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Accounting and Reporting of Financial Instruments

1. Introduction

During the last few years, a number of new financial instruments have assumed significance in the Indian economy. With rapid globalisation, this trend is likely to accelerate in future. Derivatives are financial instruments whose values change in response to the change in an underlying which can be specified interest rates, security prices, commodity prices, index of prices or rates, or similar variables. Typical examples of derivatives are futures and forward contracts, swaps and option contracts.

The Institute of Chartered Accountants of India came out with the Accounting Standards 30, 31, 32 for recognition, measurement, presentation and disclosures of financial instruments in the year 2009. However, they were not notified by the Ministry of Corporate Affairs and hence not made mandatory. Earlier, these standards were to be made mandatory for Level I Entities only. Now, since the Ind ASs have been notified, the same would be applicable in respect of Level I Entities w.e.f 1.4.2016 and Level II entities w.e.f. 1.4.2017 and 1.4.2018, as the case may be. Consequently, AS 30, 31 and 32 are no longer relevant to corporate entities. For non-corporate entities also, the status of AS 30, 31 and 32 is only “encouraged to be followed”. Therefore, AS 30, 31 and 32 had been removed from the syllabus and in place of it Ind AS 32, Ind AS 107 and Ind AS 109 have been made applicable.

Accordingly, this chapter has been revised on the basis of the provisions of Ind AS 32 “Financial Instruments: Presentation”, Ind AS 107 “Financial Instruments: Disclosures” and Ind AS 109 “Financial Instruments”.

2. Meaning of Financial Instrument

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.

‘Contract’ and ‘contractual’ refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law.

Contracts, and thus financial instruments, may take a variety of forms and need not be in writing. Financial Instruments may be classified as primary and derivative financial instruments. The classifications can be shown as:
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2.1 Meaning of Financial Asset

A financial asset is any asset that is:

(a) cash;

1. Currency (cash) is a financial asset because it represents the medium of exchange and is therefore the basis on which all transactions are measured and recognised in financial statements.

2. A deposit of cash with a bank or similar financial institution is a financial asset because it represents the contractual right of the depositor to obtain cash from the institution or to draw a cheque or similar instrument against the balance in favour of a creditor in payment of a financial liability.

(b) an equity instrument of another entity;

(Example: Investment in equity shares of another company)

(c) a contractual right to:

(i) receive

♦ cash or

♦ another financial asset from another entity; or

Common examples of financial assets representing a contractual right to receive cash in the future and corresponding financial liabilities representing a contractual obligation to deliver cash in the future are:

(a) trade accounts receivable and payable;

(b) notes receivable and payable;

(c) loans receivable and payable; and

(d) bonds receivable and payable.

In each case, one party’s contractual right to receive (or obligation to pay) cash is matched by the other party’s corresponding obligation to pay (or right to receive).

Another type of financial instrument is one for which the economic benefit to be received or given up is a financial asset other than cash. There can be chain of financial instruments that give right to receive financial asset. However, the chain
should always end with a financial asset that gives rise to contractual right to receive case to one party and contractual obligation to pay cash or issue equity to another party.

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. The bonds are financial assets because they represent obligations of the issuing government to pay cash. The note is, therefore, a financial asset of the note holder and a financial liability of the note issuer.

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable 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 puttable financial instruments, instruments that impose on the entity an obligation to deliver to another party a pro-rata share of the net assets of the entity only on liquidation or instruments that are contracts for the future receipt or delivery of the entity’s own equity instruments if such instruments are classified as equity instruments.

2.2 Meaning of Financial Liability

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, it excludes rights, options or warrants used to acquire a fixed number of the entity’s own equity instruments for a fixed amount of any currency since they are equity instruments.
instruments if the entity offers the rights, options or warrants pro-rata to all of its existing owners of the same class of its own non-derivative equity instruments.

**Points to remember**

1. A contractual right or contractual obligation to receive, deliver or exchange financial instruments is itself a financial instrument.

2. A *chain* of contractual rights or contractual obligations meets the definition of a financial instrument if it will *ultimately lead to the receipt or payment of cash* or to the acquisition or issue of an equity instrument.

3. The ability to exercise a contractual right or the requirement to satisfy a contractual obligation may be absolute or contingent on the occurrence of a future event.

4. A contingent right and obligation meet the definition of a financial asset and a financial liability, even though such assets and liabilities are not always recognised in the financial statements. Some of these contingent rights and obligations may be insurance contracts within the scope of Ind AS 104.

**For example:** A financial guarantee is a contractual right of the lender to receive cash from the guarantor, and a corresponding contractual obligation of the guarantor to pay the lender, if the borrower defaults. Here the financial guarantee may actualize in contingent circumstances therefore, it shall be constituted as financial instrument as per Ind AS 32.

**Illustration 1 (Exchange of Financial Liability at Unfavourable terms)**

A company borrowed `50 lacs @ 12% p.a. Tenure of the loan is 10 years. Interest is payable every year and the principal is repayable at the end of 10th year. The company defaulted in payment of interest for the year 4, 5 and 6.

A loan reschedule agreement took place at the end of 7th year. As per the agreement the company is required to pay `90 lacs at the end of 8th year. Calculate the additional amount to be paid on account of rescheduling and also the book value of loan at the end of 8th year when reschedule agreement took place.

