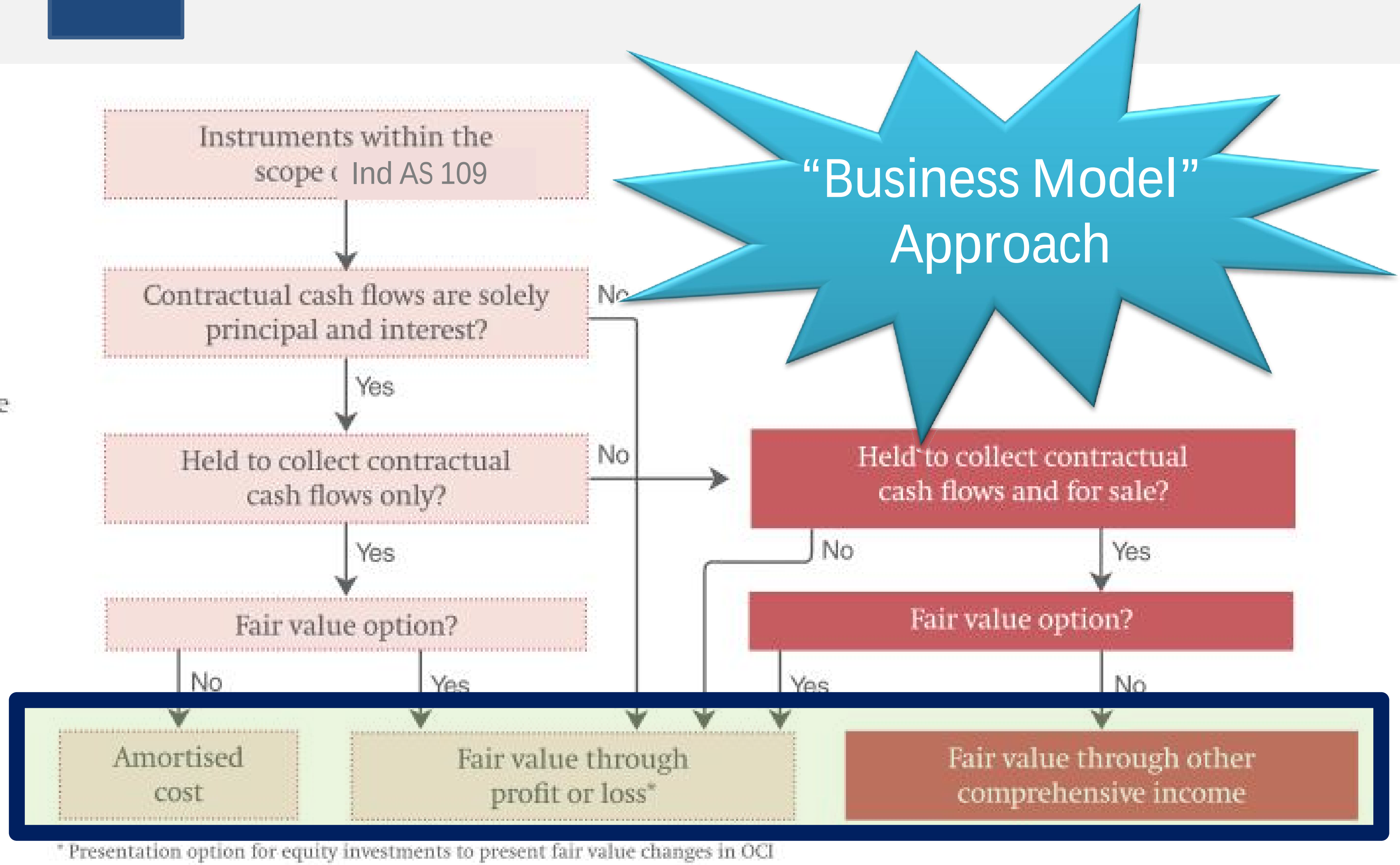
How do you initially record a financial instrument?

Rapid Quiz

How do you initially record a financial instrument?

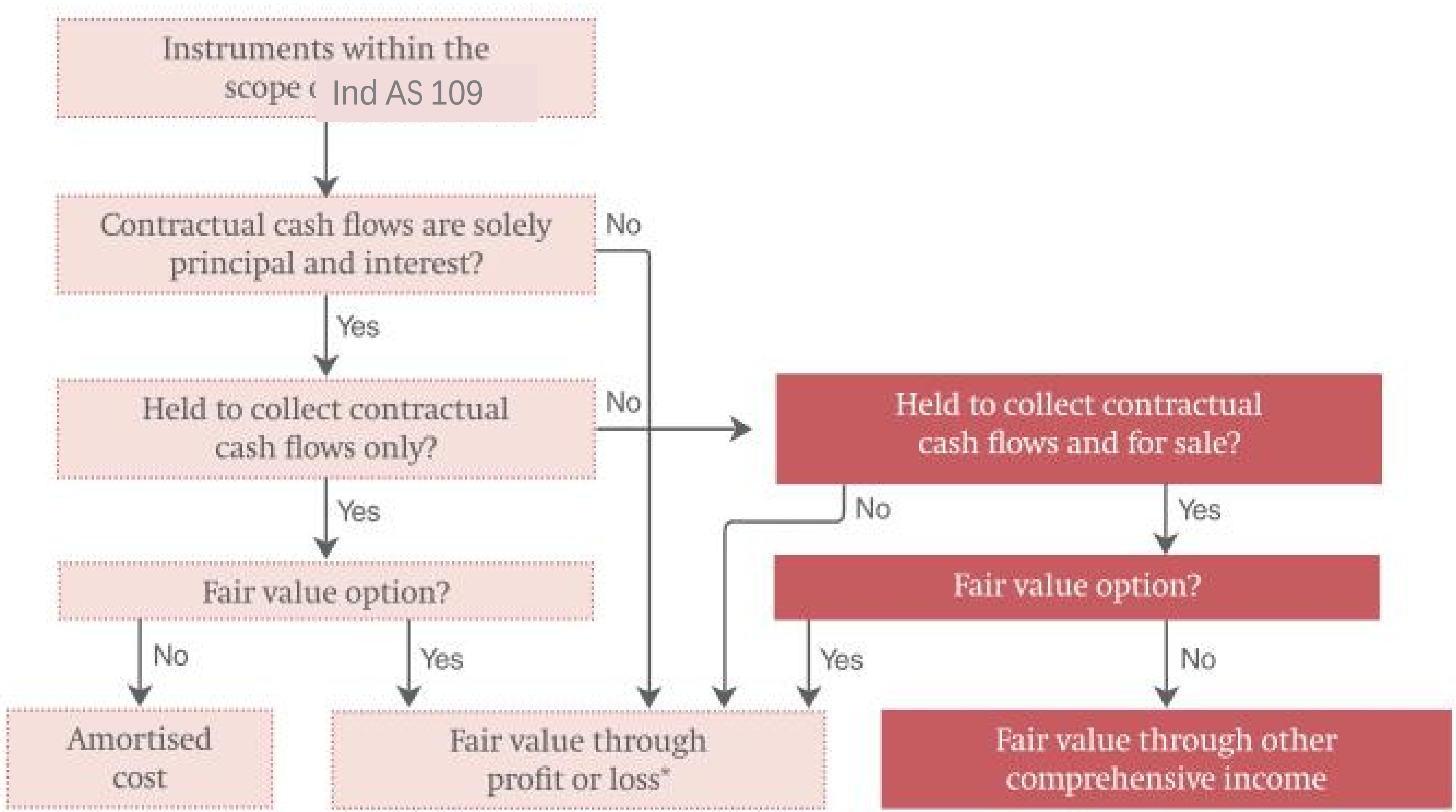
At fair value adjusted for transaction costs. However, transaction costs are expensed for financial instruments recorded at FVPL

