



IND AS 109
FINANCIAL INSTRUMENTS



DEFINITION



DEFINITION - FINANCIAL INSTRUMENT

- 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”.
- **Financial asset is**
 - cash
 - an equity instrument of another entity
 - a **contractual right**: -
 - to receive cash or another financial asset from another entity
 - to exchange financial assets or financial liabilities under favorable conditions
 - a **contract** that will or may be settled in the entity's own equity instruments and is
 - 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
 - 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



CLASSIFICATION & MEASUREMENT



CATEGORIES OF FINANCIAL ASSETS

Based on subsequent measurement

1

Amortised
cost

2

Fair Value

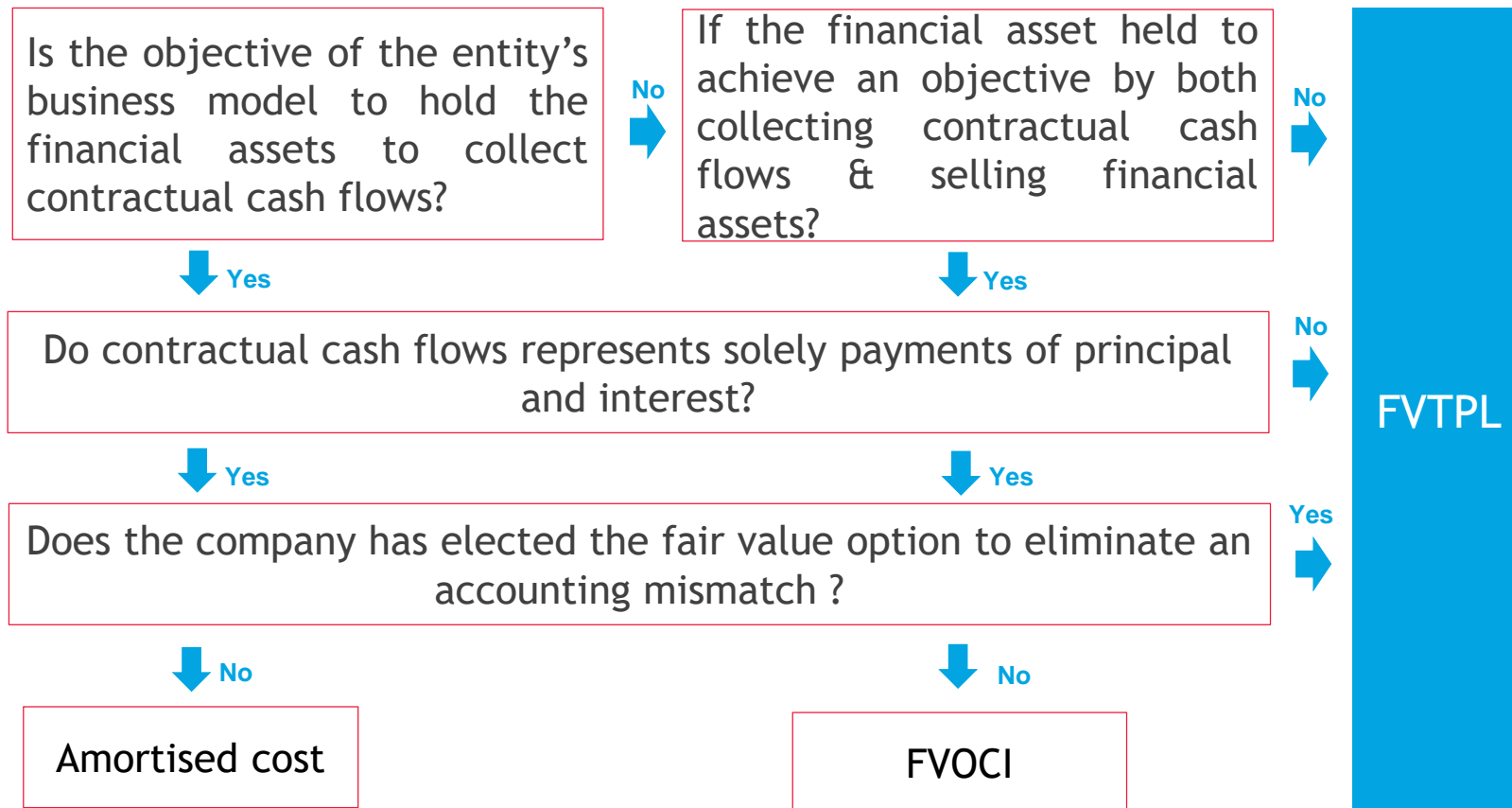
2A

Fair value
through OCI

2B

Fair value
through P&L

CLASSIFICATION - FINANCIAL ASSET



CLASSIFICATION - FINANCIAL ASSET

The classification categories that are possible for different financial assets are summarised below:

Measurement category	Type of financial asset		
	Derivative instrument	Equity Instrument	Debt Instrument
Amortised cost			✓
FVTOCI			
- classified			✓
- elected at initial recognition		✓	
FVTPL			
- classified	✓	✓	✓
- elected at initial recognition			✓

INVESTMENT IN EQUITY INSTRUMENT

- ▶ Ind AS 109 requires all investment in equity instruments to be measured at FVTPL. However, the standard also recognises that, cost may be an appropriate estimate of fair value for an unquoted equity investment. That may be the case if insufficient more recent information is available to measure fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range.

- ▶ On initial recognition, an entity may make an irrevocable election to present in other comprehensive income subsequent changes in fair value if an investment in equity instrument that is:
 - Neither held for trading; nor
 - contingent consideration recognised by an acquirer in a business combination.

- ▶ This election is irrevocable and can be made on an instrument-by-instrument basis on initial recognition.

- ▶ Held for trading means financial asset /liability
 - is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
 - on initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
 - A derivative



BUSINESS MODEL

What it is...

- ▶ a **matter of fact** and not merely an assertion
- ▶ determined by **entity's key management personnel (KMP)**
- ▶ determined at a level that reflects how **groups of financial assets are managed** together to achieve a particular business objective