**Solution**

Assumption: Interest is compounded in case of default.

Outstanding Amount at the end of 8th year = `50,00,000 x 1.12 x 1.12 x 1.12 x 1.12 x 1.12

= `88,11,708 (i.e. adding interest for 4th to 8th year)

Rescheduled amount to be paid at the end of the 8th year = `90,00,000

Additional amount to be paid on rescheduling = `90,00,000 - `88,11,708 = `1,88,291

**Illustration 2**

**Entity A holds an option to purchase equity shares in a listed entity B for `100 per share at the end of a 90 day period. Evaluate the contract whether a financial asset or a financial liability? What if the entity A has written the option and the price of the share on the expiry date is `120?**
Solution

The above call option gives entity A, a contractual right to exchange cash of ₹100 for an equity share in another entity and will be exercised if the market value of the share exceeds ₹100 at the end of the 90 day period. If the market value of a share will be such that the entity A will gain on the exercise date, it will exercise the call option.

Since entity A stands to gain if the call option is exercised, the exchange is potentially favourable to the entity. Also, the determination of whether the option is a derivative is dependent on whether it satisfies all the following conditions as contained in the definition of derivative and not whether the contract is potentially favourable or unfavourable:

1. Its value changes on the basis of the change in some variable. If the variable is a non-financial variable, it is not specific to a party to the contract
2. It requires no or little initial net investment
3. It is settled at a future date.

Therefore, the option is a derivative financial asset from the time the entity becomes a party to the option contract.

On the other hand, if entity A writes an option under which the counterparty can force the entity to sell equity shares in the listed entity B for ₹100 per share at any time (if it is an American option∗) in the next 90 days, then entity A will be said to have a contractual obligation to exchange its equity shares to another entity for cash of ₹100 per share on potentially unfavourable∗∗ terms i.e. if the holder exercises the option, on account of the market price per share being above the exercise price of ₹100 per share at the end of the 90 day period.

Since entity A, the writing party will have to buy shares from the market at ₹120 and sell those to the purchasing party at ₹100, it stands to lose if the option is exercised. Therefore, the exchange is potentially unfavourable and the option is a derivative financial liability from the time the entity becomes a party to the option contract.

Clarifications

1. ‘Perpetual’ debt instruments (such as ‘perpetual’ bonds, debentures and capital notes):

   Perpetual debt instruments normally provide the holder with the contractual right to receive payments on account of interest at fixed dates extending into the indefinite future, either

∗ The purchase option is an example of european option where the exercise happens at the expiry date whereas the written option is an american option where the exercise can happen at any time before the expiry date.

∗∗ Whether a derivative is favourable or unfavourable is determined at the end of each reporting period. At the date the contract is entered into, it is neither favourable or unfavourable. It is neutral and therefore the premium paid for the option is its fair value as on that date.
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with no right to receive a return of principal or a right to a return of principal under terms that make it very unlikely or very far in the future.

For example:

An entity may issue a financial instrument requiring it to make annual payments in perpetuity equal to a stated interest rate of 8 per cent applied to a stated par or principal amount of ₹1,000. Assuming 8 per cent to be the market rate of interest for the instrument when issued, the issuer assumes a contractual obligation to make a stream of future interest payments having a fair value (present value) of ₹1,000 on initial recognition. The holder and issuer of the instrument have a financial asset and a financial liability, respectively.

2. Leases under Ind AS 17:

A **finance lease** is regarded as primarily an entitlement of the lessor to receive, and an obligation of the lessee to pay, a stream of payments that are substantially the same as blended payments of principal and interest under a loan agreement.

The lessor accounts for its investment in the amount receivable under the lease contract rather than the leased asset itself.

An **operating lease**, on the other hand, is regarded as primarily an uncompleted contract committing the lessor to provide the use of an asset in future periods in exchange for consideration similar to a fee for a service. The lessor continues to account for the leased asset itself rather than any amount receivable in the future under the contract.

Accordingly, a finance lease is regarded as a financial instrument and an operating lease is not regarded as a financial instrument (except as regards individual payments currently due and payable).

3. Physical assets (such as inventories, property, plant and equipment), leased assets and intangible assets (such as patents and trademarks):

There is no contract existing for tangible assets recognised. Even if a contract is existing, the same is a contract to buy or sell non-financial item and hence not a financial instrument.

Also, physical assets, leased assets and intangible assets are not financial assets because control of such physical and intangible assets creates an opportunity to generate an inflow of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset.

4. Assets (such as prepaid expenses):

Future economic benefit from prepaid expenses is the receipt of goods or services, rather than the right to receive cash or another financial asset. Therefore, such prepaid expenses shall not be considered as financial assets.

Similarly, items such as deferred revenue and most warranty obligations are not financial liabilities because the outflow of economic benefits associated with them is the delivery of
goods and services rather than a contractual obligation to pay cash or another financial asset.

5. **Liabilities or assets that are not contractual:**

Non contractual liabilities or assets are not financial liabilities or financial assets. Income taxes that are created as a result of statutory requirements imposed by Governments are accounted in accordance with Ind AS 12.

Similarly, constructive obligations, as defined in Ind AS 37, “Provisions, Contingent Liabilities and Contingent Assets”, do not arise from contracts and hence are not financial liabilities.