Accounting Map for Financial Assets



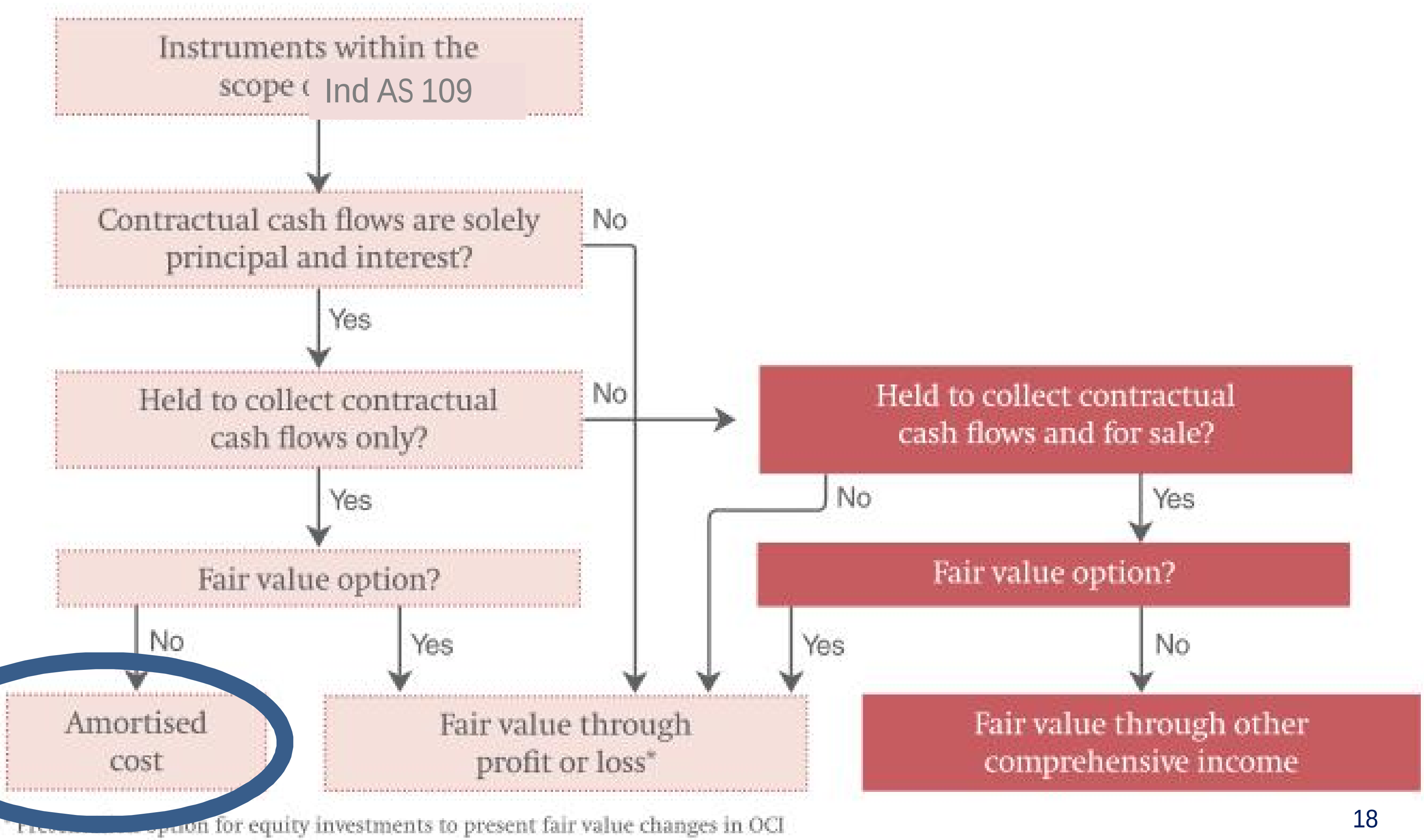
What is the most common measurement basis of Loans originated by a bank or Financial Institution

Loans by Financial Institutions
– *Common Classification*



* Presentation option for equity investments to present fair value changes in OCI

Loans by Financial Institutions
– *Common Classification*



Amortized Cost
– *Example*

Amortized Cost - Customer Repayment Schedule				
Loan	100,000			
Up-front Fees	(10,000)			
	Cash Flows	**Principal**	**Interest**	**Balance**
Loan	100,000			100,000
Year 1	(39,000)	30,719	8,281	69,281
Year 2	(39,000)	33,263	5,737	36,018
Year 3	(39,000)	36,018	2,982	(0)
			17,000	
IRR			**8.28%**	

What is the lender's rate (IRR)