- ▶ **observable through the activities** that the entity undertakes to achieve the objective of the business model
- ▶ a single entity may have **more than one business model** for managing its financial instruments

What it is not...

- ▶ **does not depend on management's intentions** for an individual instrument
- ▶ need not be determined at the reporting entity level
- ▶ not determined on the basis of scenarios that the entity does not reasonably expect to occur ('worst case' or 'stress case' scenarios)



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BUSINESS MODEL

- ▶ An entity must consider all relevant evidence that is available at the time business model assessment. Such relevant evidence includes, but is not limited to:
 - how the performance of the business model and the financial assets held within that business model are evaluated and reported to the entity's key management personnel;
 - the risks that affect the performance of the business model (and the financial assets held within that business model) and, in particular, the way in which those risks are managed; and
 - how managers of the business are compensated (for example, whether the compensation is based on the fair value of the assets managed or on the contractual cash flows collected)

'HOLD TO COLLECT' BUSINESS MODEL

Objective

- collect contractual payments over life of the instrument
- entity manages the assets held within the portfolio to collect those particular contractual cash flows

Factors to consider

Frequency of sales in prior periods

Value of sales in prior business

Timing of sales in prior periods

Reason for such sales

Expectations about future

Examples Of Exceptions

- policy to sell assets when there is an increase in the asset's credit risk or to manage credit concentration risk
- sales close to maturity of the assets where proceeds approximate remaining contractual cash flows
- increased sales in a particular period if the entity can explain the reasons for the sales



HOLD TO COLLECT' BUSINESS MODEL - EXAMPLE

Sales in a held-to-collect business model

Example

Entity A has a portfolio of financial assets which is part of a held-to-collect business model. Due to change in legal requirement, entity A has sell some of the assets and has to significantly rebalance its portfolio.

Whether, business model needs to be assessed or changed

Solution

No, as the selling activity is considered an isolated or one time event.

However, if the rules require entity A to routinely sell financial assets from its portfolio and the value of assets sold is significant, entity A's business model would not be held-to-collect.