### 2.3 Meaning of Equity Instrument

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

**Examples of equity instruments:**

- Non-puttable Ordinary Shares
- Puttable Instruments (If not financial liabilities and specific conditions are met)
- Instruments imposing obligation to deliver pro rata share in Net Assets only on Liquidation (If not financial liabilities and specific conditions are met)
- Preference Shares (when distribution is at the discretion of the issuer)
- Warrants or Written call options

#### 2.3.1 Criteria for Classification of Equity Instruments

1. **Puttable Financial Instrument:**

   A puttable financial instrument includes a *contractual obligation for the issuer* to repurchase or redeem that instrument for cash or another financial asset on exercise of the put. Therefore, it is a financial liability.

   However, as an exception, such an instrument is classified as an equity instrument if it has all the following features:
Instrument specific conditions

(a) It entitles the holder to a pro rata share of the entity’s net assets in the event of the entity’s liquidation. The entity’s net assets are those assets that remain after deducting all other claims on its assets.

A pro rata share is determined by:

\[
\text{Entity's net assets on liquidation} / \text{Number of units} \times \text{Number of units held by the financial instrument holder}
\]

(b) The instrument is in the class of instruments that is subordinate to all other classes of instruments.

The following conditions must be fulfilled to be in such a class the instrument:

(i) Has no priority over other claims to the assets of the entity on liquidation, and
(ii) Does not need to be converted into another instrument before it is in the class of instruments that is subordinate to all other classes of instruments

(c) All financial instruments in the class of instruments that is subordinate to all other classes of instruments shall have identical features.
For example:
They must all be puttable, and the formula or other method used to calculate the repurchase or redemption price is the same for all instruments in that class.

(d) Apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, the instrument does not include any 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 unfavourable to the entity, and it is not a contract that will or may be settled in the entity’s own equity instruments.

(e) The total expected cash flows attributable to the instrument over the life of the instrument are based substantially on:
(i) The profit or loss
(ii) The change in the recognised net assets or
(iii) The change in the fair value of the recognised and unrecognised net assets of the entity over the life of the instrument (excluding any effects of the instrument)

Issuer Specific Conditions

In addition to the instrument having all the above features, the issuer must have no other financial instrument or contract that has:

(a) Total cash flows based substantially on
(i) The profit or loss
(ii) The change in the recognised net assets or
(iii) The change in the fair value of the recognised and unrecognised net assets of the entity (excluding any effects of such instrument or contract)

(b) The effect of substantially restricting or fixing the residual return to the puttable instrument holders

In case an Entity cannot carry out the above 2 tests, the puttable instrument is classified as a Financial Liability and if all the above conditions are satisfied than it will be treated as an equity instrument.

2. Instruments, or components of instruments, that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation

An instrument that includes such an obligation is classified as an equity instrument if it has all the following features:
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Instrument Specific Conditions

(a) It entitles the holder to a pro rata share of the entity’s net assets in the event of the entity’s liquidation. The entity’s net assets are those assets that remain after deducting all other claims on its assets.

A pro rata share is determined by:

\[
\text{Entity’s net assets on liquidation} \times \frac{\text{Number of units}}{\text{Number of units held by the financial instrument holder}}
\]

(b) The instrument is in the class of instruments that is subordinate to all other classes of instruments.

To be in such a class the instrument:

(i) Has no priority over other claims to the assets of the entity on liquidation, and
(ii) Does not need to be converted into another instrument before it is in the class of instruments that is subordinate to all other classes of instruments

(c) All financial instruments in the class of instruments that is subordinate to all other classes of instruments must have an identical contractual obligation for the issuing entity to deliver a pro rata share of its net assets on liquidation.

Issuer Specific Conditions

In addition to the instrument having all the above features, the issuer must have no other financial instrument or contract that has:

(a) Total cash flows based substantially on

(i) The profit or loss
(ii) The change in the recognised net assets or
(iii) The change in the fair value of the recognised and unrecognised net assets of the entity (excluding any effects of such instrument or contract)

(b) The effect of substantially restricting or fixing the residual return to the puttable instrument holders.

If all the conditions stated above are satisfied then instruments, or components of instruments, that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation will be treated as an equity instrument.

3. Preference Shares

Preference shares may be issued with various rights.

In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability.
Preference share is the name given to any share that has some preferential rights in relation to other classes of shares, particularly in relation to ordinary shares. These preferential rights are of great variety, but refer normally to the right to a fixed dividend, although they could also refer to the right on winding up to receive a fixed part of the capital or otherwise to participate in the distribution of the company's assets (share with such rights are often known as participating preference shares).

Redemption option:

1. A preference share that provides for redemption on a specific date or at the option of the holder contains a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share.

   Note: The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves, does not negate the obligation.

2. An option of the issuer to redeem the shares for cash does not satisfy the definition of a financial liability because the issuer does not have a present obligation to transfer financial assets to the shareholders.

   In this case, redemption of the shares is solely at the discretion of the issuer. An obligation may arise, however, when the issuer of the shares exercises its option, usually by formally notifying the shareholders of an intention to redeem the shares.

   Note: When preference shares are non-redeemable, the appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument.