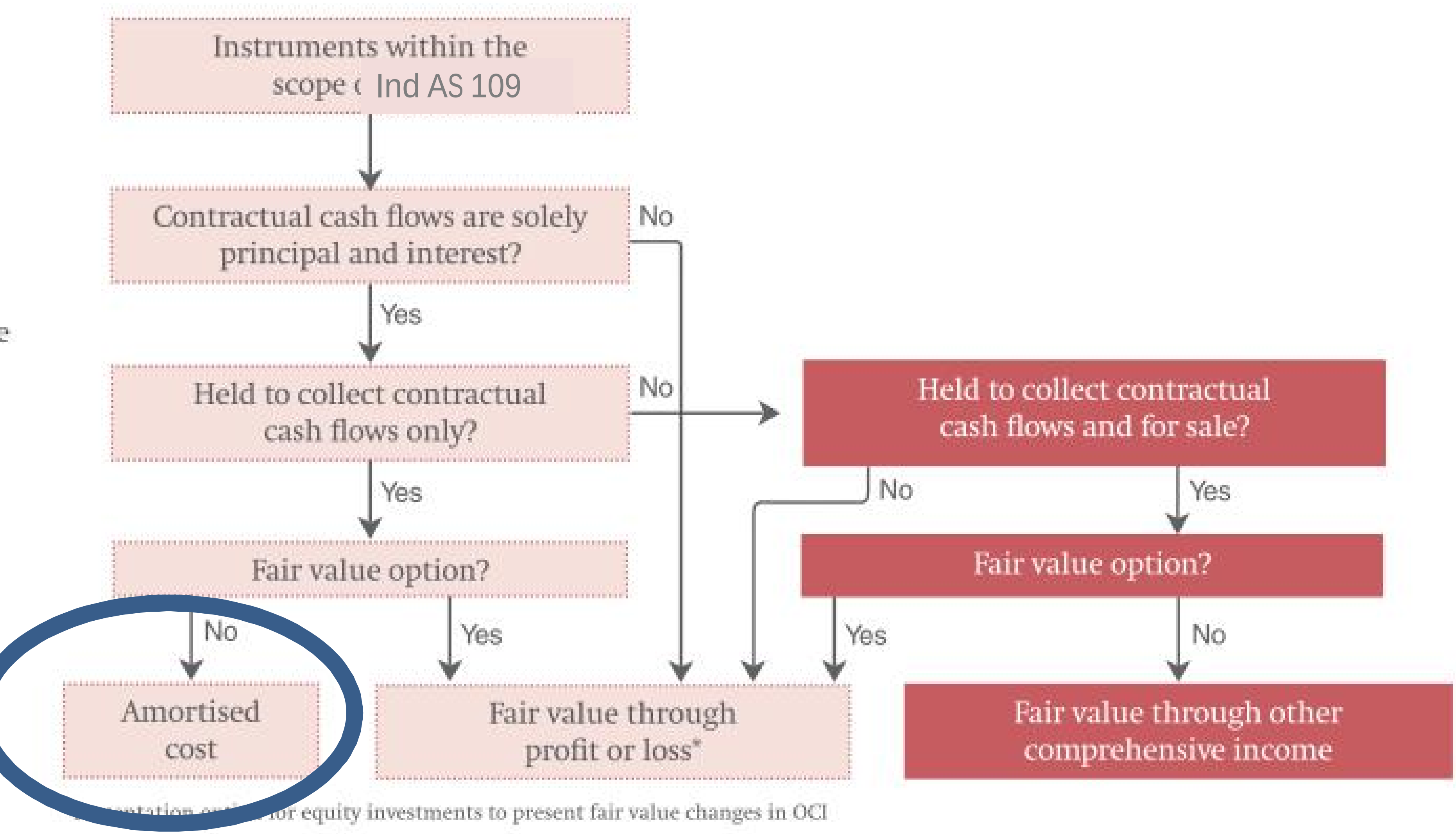
Amortized Cost
– *Example*

Amortized Cost - Customer Repayment Schedule				
Loan	100,000			
Up-front Fees	(10,000)			
	Cash Flows	Principal	Interest	Balance
Loan	100,000			100,000
Year 1	(39,000)	30,719	8,281	69,281
Year 2	(39,000)	33,263	5,737	36,018
Year 3	(39,000)	36,018	2,982	(0)
			17,000	
IRR			**8.28%**	

Amortized Cost - Accounting				
Loan	100,000			
Up-front Fees	(10,000)			
	90,000			
			Ind AS	
	Cash Flows	Principal	Interest	Balance
Net Loan	90,000			90,000
Year 1	(39,000)	26,076	12,924	63,924
Year 2	(39,000)	29,821	9,179	34,103
Year 3	(39,000)	34,103	4,897	(0)
			27,000	
IRR			**14.36%**	

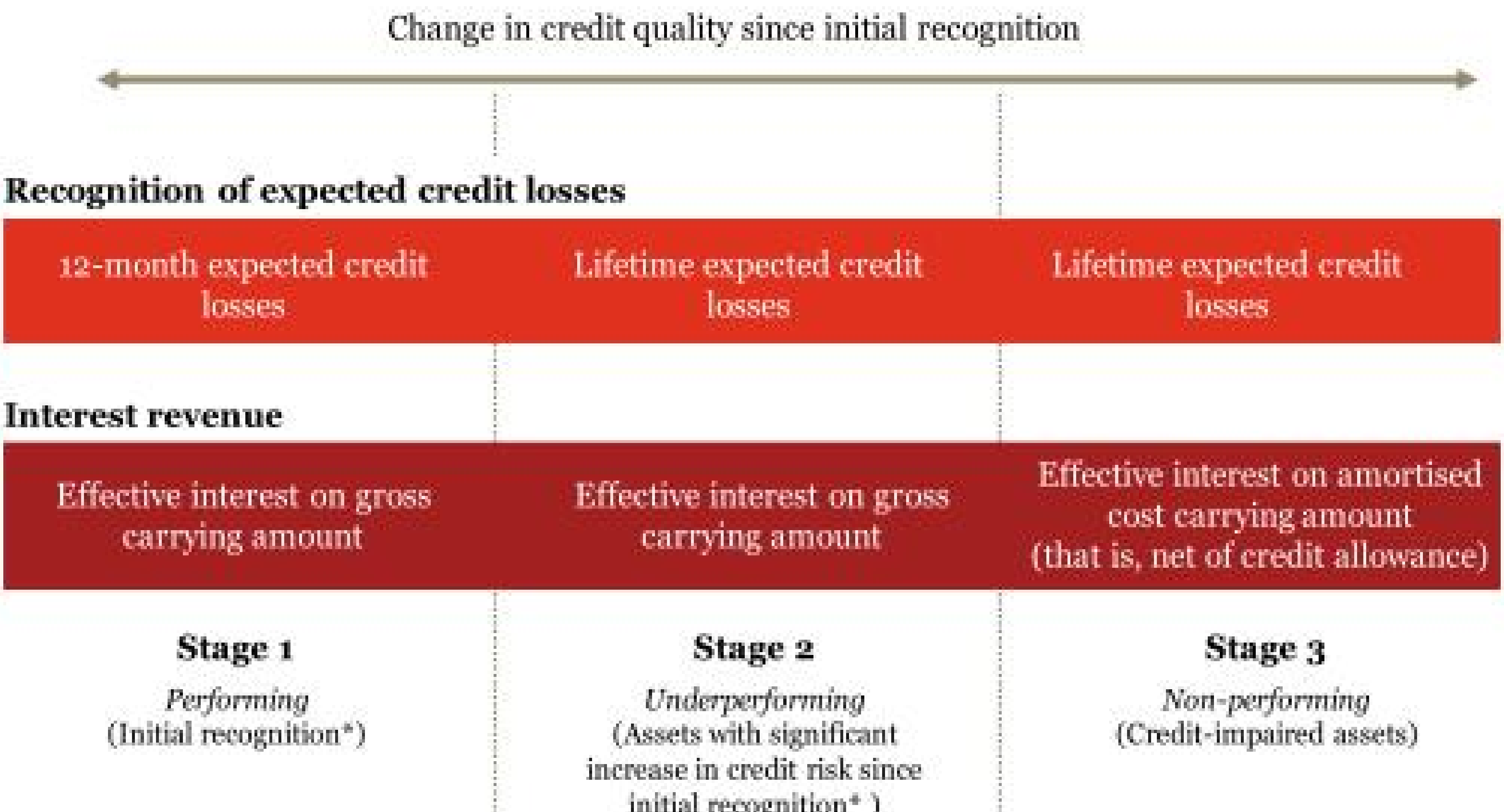
What is the most common measurement basis of Trade Receivables