'HOLD TO COLLECT AND SELL' BUSINESS MODEL

- ▶ KMP's decision - **both**:
 - collecting contractual cash flows and
 - selling financial assetsare **integral** to achieving the objective of the business model
- ▶ compared to 'hold to collect' business model, this business model will typically involve greater **frequency** and **value** of sales
- ▶ no threshold for the frequency or value of sales
- ▶ **Examples** of **objectives consistent** with 'hold to collect and sell' business model:
 - manage everyday liquidity needs
 - maintain a particular interest yield profile
 - match the duration of the financial assets to the duration of the liabilities that those assets are funding



HOLD TO COLLECT & SELL BUSINESS MODEL - EXAMPLE

Holding investments in anticipation of capital expenditure

Example

Entity A is planning a capital expenditure in five years. For funding the expansion, entity A invested, funds in financial assets. However the maturity of financial assets does not match with the period of capital expenditure.

Entity A might hold the financial assets, till its maturity or will sell before maturity, if they fetch higher returns. Remuneration of the portfolio's managers is based on return from the assets.

Solution

Entity A's objective for managing the financial assets is achieved by both collecting contractual cash flows and selling financial assets.



'OTHER' BUSINESS MODELS - THE RESIDUAL CATEGORY

- ▶ Financial assets are measured at fair value through profit or loss if they are not held within a business model whose objective is:
 - to hold assets to collect contractual cash flows, or
 - achieved by both collecting contractual cash flows and selling financial assets

- ▶ Examples
 - assets managed with the objective of realising cash flows through sale
 - a portfolio that is managed, and whose performance is evaluated, on a fair value basis
 - a portfolio that meets the definition of 'held-for-trading'

'SOLELY PAYMENT OF PRINCIPAL AND INTEREST' ('SPPI') TEST

- ▶ Contractual cash flows that are SPPI are consistent with a [basic lending arrangement](#)
- ▶ [Principal](#) is the fair value of the financial asset at initial recognition - principal amount may change over the life of the financial asset (for example, if there are repayments of principal)
- ▶ [Interest elements](#) - consideration consistent with basic lending arrangement:
 - time value of money
 - credit risk
 - other basic lending risks (example, liquidity risk)
 - costs associated with holding the financial asset for a particular period of time
 - profit margin that is consistent with a basic lending arrangement
- ▶ Assessment done in the [currency in which financial asset is denominated](#)



SPPI TEST

Examples of terms inconsistent with basic lending arrangement

- ▶ Contractual terms that **introduce exposure to risks or volatility in the contractual cash flows** that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices

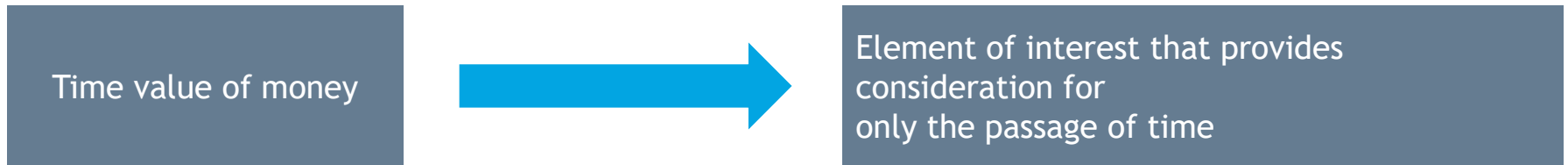
Examples

- Interest rate is linked with equity index
 - A simple loan Interest is linked with gold index
-
- ▶ **Leverage increases the variability of the contractual cash flows** with the result that they do not have the economic characteristics of interest.

Examples

- Interest is leveraged - say 3 times of risk free rate
- Indian loan interest rate is 5 times of EPS of the company

CONSIDERATION FOR TIME VALUE OF MONEY



- ▶ In order to assess whether the element provides consideration for only the passage of time, an entity:
 - applies judgment
 - considers relevant factors such as
 - currency in which the financial asset is denominated
 - period for which the interest rate is set
 - assesses nature of modification to time value of money element



CONTRACTUAL CASH FLOWS CHARACTERISTICS TEST

Non-genuine and de minimis contractual terms

- ▶ An entity need not take into consideration any contractual cash flows characteristics that do not represent SPPI if they could only have a ‘de minimis’ effect on the contractual cash flows of the financial asset.
- ▶ In considering whether the effect is ‘de minimis’, an entity must consider the possible effect of the contractual cash flow characteristic in each reporting period and cumulatively over the life of the financial instrument.
- ▶ Additionally, if a contractual cash flow characteristic could have an effect on the cash flows that is more than de minimis but that characteristic is not genuine, it does not affect the classification of a financial asset.
- ▶ A cash flow characteristics is not genuine if it affects the instrument’s cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur.