Distributions:

When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments. Also, if distributions to the holders of the preference shares is cumulative, the issuer has an obligation to distribute and if not distributed it accumulates. Where such accumulation is to be paid only on liquidation, then the preference shares could be classified as equity.

However, a question arises that whether the accumulation of dividend payable is off the books? If the obligation to accumulated dividend and pay on liquidation does not satisfy the exceptions specified in paragraphs 16C and 16D of Ind AS 32 for classifying an instrument that is payable only on liquidation as an equity. Therefore, the accumulation of dividend will always be recognised as liability. Such an instrument is a compound financial instrument.

4. Warrants or written call options:

Warrants or written call options that allow the holder to subscribe for or purchase a fixed number of non-puttable ordinary shares in the issuing entity in exchange for a fixed amount of cash or another financial asset.
Illustration 3 (Mandatorily Redeemable Preference Shares with Mandatory Fixed Dividends)

A Company has issued 6% mandatorily redeemable preference shares with mandatory fixed dividends. Evaluate whether such preference shares are an equity instrument or a financial liability to the issuer entity?

Solution

In determining whether a mandatorily redeemable preference share is a financial liability or an equity instrument, it is necessary to examine the particular contractual rights attaching to the instrument's principal and return components.

The instrument in this example provides for mandatory periodic fixed dividend payments and mandatory redemption by the issuer for a fixed amount at a fixed future date. Since there is a contractual obligation to deliver cash (for both dividends and repayment of principal) to the shareholder that cannot be avoided, the instrument is a financial liability in its entirety.

Illustration 4 (Non-redeemable Preference Shares with Mandatory Fixed Dividends)

A Company issued non-redeemable preference shares with mandatory fixed dividends. Evaluate whether such preference shares are an equity instrument or a financial liability to the issuer entity?

Solution

When preference shares are non-redeemable, the appropriate classification is determined by the other rights attached to them. Classification is based on an assessment of the contractual arrangement's substance and the definitions of a financial liability and an equity instrument.

It is necessary to examine the particular contractual rights attaching to the instrument's principal and return components. In this example, the shares are non-redeemable and thus the amount of the principal has equity characteristics, but the entity has a contractual obligation to pay dividends that provides the shareholders with a lender's return. This obligation is not negated if the entity is unable to pay the dividends because of lack of funds or insufficient distributable profits. Therefore, the obligation to pay the dividends meets the definition of a financial liability.

The overall classification is that the shares may be a compound instrument, which may require each component to be accounted for separately. It would be a compound instrument if the coupon was initially set at a rate other than the prevailing market rate or the terms specified payment of discretionary dividends in addition to the fixed coupon. If the coupon on the preference shares was set at market rates at the date of issue and there were no provisions for the payment of discretionary dividends, the entire instrument would be classified as a financial liability, because the stream of cash flows is in perpetuity.

Illustration 5 (Non-redeemable Preference Shares with Dividend Payments linked to Equity Shares)

A company issued Non-redeemable preference shares with dividend payments linked to equity shares. Evaluate whether such preference shares are an equity instrument or a financial liability to the issuer entity?
Solution

An entity issues a non-redeemable preference shares on which dividends are payable only if the entity also pays a dividend on its equity shares.

The dividend payments on the preference shares are discretionary and not contractual, because no dividends can be paid if no dividends are paid on the equity shares, which are an equity instrument. As the perpetual preference shares contain no contractual obligation ever to pay dividends and there is no obligation to repay the principal, they should be classified as equity in their entirety.

Where the dividend payments are also cumulative, that is, if no dividends are paid on the equity shares, the preference dividends are deferred, the perpetual shares will be classified as equity only if the dividends can be deferred indefinitely and the entity does not have any contractual obligations whatsoever to pay those dividends. This is an exception to the classification principle that certain instruments that are payable only on liquidation can be classified as equity (paragraphs 16C and 16D of Ind AS 32). However, generally, preference shares are not subordinate to all other classes of instruments. Hence, if the preference shares are cumulative, the accumulation is always a liability that should be recorded in books and not accumulated as an off balance sheet item.

A liability for the dividend payable would be recognised once the dividend is declared.

3. Derivatives

Financial instrument or other contract within the scope of this Standard with all three of the following characteristics.

1. Its value changes in response to the change in an underlying which can be a specified interest rate, financial instrument price, commodity price, foreign exchange rate, prices of indices, credit rating or credit index, or other variable provided in the case of a non-financial variables.

2. It requires no initial or very less investment than it would be required otherwise to enter into a contract in normal course.

3. It is settled at a future period. The settlement can either by delivery of the underlying or cash settlement. In case of cash settlement no delivery of underlying takes place rather difference is settled in cash.
Financial instruments include primary instruments (such as receivables, payables and equity instruments) and derivative financial instruments (such as financial options, futures and forwards, interest rate swaps and currency swaps). Derivatives that meet the conditions specified above are financial instruments and accordingly are within the scope of this standard.

Derivative financial instruments create rights and obligations that have the effect of transferring between the parties to the instrument one or more of the financial risks inherent in an underlying primary financial instrument. On inception, derivative financial instruments give one party a contractual right to exchange financial assets or financial liabilities with another party under conditions that are potentially favourable or a contractual obligation to exchange financial assets or financial liabilities with another party under conditions that are potentially unfavourable. However, they generally do not result in a transfer of the underlying primary financial instrument on inception of the contract and even in some cases a transfer of underlying financial instrument/s necessarily may not take place on maturity of the contract. Some instruments embody both a right and an obligation to make an exchange. Since the terms of the exchange are determined on inception of the derivative contract, as prices of underlying in financial markets change derivative contracts may become either favourable or unfavourable.