Trade Receivables
– *Common Classification*



Recognition of Expected Credit Losses

Example – Financial Institution



Recognition of Expected Credit Losses
Example – Financial Institution

Stages	1	2	3
Evidence of credit risk	No evidence of increase in credit risk	Macro evidence of significant increase in credit risk (a)	Micro evidence of credit impairment (b)
Indicators	Past history	Past history	Past history
	+	+	+
	Current information	Current information	Current information
	+	+	+
	Forecast	Forecast	Forecast
Mechanics			
Collective evaluation	PD x LGD*	PD x LGD	PD x LGD
Individual evaluation	NA	NA	PV of CF
Technique	12 month ECL**	Lifetime ECL	Lifetime ECL
Loan Book			
6-year Term Loans	0.4% x 10000 = 40	0.8% x 10000 = 80	0.8% x 9900 = 79
1000 x 10 crores each			+
			30% x 100 = 30
Total Loss Provision	**40**	**80**	**109**

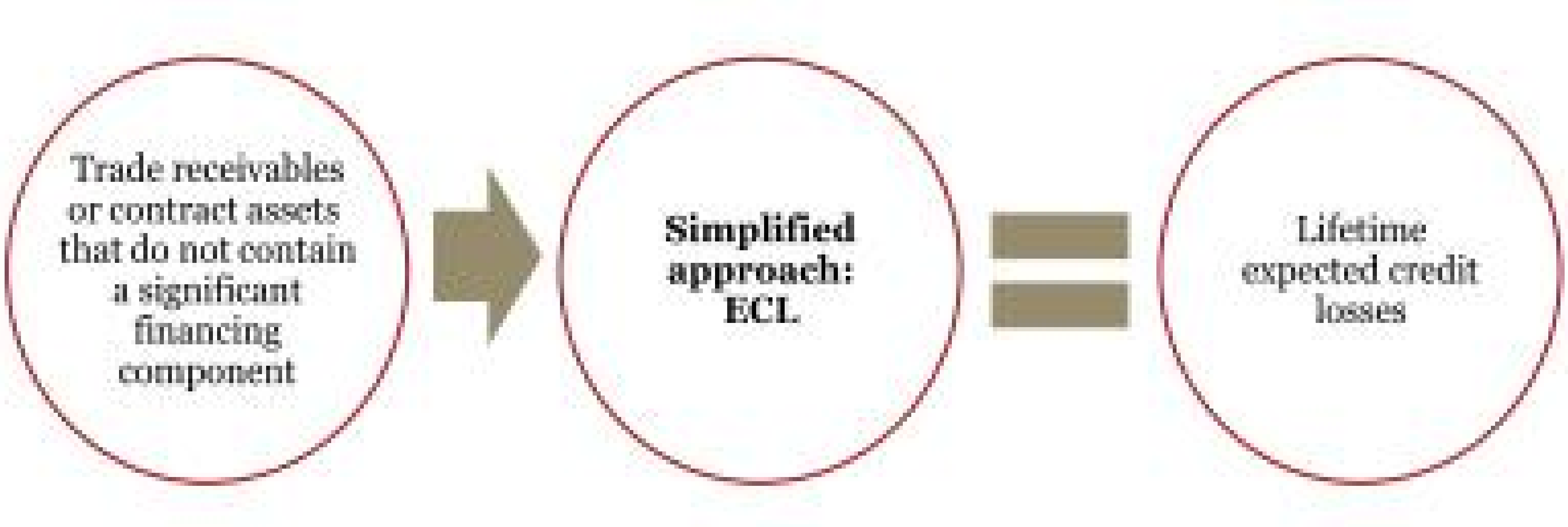
(a) 30-day past due = presumption of significant increase in credit risk

(b) Credit Impairment = can't reasonably expect to recover all cash flows

** PD = Probability of Default; LGD = Loss Given Default*

*** ECL = Expected Credit Losses*

Trade Receivables



Recognition of Expected Credit Losses

Example – Trade Receivable

Rupees Cr	Stage 1	Stage 2	Stage 3
Evidence of credit risk	No evidence of increase in credit risk	Macro evidence of significant increase in credit risk (a)	Micro evidence of credit impairment (b)
Indicators	Past history	Past history	Past history
	+	+	+
	Current information	Current information	Current information
	+	+	+
	Forecast	Forecast	Forecast
Mechanics			
Collective evaluation	PD x LGD*	PD x LGD	PD x LGD
Individual evaluation	NA	NA	PV of CF
Technique	Lifetime ECL**	Lifetime ECL	Lifetime ECL
Lifetime ECL	1% x 500	1% x 400	1% x 400
		+	+
		5% x 100	5% x 90
			+
			20% x 10
	=	=	=
Total	**5**	**9**	**10.5**