CONTRACTUAL CASH FLOWS CHARACTERISTICS TEST

Non-contractual terms

- ▶ The contractual cash flow characteristics test should consider only those provisions that form part of the contractual arrangement.
- ▶ In some cases, the return to the holder receives may depend on non-contractual term, for example, a statutory right which impact the amount of contractual cash flows that the holder receives



CONTRACTUAL CASH FLOWS CHARACTERISTICS TEST

Non-contractual terms - Example

Example

Instrument E is issued by a regulated bank and has a stated maturity date. The instrument pays a fixed interest rate and all contractual cash flows are non-discretionary

However, the issuer is subject to legislation that permits or requires national resolving authority to impose losses on holders of particular instruments, including Instrument E, in particular circumstances. For example, the national resolving authority has the power to write-down the par amount of Instrument E or to convert it into a fixed number of the issuer's ordinary shares if the national resolving authority determines that the issuer is having severe financial difficulties, needs additional regulatory capital or is 'failing'

Analysis:

The holder would analyse the contractual terms of the financial instrument to determine whether they give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding and thus are consistent with basic lending arrangement.

That analysis would not consider the payments that arise only as a result of the national resolving authority's power to impose losses on the holders of Instrument E. That is because that power, and the resulting payments, are not contractual terms of the financial instrument



CONTRACTUAL CASH FLOWS CHARACTERISTICS TEST

Extension option

- ▶ A contract may permit the issuer to extend the term of the borrowing, or permit the holder to extend the term of its lending.
- ▶ A financial asset passes contractual cash flow characteristics test if the terms of the extension option result in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding.
- ▶ If these conditions are met, the financial asset could still be measured at amortised cost or FVOCI, subject to satisfying the business model assessment.



CONTRACTUAL CASH FLOWS CHARACTERISTICS TEST

Extension option

Example

Entity U lends Rs. 10 million to Entity V at a fixed interest rate; the loan is repayable in 3 years. Entity V has the right to extend the term of the borrowing by further 2 years. If entity V wishes to exercise its right to extend its borrowings, it must make the election in the final year prior to maturity.

The principal of loan payable in Year 5 (i.e. after extension) will be based on the movements in the BSE-100 equity price index from the start of Year 4

Analysis:

The extension option inherent in the loan breaches the contractual cash flow characteristics test because, although the option is not contingent on future events, the extended loan would not provide Entity U with payment of only principal and interest on principal amount outstanding because principal return is derived from an equity price index.

CONTRACTUAL CASH FLOWS CHARACTERISTICS TEST

Prepayment option

- ▶ A contract may permit the issuer to prepay, or the holder to put back, a debt instrument before maturity.
- ▶ A prepayment option that is exercisable only when an event happens that is unrelated to the risks associated with the basic lending arrangement may not pass the contractual cash flow characteristics test.
- ▶ If all other contractual cash flow of the financial assets pass the contractual cash flow characteristics test other than the prepayment feature, and despite the requirements to assess the contingent event in case where the prepayment option is subject to contingent event, the instrument will pass the SPPI test if :
 - the entity acquires or originates the financial asset at a premium or discount to the contractual par amount;
 - the prepayment amount substantially represents the contractual par amount and accrued (but unpaid) contractual interest, which might include reasonable additional compensation for the early termination of the contract; and
 - when the entity initially recognises the financial asset, the fair value of the prepayment feature is insignificant.



CONTRACTUAL CASH FLOWS CHARACTERISTICS TEST

Prepayment option - Example

Example

IND AS 109 states that “a contractual term that permits the issuer (i.e. the debtor) to prepay a debt instrument or permits the holder (i.e. the creditor) to put a debt instrument back to the issuer before maturity and the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract results in contractual cash flows that are solely SPPI

Assume that a similar contract issued at par permits the issuer to repay the debt instrument or the holder to put the debt instrument back to the issuer before maturity at par when the FTSE 100 index reaches a specific level. If the contingent event takes place, but only the timing of the cash flow changes (resulting in a prepayment that represents unpaid amounts of principal and interest on the principal amount outstanding), does this always pass the SPPI test?