### 3.1 Forward Contracts

Forward Contract is the simplest form of a Derivatives Contract. Basically forward contract is a valid contract settled at some future point of time. For example, a forward contract involving settlement in six months’ time in which one party (the purchaser) promises to purchase ₹ 1,000,000 face value of fixed interest rate government bonds, in exchange of ₹ 1,000,000 cash; and the other party (the seller) promises to deliver ₹ 1,000,000 face value of fixed rate government bonds in exchange for ₹ 1,000,000 cash. During the six months, both parties have a contractual right and a contractual obligation to exchange financial instruments. If the market price of the government bonds rises above ₹ 1,000,000, the conditions will be favourable to the purchaser and unfavourable to the seller; if the market price falls below ₹ 1,000,000, the effect will be the opposite. However, both parties to a forward contract have an obligation to perform at the agreed time.

### 3.2 Option

As mentioned above both parties to a forward contract have an obligation to perform at the agreed time. However, under Option contract the option-holder has a right not an obligation to exchange the financial asset but the writer (seller) of the option has the obligation to exchange the financial asset upon exercise of the option. The nature of the holder’s right and writer’s obligation are not affected by the likelihood that the option will be exercised.

Thus, the purchaser has a contractual right (a financial asset) similar to the right under a call option held and a contractual obligation (a financial liability) similar to the obligation under a put option written; the seller has a contractual right (a financial asset) similar to the right under a put option held and a contractual obligation (a financial liability) similar to the obligation under a call option written. As with options, these contractual rights and obligations constitute financial assets and financial liabilities separate and distinct from the underlying financial instruments.
(the bonds and cash to be exchanged). Both parties to a forward contract have an obligation to perform at the agreed time, whereas performance under an option contract occurs only if and when the holder of the option chooses to exercise it.

### 3.3 Others

Many other types of derivative instruments embody a right or obligation to make a future exchange, including interest rate and currency swaps, interest rate caps, collars and floors, loan commitments and note issuance facilities. An interest rate swap contract may be viewed as a variation of a forward contract in which the parties agree to make a series of future exchanges of cash amounts, one amount calculated with reference to a floating interest rate and the other with reference to a fixed interest rate. Futures contracts are another variation of forward contracts, differing primarily in that the contracts are standardised and traded on an exchange.


#### 4.1 Classification of Financial Assets

An entity shall classify financial assets depending upon the following 2 criteria and options elected by the entity:

(a) the entity’s Business Model (BM) for managing the financial assets and

(b) the Contractual Cash Flow Characteristics (CCFC) of the financial asset

#### A Business Model (BM) Test

Ind AS 109 requires an entity to classify financial assets on the basis of the entity’s business model for managing the financial assets.

An entity assesses whether its financial assets meet the conditions on the basis of the business model as determined by the entity’s key management personnel (As defined in Ind AS 24 Related Party Disclosures).

- An entity’s business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective.
The entity’s business model does not depend on management’s intentions for an individual instrument. Accordingly, this condition is not an instrument-by-instrument approach to classification and should be determined on a higher level of aggregation.

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

That is, the entity’s business model determines whether cash flows will result from collecting contractual cash flows, selling financial assets or both. Consequently, this assessment is not performed on the basis of scenarios that the entity does not reasonably expect to occur, such as so-called ‘worst case’ or ‘stress case’ scenarios.

For example:

If an entity expects that it will sell a particular portfolio of financial assets only in a stress case scenario, that scenario would not affect the entity’s assessment of the business model for those assets if the entity reasonably expects that such a scenario will not occur.

- If cash flows are realised in a way that is different from the entity’s expectations at the date that the entity assessed the business model (For example: If the entity sells more or fewer financial assets than it expected when it classified the assets), that does not give rise to a prior period error in the entity’s financial statements nor does it change the classification of the remaining financial assets held in that business model.

- However, when an entity assesses the business model for newly originated or newly purchased financial assets, it must consider information about how cash flows were realised in the past, along with all other relevant information.

- An entity’s business model for managing financial assets is a matter of fact and not merely an assertion. It is typically observable through the activities that the entity undertakes to achieve the objective of the business model. An entity will need to use judgement when it assesses its business model for managing financial assets and that assessment is not determined by a single factor or activity. Instead, the entity must consider all relevant evidence that is available at the date of the assessment. Such relevant evidence includes, but is not limited to:
  
  a. 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;
  
  b. 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
  
  c. 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).
Ind AS 109 elaborates these Models in the Application Guidance (AG) in Appendix B (B4.1.2C to B4.1.6).

Below given are various examples explaining Business Model (BM) Test:

**Example 1:** ABC Ltd. holds investments to collect their contractual cash flows. Funding needs of the Company are predictable and the maturity of its financial assets is matched to the entity's estimated funding needs. The Company performs credit risk management activities with the objective of minimising credit losses.

In the past, sales have typically occurred when the financial assets' credit risk has increased such that the assets no longer meet the credit criteria specified in the Company’s documented investment policy.