Trade Receivables 500 customers x 1 crore each = 500 crore

(a) 30-day past due = presumption of significant increase in credit risk

(b) Credit Impairment = can't reasonably expect to recover all cash flows

** PD = Probability of Default; LGD = Loss Given Default*

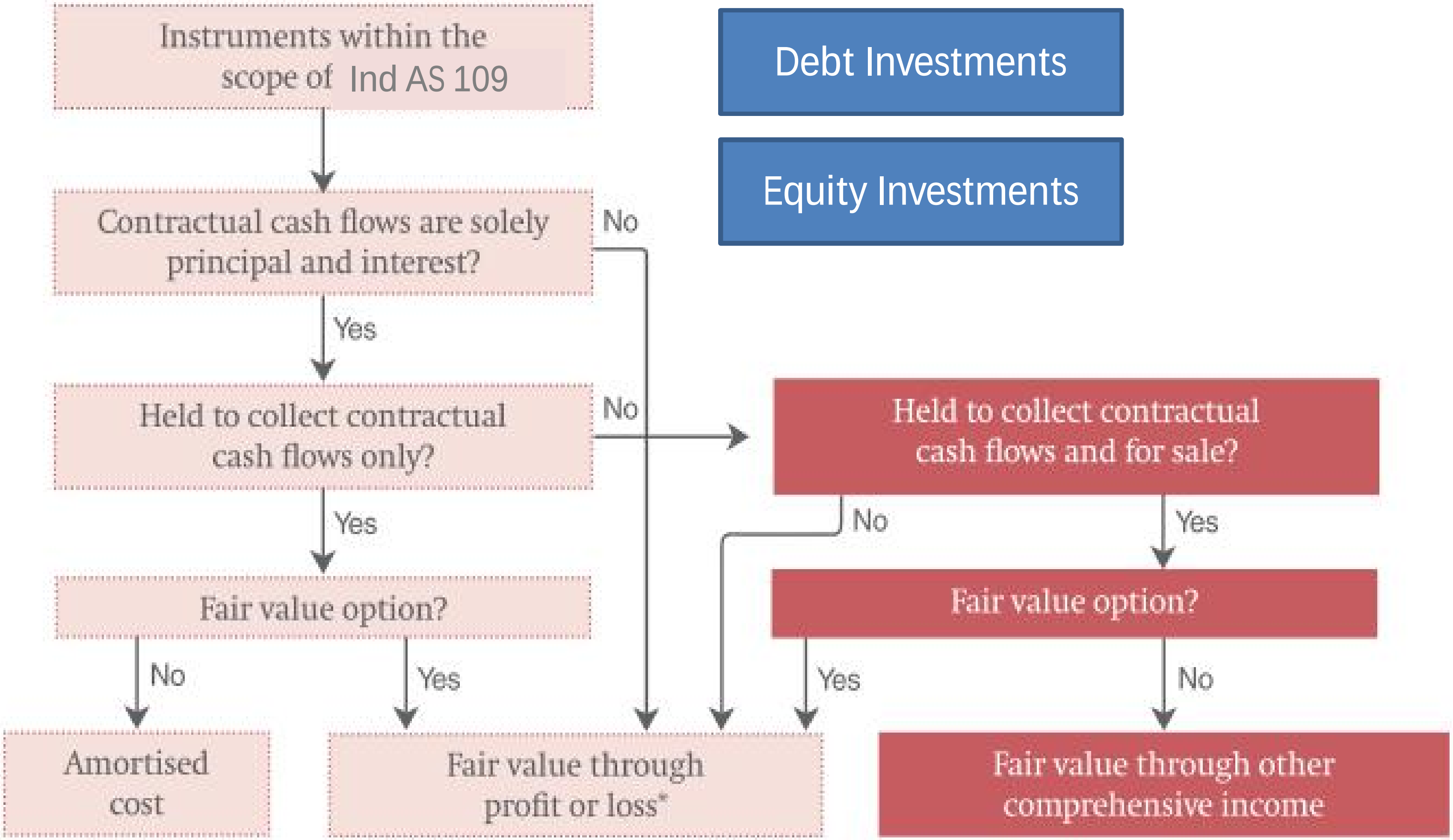
*** ECL = Expected Credit Losses*

What is a common measurement basis of Investments

Investments
– *Common Classification*

Debt Investments

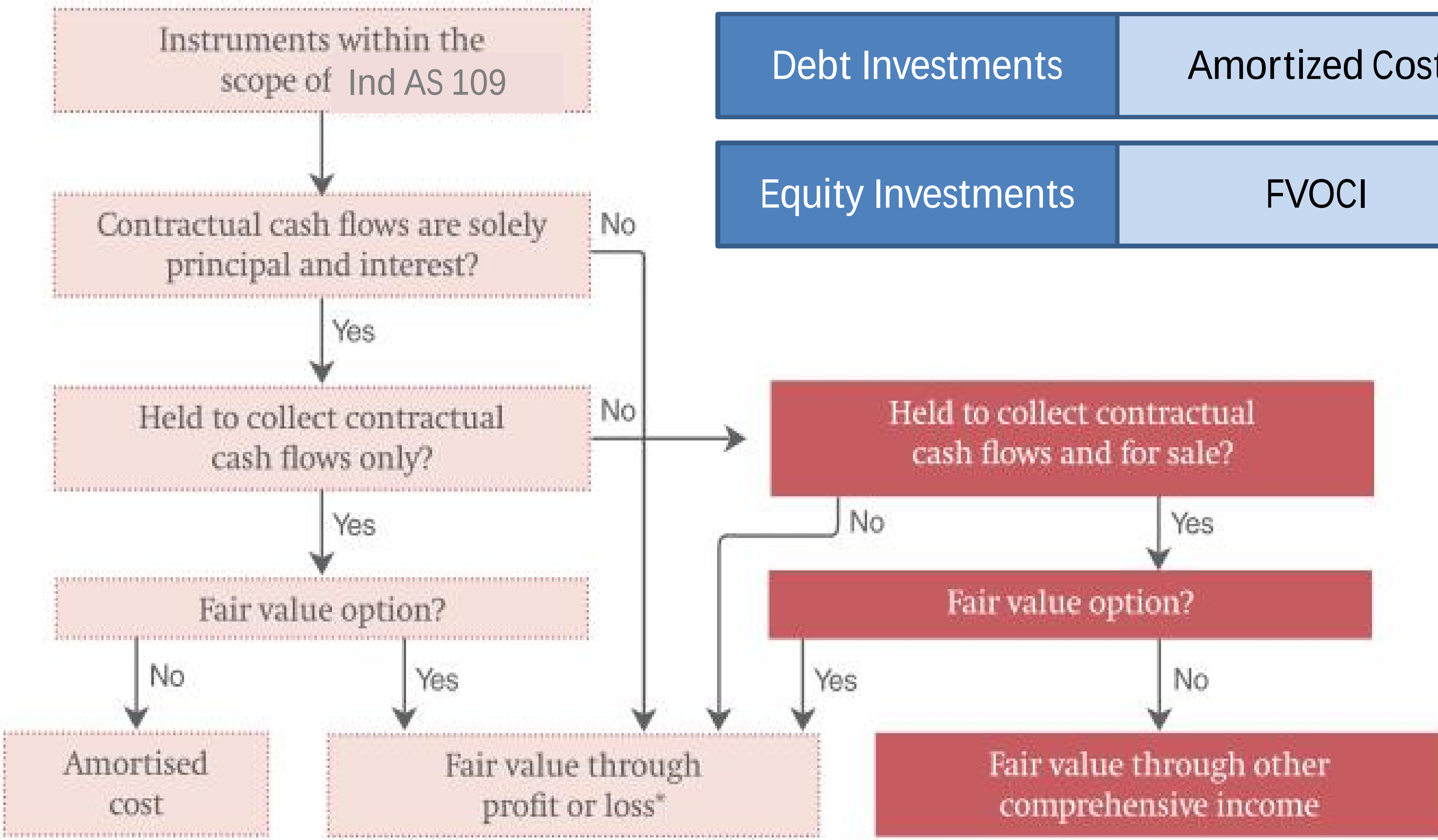
Equity Investments



* Presentation option for equity investments to present fair value changes in OCI

Investments
– *Common Classification*

Debt Investments	Amortized Cost
Equity Investments	FVOCI

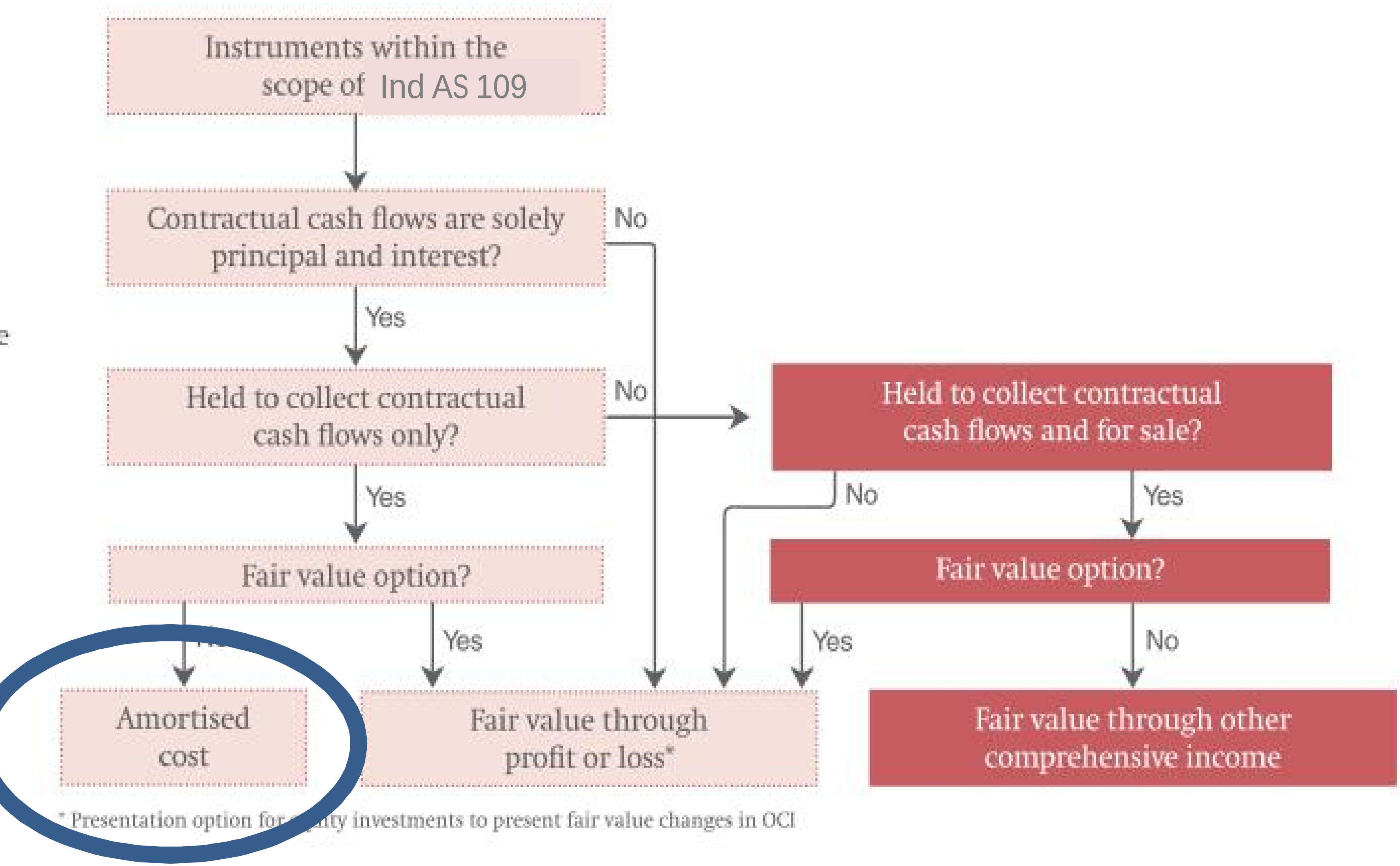


* Presentation option for equity investments to present fair value changes in OCI

Investments - Examples		Debt	Trading Shares	Strategic Investment in Shares
Invest		10 cr (assume no premium / discount)	10 cr	10 cr
Terms		10% Interest; Bullet repayment after 3 years	Ordinary shares with no special rights	Ordinary shares with no special rights
Accounting		*Amortized Cost* (since contractual interest and principal payments, in line with entity's business model and no fair value option taken)	*FVPL* (since no contractual interest and principal payments and FVOCI option not taken)	*FVOCI* (option)
End of Year 1	Fair Value	9	9	9
	Fair Value Change	1	1	1
	Accounting for Fair Value Change	NA	P&L	OCI
During Year 2	Selling Price	11	11	11
	Profit	1	2	2
	Accounting for Profit	P&L	P&L	OCI

Financial Liabilities

– *Common Accounting*



Reclassification

Only allowed (for financial assets*) if business model changes

__Examples:__
acquisition, disposal, or termination of business line

**Not allowed for financial liabilities*

Derecognition

Assets	Expiry of contractual rights, transfer of rights, obligation to pay cash flows, transfer of substantially all risks, transfer of control	*Examples:* Sale, assignment, securitization
Liabilities	Extinguishment, i.e. obligation discharged, cancelled or expires	*Example:* Discharge in normal course of business


Derivative

Derivative

Value changes in response to interest rates, financial instrument prices, commodity prices, currency rates, indices, credit rating, other variable

Little or no initial investment

Settled at future date

Derivatives
– *Examples*

- Forward contracts
- Interest rate swaps
- Cross-currency swaps
- Commodity futures

Embedded Derivative

Host + Embedded feature = Hybrid contract

If economic characteristics are closely related then no separation. Otherwise, embedded feature is separated and accounted for as derivative.