Analysis:

The contingent event in the example above (the FTSE 100 index reaching a specific level) changes the timing of the cash flows but still results in the redemption of the debt for an amount equal to par plus accrued interest. Therefore, it will always pass the SPPI test, because the cash flows still represent solely payments of principal and interest on the principal amount outstanding. If on the other hand, the debt instrument was issued at a discount, but is repayable at par, this may represent compensation to the issuer for the FTSE achieving the target level which is not congruent with SPPI.



CONTRACTUAL CASH FLOWS CHARACTERISTICS TEST

Examples of financial assets that fail contractual cash flow characteristics test

- ▶ Investments in equity instrument;
- ▶ Derivative financial asset;
- ▶ Investment in convertible bond or loan note;
- ▶ A purchased option to buy a financial asset;
- ▶ Investment in dual currency bond or loan note;
- ▶ Investment in an equity-linked note where, at redemption, repayment of principal is derived from movements in a specified equity price index;
- ▶ Investment in property loan where amount repayable on redemption is derived from the proceeds realised on the disposal of the property by the issuer;

THE CONCEPT OF AMORTISED COST

Financial assets

$$\text{Amortised cost} = \text{Amount initially recognised} - \text{Principal repayments} +/\text{- cumulative amortisation using EIR} - \text{Impairment}$$

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.

No option to use straight line method



RECLASSIFICATION





RECLASSIFICATION

Scope, timing and definition

- ▶ Reclassification of financial assets **is required if and only if** the objective of the entity's business model for managing those financial assets changes.

- ▶ Such changes are expected to be **very infrequent** and are determined by the entity's senior management as a result of internal or external changes and must be significant to entity's operations and demonstrable to external parties.

- ▶ A change in the objective of an entity's business model will occur only when an entity **either begins or ceases to carry out an activity that is significant to its operations.**

- ▶ Following are not considered to be change in business model:
 - a change in intention related to particular financial assets.
 - the temporary disappearance of a particular market for financial assets.
 - a transfer of financial assets between parts of the entity with different business models.

- ▶ Reclassification applies prospectively from the reclassification date, defined as the first date of the first reporting period following the change in the business model and therefore previously recognised gains, losses or interest are not restated.

RECLASSIFICATION

		Reclassified to		
		Amortised Cost	FVTOCI	FVTPL
Reclassified from	Amortised Cost	NA	<ul style="list-style-type: none"> Recognise at fair value and difference between fair value and closing amortised cost is recognised in OCI. The EIR and the measurement of expected credit losses are not adjusted. 	<ul style="list-style-type: none"> Recognise at fair value with the difference between fair value and closing amortised cost is recognised in profit or loss. The EIR and the impairment gains or losses are not required to be separately recognised following classification.
	FVTOCI	<ul style="list-style-type: none"> Closing fair value plus/less the cumulative amount in OCI at the reclassification date becomes the new amortised cost gross opening carrying amount. The EIR and the measurement of expected credit losses are not adjusted. This adjustments affects OCI but does not affect profit or loss and therefore is not an Ind AS 1 reclassification adjustment. 	NA	<ul style="list-style-type: none"> Continue to measure at fair value with cumulative amount in OCI reclassified immediately to profit or loss as an Ind AS 1 reclassification adjustment. An EIR and impairment gains or losses are not required to be separately recognised following classification.

RECLASSIFICATION

	Reclassified to			
		Amortised Cost	FVTOCI	FVTPL
Reclassified from	FVTPL	<ul style="list-style-type: none"> Closing fair value becomes the new amortised cost opening gross carrying amount. At reclassification date a new EIR and measurement of expected credit losses will be determined. 	<ul style="list-style-type: none"> Continue to measure at fair value with a new EIR and measurement of a loss allowance for expected credit losses will be determined at the reclassification date. 	NA



THANK YOU