In addition, infrequent sales have occurred as a result of unanticipated funding needs. Reports to Key Management Person focus on the credit quality of the financial assets and the contractual return. The Company also monitors fair values of the financial assets, among other information.

**Analysis**

Although the Company considers, among other information, the financial assets’ fair values from a liquidity perspective (i.e. the cash amount that would be realised if the entity needs to sell assets), the Company’s objective is to hold the financial assets in order to collect the contractual cash flows. Sales would not contradict that objective if they were in response to an increase in the assets’ credit risk, for example if the assets no longer meet the credit criteria specified in the Company’s documented investment policy.

Infrequent sales resulting from unanticipated funding needs (eg. in a stress case scenario) also would not contradict that objective, even if such sales are significant in value.

**Example 2:** ABC Company anticipates capital expenditure in a few years. The Company invests its excess cash in short and long-term financial assets so that it can fund the expenditure when the need arises. Many of the financial assets have contractual lives that exceed the Company’s anticipated investment period.

The Company will hold financial assets to collect the contractual cash flows and, when an opportunity arises, it will sell financial assets to re-invest the cash in financial assets with a higher return. The managers responsible for the portfolio are remunerated based on the overall
return generated by the portfolio.

Analysis

The objective of the business model is achieved by both collecting contractual cash flows and selling financial assets. The Company will make decisions on an ongoing basis about whether collecting contractual cash flows or selling financial assets will maximise the return on the portfolio until the need arises for the invested cash.

In contrast, consider a Company that anticipates a cash outflow in five years to fund capital expenditure and invests excess cash in short-term financial assets.

When the investments mature, the Company reinvests the cash in new short-term financial assets.

The Company maintains this strategy until the funds are needed, at which time the Company uses the proceeds from the maturing financial assets to fund the capital expenditure.

Only sales that are insignificant in value occur before maturity (unless there is an increase in credit risk).

The objective of this contrasting business model is to hold financial assets to collect contractual cash flows.

Example 3: 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.

Analysis

Entity B's objective is to collect the contractual cash flows from the trade receivables and, therefore, the trade receivables meet the business model test for the purpose of classifying the financial assets at amortised cost.

B Contractual Cash Flow Characteristic (CCFC) Test

Principal and Interest for SPPI TEST

Ind AS 109 requires an entity to classify a financial asset on the basis of its contractual cash flow characteristics if the financial asset is held within a business model whose objective is to hold assets to collect contractual cash flows or within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

To do so, an entity has to determine whether the asset’s contractual cash flows are solely payments of principal and interest on the principal amount outstanding.

Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with a basic lending arrangement. In a basic lending arrangement, consideration for the time value of money and credit risk are typically the most significant elements of interest.

However, in such an arrangement, interest can also include consideration for other basic lending
risks (For example, liquidity risk) and costs (For example, administrative costs) associated with holding the financial asset for a particular period of time.

In addition, interest can include a profit margin that is consistent with a basic lending arrangement.

However, 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, do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.

An entity shall assess whether contractual cash flows are solely payments of principal and interest on the principal amount outstanding for the currency in which the financial asset is denominated.

- Principal is the fair value of the financial asset at initial recognition.

However, that principal amount may change over the life of the financial asset.

For example:
If there are repayments of principal:

- Interest consists of consideration for:
  - The time value of money
  - Credit risk associated with the principal amount outstanding during a particular period of time and
  - For other basic lending risks and costs
  - As well as a profit margin

Below given are various examples explaining Contractual Cash Flow Characteristic (CCFC) Test:

Example 1: Illustrating contractual cash flows that are solely payments of principal and interest on the principal amount outstanding

There is a bond with a stated maturity date. Payments of principal and interest on the principal amount outstanding are linked to an inflation index of the currency in which the instrument is issued. The inflation link is not leveraged and the principal is protected.

Analysis

The contractual cash flows are solely payments of principal and interest on the principal amount outstanding. Linking payments of principal and interest on the principal amount outstanding to an unleveraged inflation index resets the time value of money to a current level. In other words, the interest rate on the instrument reflects ‘real’ interest. Thus, the interest amounts are consideration for the time value of money on the principal amount outstanding.

However, if the interest payments were indexed to another variable such as the debtor’s performance (e.g., the debtor’s net income) or an equity index, the contractual cash flows are not payments of principal and interest on the principal amount outstanding (unless the indexing
to the debtor’s performance results in an adjustment that only compensates the holder for changes in the credit risk of the instrument, such that actual cash flows are solely payments of principal and interest). That is because the contractual cash flows reflect a return that is inconsistent with a basic lending arrangement.

**Example 2  Illustrating contractual cash flows that are not solely payments of principal and interest on the principal amount outstanding**

Instrument F is a bond that is convertible into a fixed number of equity instruments of the issuer.

**Analysis**

The holder would analyse the convertible bond in its entirety. The contractual cash flows are not payments of principal and interest on the principal amount outstanding because they reflect a return that is inconsistent with a basic lending arrangement i.e. the return is linked to the value of the equity of the issuer.

Ind AS 109 elaborates the SSPI Test in the Application Guidance (AG) in Appendix B (B4.1.7 to B4.1.26)

---

To decide whether a Financial Asset is a Debt Instrument or an Equity Instrument the holder needs to look at the issuer classification.