Embedded Derivatives
– *Examples*

Not Closely Related

- Put option in debt instrument, linked to ordinary share prices

Closely Related

- Lease rental linked to inflation
    - *No separation of base rental and inflation piece*


Accounting for Derivatives and Embedded Derivatives

At fair value

Fair Value of a Derivative

	Derivative Contract Rate	Balance Sheet Rate of Equivalent Contract	Derivative Gain / Loss	Accounting for Derivative Gain / Loss ***(without hedge accounting)***
Exporter: Forward Contract to pay USD and receive Rupee	60	62	2 Notional Loss	P&L
Borrower: IRS (Interest Rate Swap) – Floating to Fixed	10%	11%	1% Notional Gain	P&L
Borrower: IRS (Interest Rate Swap) – Fixed (10%) to Floating	Floating	11%	1% Notional Loss	P&L
Manufacturer: Copper Future (hedging raw material cost of forecast transaction)	100 per tonne	90 per tonne	10 loss per tonne	P&L

What is Hedge Accounting?

Accounting that protects the P&L from volatility by mirroring the entity's risk management activities


Hedge Accounting

	Derivative Contract Rate	Balance Sheet Rate of Equivalent Contract	Derivative Gain / Loss	Accounting for Derivative Gain / Loss ***(without hedge accounting)***	Hedge Accounting
Exporter: Forward Contract to pay USD and receive Rupee	60	62	2 Notional Loss	P&L	OCI
Borrower: IRS (Interest Rate Swap) – Floating to Fixed	10%	11%	1% Notional Gain	P&L	OCI
Borrower: IRS (Interest Rate Swap) – Fixed (10%) to Floating	Floating	11%	1% Notional Loss	P&L	P&L, along with Fair Value of hedged item, i.e. borrowing
Manufacturer: Copper Future (hedging raw material cost of forecast transaction)	100 per tonne	90 per tonne	10 loss per tonne	P&L	OCI

Hedge Accounting

Hedging Criteria

- Economic correlation, common hedge ratio
- Formal designation and documentation
- Eligible Instruments

What can be hedged

- Assets
- Liabilities
- Firm Commitments
- Highly Probable Forecast Transactions

Hedges
– *Examples*

Types of Hedge	Hedge Examples
Fair Value Hedge	• Forward contracts
Cash Flow Hedge	• Interest rate swaps
Hedge of Net Investment in Foreign Operation	• Cross-currency swaps
	• Commodity futures

Hedge Accounting

	Derivative Contract Rate	Balance Sheet Rate of Equivalent Contract	Derivative Gain / Loss	Accounting for Derivative Gain / Loss ***(without hedge accounting)***	Hedge Accounting
Exporter: Forward Contract to pay USD and receive Rupee	60	62	2 Notional Loss	P&L	OCI ***(Cash Flow Hedge)***
Borrower: IRS (Interest Rate Swap) – Floating to Fixed	10%	11%	1% Notional Gain	P&L	OCI ***(Cash Flow Hedge)***
Borrower: IRS (Interest Rate Swap) – Fixed (10%) to Floating	Floating	11%	1% Notional Loss	P&L	P&L, along with Fair Value of hedged item, i.e. borrowing ***(Fair Value Hedge)***
Manufacturer: Copper Future (hedging raw material cost of forecast transaction)	100 per tonne	90 per tonne	10 loss per tonne	P&L	OCI ***(Cash Flow Hedge)***

Hedge Accounting

Hedge accounting is a privilege, you *CAN* use it *IF YOU QUALIFY FOR HEDGE ACCOUNTING,* you can't use it if you don't qualify for hedge accounting, you need not use it if you do qualify

Equity versus Liability

	AS *(Legal form takes precedence)*	Ind AS *(Contractual substance takes precedence)*
Ordinary Equity Shares		
Redeemable Preference Shares		
Optionally Convertible Bonds		
Equity Shares with Put Options requiring cash settlement		
Compulsorily Convertible Debentures		
Obligation to issue Variable Number of Shares		


Equity versus Liability

	AS *(Legal form takes precedence)*	Ind AS *(Contractual substance takes precedence)*
Ordinary Equity Shares	Equity	
Redeemable Preference Shares	Equity	
Optionally Convertible Bonds	Liability	
Equity Shares with Put Options requiring cash settlement	Equity	
Compulsorily Convertible Debentures	Liability	
Obligation to issue Variable Number of Shares	???	


Equity versus Liability

	AS *(Legal form takes precedence)*	Ind AS *(Contractual substance takes precedence)*
Ordinary Equity Shares	Equity	Equity
Redeemable Preference Shares	Equity	Liability
Optionally Convertible Bonds	Liability	Split**
Equity Shares with Put Options requiring cash settlement	Equity	Liability
Compulsorily Convertible Debentures	Liability	Equity
Obligation to issue Variable Number of Shares	???	Liability

General concept: Residual Interest = Equity

***Under carve-out, FCCB will be entirely equity*

Disclosures

Qualitative Disclosures

- Accounting policies
- Risk management strategy
- Hedging activities
- Hedge effectiveness evaluation processes
- Credit risk management practices

Quantitative Disclosures

- Categories of financial instruments
- Carrying values and fair values of financial instruments
- Exposures to credit risk and amount mitigated through derivatives
- Income, expense, gain, loss
- OCI movements
- Credit risk movements
- Hedge movements

GAAP Differences – Common Examples

	AS	Ind AS
Forward Contract		
- *Existing receivable*	Amortize premium	Recognize MTM Gain / Loss
- *Forecast transaction*	Recognize MTM losses	Recognize MTM Gain / Loss
Interest Rate Swap	Recognize MTM losses	Recognize MTM Gain / Loss
Commodity Contract	Recognize MTM losses	Recognize MTM Gain / Loss

Fair Value Concepts of Ind AS 113

What is Fair Value?

What is Fair Value?