<table>
<thead>
<tr>
<th>Classification of Financial Asset</th>
<th>Debt Instrument</th>
<th>Equity Instrument</th>
<th>Derivatives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity for Issuer as per Ind AS 32</td>
<td>• Holder applies Ind AS 109 • Equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity for Issuer as per Ind AS 32 under Exception Rules (Para 16A, B, C &amp; D)</td>
<td>• Holder applies Ind AS 109 • Debt Instrument</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt for Issuer as per Ind AS 32</td>
<td>• Holder applies Ind AS 109 • Debt</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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4.1.1 Classification of Debt Instruments (Financial Assets)
Classification of Debt Instruments has been explained by way of following flowchart:

4.1.2 Classification of Equity (Financial Asset)
Classification of Equity which is a Financial Asset has been explained as follows:
4.1.3 Classification of Derivatives (Financial Asset)
Derivative classified as financial asset would be measured at Fair Value Through Profit and Loss (FVTPL) only. The classification of derivatives is only as per one basis i.e. Fair Value Through Profit and Loss (FVTPL)

4.2 Classification of Financial Liabilities

Financial Liabilities are classified as financial liability measured at fair value through profit or loss and financial liability measured at amortised cost.

4.3 Held for Trading

A financial asset or financial liability that:
1. Is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
2. 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
3. Is a derivative (Except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

A Table showing classification of various items into Financial Asset or Financial Liability

<table>
<thead>
<tr>
<th>S.No.</th>
<th>Items</th>
<th>Financial Instrument Whether Financial Asset (FA) or Financial Liability (FL)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Cash</td>
<td>FA</td>
</tr>
<tr>
<td>2.</td>
<td>Cash Equivalents</td>
<td>FA</td>
</tr>
<tr>
<td>3.</td>
<td>Bank Balance</td>
<td>FA</td>
</tr>
<tr>
<td>4.</td>
<td>Deposits given</td>
<td>FA</td>
</tr>
<tr>
<td>5.</td>
<td>Deposits received</td>
<td>FL</td>
</tr>
<tr>
<td>6.</td>
<td>Trade and other Receivables</td>
<td>FA</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>7.</td>
<td>Trade and other Payables</td>
<td>FL</td>
</tr>
<tr>
<td>8.</td>
<td>Bills Receivable</td>
<td>FA</td>
</tr>
<tr>
<td>9.</td>
<td>Bills Payable</td>
<td>FL</td>
</tr>
<tr>
<td>10.</td>
<td>Loans including Bank Loan</td>
<td>FL</td>
</tr>
<tr>
<td>11.</td>
<td>Investments in Equity Shares</td>
<td>FA</td>
</tr>
<tr>
<td>12.</td>
<td>Investment in Debentures</td>
<td>FA</td>
</tr>
<tr>
<td>13.</td>
<td>Promissory Note to receive Government bonds</td>
<td>FA</td>
</tr>
<tr>
<td>14.</td>
<td>Promissory Note payable in Government Bonds</td>
<td>FL</td>
</tr>
<tr>
<td>15.</td>
<td>Perpetual Debt instrument held</td>
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</tr>
<tr>
<td>16.</td>
<td>Prepaid Expenses</td>
<td>Not a Financial Instrument</td>
</tr>
<tr>
<td>17.</td>
<td>Inventory</td>
<td>Not a Financial Instrument</td>
</tr>
<tr>
<td>18.</td>
<td>Property, Plant and Equipment</td>
<td>Not a Financial Instrument</td>
</tr>
<tr>
<td>19.</td>
<td>Intangible Assets</td>
<td>Not a Financial Instrument</td>
</tr>
<tr>
<td>20.</td>
<td>Advances given for goods and services</td>
<td>Not a Financial Instrument</td>
</tr>
<tr>
<td>21.</td>
<td>Advances received for goods and services</td>
<td>Not a Financial Instrument</td>
</tr>
<tr>
<td>22.</td>
<td>Deferred Revenue</td>
<td>Not a Financial Instrument</td>
</tr>
<tr>
<td>23.</td>
<td>Warranty obligations</td>
<td>Not a Financial Instrument</td>
</tr>
<tr>
<td>24.</td>
<td>Income Taxes</td>
<td>Not a Financial Instrument</td>
</tr>
<tr>
<td>25.</td>
<td>Financial Guarantee received</td>
<td>FA</td>
</tr>
<tr>
<td>26.</td>
<td>Financial Guarantee given</td>
<td>FL</td>
</tr>
<tr>
<td>27.</td>
<td>Finance Lease – Lessor</td>
<td>FA</td>
</tr>
<tr>
<td>28.</td>
<td>Finance Lease – Lessee</td>
<td>FL</td>
</tr>
<tr>
<td>29.</td>
<td>Operating Lease – Lessor</td>
<td>Not a Financial Instrument</td>
</tr>
<tr>
<td>30.</td>
<td>Operating Lease – Lessee</td>
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</tr>
<tr>
<td>31.</td>
<td>Gold</td>
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<tr>
<td>32.</td>
<td>Gold bond held</td>
<td>FA</td>
</tr>
</tbody>
</table>

### 5. Recognition of Financial Instrument

**Initial recognition**

An entity shall recognise a financial asset or a financial liability in its balance sheet *when, and only when*, the entity becomes party to the contractual provisions of the instrument.