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

P Ltd shares are traded on the exchange. M Ltd holds a large block of shares. The market cannot absorb the block in one tranche. What is the fair value of P Ltd shares?

P Ltd shares are traded on the exchange. M Ltd holds a large block of shares. The market cannot absorb the block in one tranche. What is the fair value of P Ltd shares?

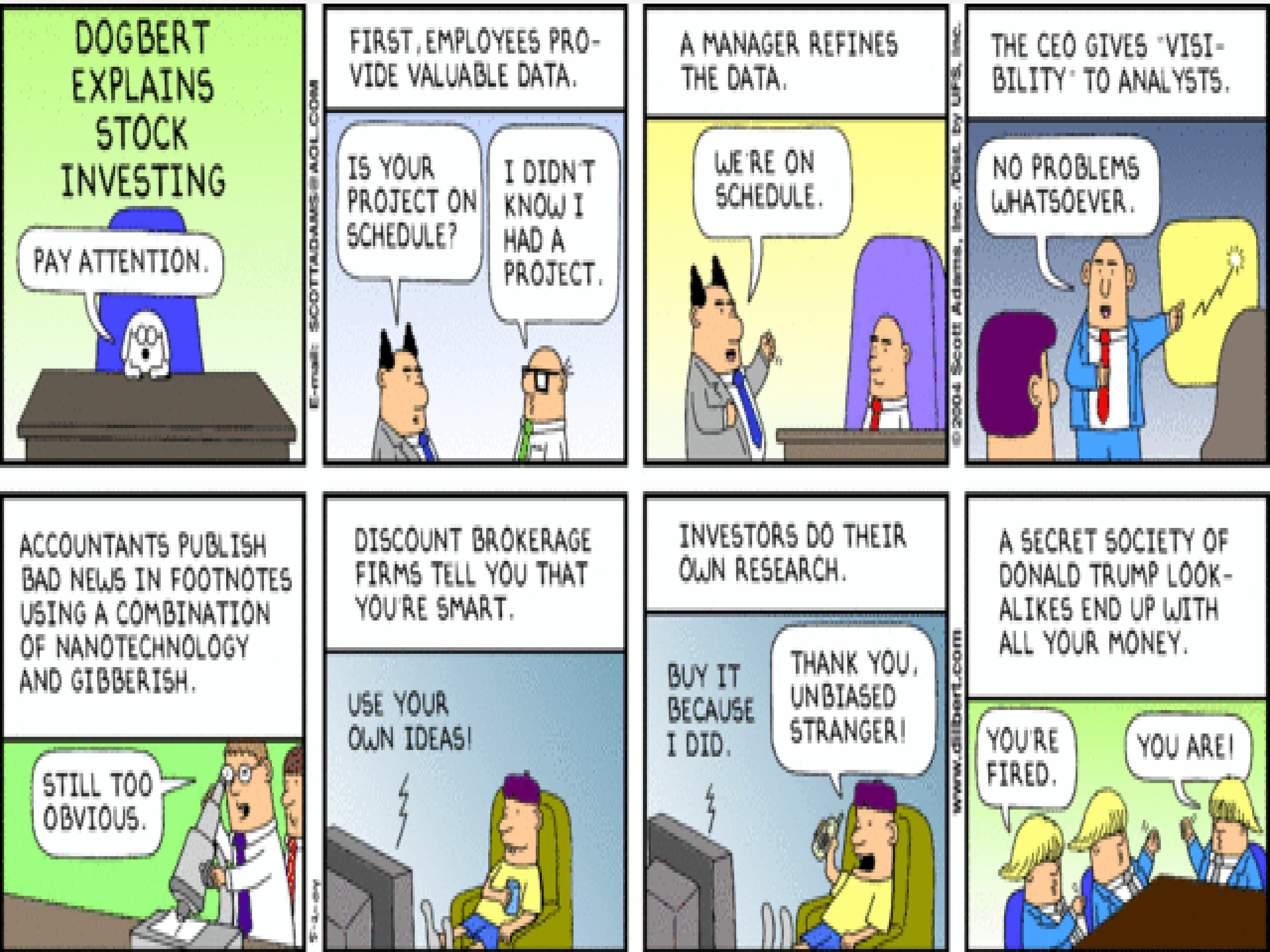
In quoted markets, fair value = P x Q , i.e. Ignore blockage factors.

Three Levels of Valuation Inputs

	Meaning	Examples
Level 1	Quoted prices in active markets for identical assets or liabilities that entity can access	Quoted prices in exchanges, brokered markets
Level 2	Inputs other than quoted prices included in Level 1 that are observable	Quoted prices of similar assets, yield curves
Level 3	Unobservable inputs	Replacement cost, present value calculation

Fair Valuation of Financial Instruments

Common Instruments	Common Valuation Sources / Techniques	
Quoted Shares	Quoted prices	Level 1
Unquoted Shares	Pricing Models	Level 3
Debt Instruments	Prices of comparative instruments, yield curve data, discounting using market rates	Level 2
Forward Contracts	Quoted forward rates	Level 1
Commodity Derivatives	Quoted futures rates	Level 1
Long Term Receivable	Discounting using market rates	Level 2



DOGBERT EXPLAINS STOCK INVESTING
PAY ATTENTION.
E-mail: SCOTTADAMS@AOL.COM
FIRST, EMPLOYEES PROVIDE VALUABLE DATA.
IS YOUR PROJECT ON SCHEDULE?
I DIDN'T KNOW I HAD A PROJECT.
A MANAGER REFINES THE DATA.
WE'RE ON SCHEDULE.
© 2004 Scott Adams, Inc./Dist. by UFS, Inc.
THE CEO GIVES "VISIBILITY" TO ANALYSTS.
NO PROBLEMS WHATSOEVER.
ACCOUNTANTS PUBLISH BAD NEWS IN FOOTNOTES USING A COMBINATION OF NANOTECHNOLOGY AND GIBBERISH.
STILL TOO OBVIOUS.
DISCOUNT BROKERAGE FIRMS TELL YOU THAT YOU'RE SMART.
USE YOUR OWN IDEAS!
INVESTORS DO THEIR OWN RESEARCH.
BUY IT BECAUSE I DID.
THANK YOU, UNBIASED STRANGER!
www.dilbert.com
A SECRET SOCIETY OF DONALD TRUMP LOOK-ALIKES END UP WITH ALL YOUR MONEY.
YOU'RE FIRED.
YOU ARE!

Further Reading

Further Reading

Some Useful Sources
icai.org
ifrs.org [standards, interpretations, work plan]
fasb.org
sec.gov
Accounting firms' guidance

Questions

Thank You