The above principle will be applied on the following:
5.1 Receivables and Payables

Unconditional receivables and payables are recognised as financial assets or financial liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash.

5.2 Firm Commitment to Purchase or Sell Goods or Services

Assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognised until at least one of the parties has performed under the agreement.

For example: An entity that receives a firm order does not generally recognise an asset (and the entity that places the order does not recognise a liability) at the time of the commitment but, instead, delays recognition until the ordered goods or services have been shipped, delivered or rendered.

5.3 Forward Contract

A forward contract that is within the scope of this Standard is recognised as a financial asset or a financial liability on the commitment date, instead of on the date on which settlement takes place.

When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero. If the net fair value of the right and obligation is not zero, the contract is recognised as an asset or liability.

5.4 Option Contracts

Option contracts that are within the scope of this Standard are recognised as assets or liabilities when the holder or writer becomes a party to the contract.

5.5 Planned Future Transactions

Planned future transactions, no matter how likely, are not assets and liabilities because the entity has not become a party to a contract.

5.6 Regular Way Purchase or Sale of Financial Assets

A purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame is established generally by regulation or convention in the market place concerned.

A regular way purchase or sale of financial assets shall be recognised and derecognised, as applicable, using trade date accounting or settlement date accounting.

Note: A contract that requires or permits net settlement of the change in the value of the contract is not a regular way contract. Instead, such a contract is accounted for as a derivative in the period between the trade date and the settlement date.
6. Trade Date

The trade date is the date that an entity commits itself to purchase or sell an asset.

Trade date Accounting:

- **Trade date accounting**
  - **In case of purchase**
    - Recognition
      - Liability to Pay
      - Asset to be Received
  - **In case of sale**
    - **Derecognition**
      - Asset that is sold
      - Gain or Loss on Disposal
    - Recognition
      - Receivable from the buyer for payment

Generally, interest does not start to accrue on the asset and corresponding liability until the settlement date when title passes.

7. Settlement Date

The settlement date is the date that an asset is delivered to or by an entity.

Settlement date Accounting:

- **Recognition on Settlement Date (in case of purchase)**: Asset on the day it is received by the entity
- **Derecognition on Settlement Date (in case of sale)**: Asset on the day that it is delivered by the entity
- **Recognition on Settlement Date (in case of sale)**: Any gain or loss on disposal on the day that the asset is delivered by the entity

When settlement date accounting is applied an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset.

In other words, the change in value is not recognised for assets measured at amortised cost; it is recognised in profit or loss for assets classified as financial assets measured at fair value through profit or loss; and it is recognised in other comprehensive income for financial assets measured at fair value through other comprehensive income.
Illustration 6
Let us say on 30th March 2015 an entity enters into an agreement to purchase a Financial Asset for ₹ 100 which is the Fair Value on that date.
On Balance Sheet date i.e. 31/3/2015 the Fair Value is 102 and on Settlement date i.e. 2/4/2015 Fair Value is 103.
Pass necessary Journal entries on trade date and settlement date when the asset acquired is measured at
(a) Amortised cost
(b) FVTPL
(c) FVTOCI

Solution

Financial Asset at Amortised Cost – Trade Date Accounting

<table>
<thead>
<tr>
<th>Dates</th>
<th>Journal Entry</th>
<th>Amount</th>
<th>Amount</th>
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<tbody>
<tr>
<td>30/3/2015</td>
<td>Financial Asset Dr.</td>
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<td>100</td>
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<tr>
<td></td>
<td>To Payables</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31/3/2015</td>
<td>No Entry</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2/4/2015</td>
<td>Payables Dr.</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>To Cash</td>
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</table>

Financial Asset at Amortised Cost – Settlement Date Accounting

<table>
<thead>
<tr>
<th>Dates</th>
<th>Journal Entry</th>
<th>Amount</th>
<th>Amount</th>
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<tbody>
<tr>
<td>30/3/2015</td>
<td>No Entry</td>
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<tr>
<td>31/3/2015</td>
<td>No Entry</td>
<td></td>
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</tr>
<tr>
<td>2/4/2015</td>
<td>Financial Asset Dr.</td>
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<td>100</td>
</tr>
<tr>
<td></td>
<td>To Cash</td>
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Financial Asset at FVTPL – Trade Date Accounting

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<thead>
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<th>Dates</th>
<th>Journal Entry</th>
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<tr>
<td>30/3/2015</td>
<td>Financial Asset Dr.</td>
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<td></td>
<td>To Payables</td>
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<tr>
<td>31/3/2015</td>
<td>Financial Asset Dr.</td>
<td>2</td>
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<tr>
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<td>To P&amp;L</td>
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<tr>
<td>2/4/2015</td>
<td>Financial Asset Dr.</td>
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<td>To P&amp;L</td>
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</tr>
<tr>
<td></td>
<td>Payables Dr.</td>
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<td>To Cash</td>
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</table>
### Financial Asset at FVTPL – Settlement Date Accounting

<table>
<thead>
<tr>
<th>Dates</th>
<th>Journal Entry</th>
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<th>Amount</th>
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<tbody>
<tr>
<td>30/3/2015</td>
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<td>To P&amp;L</td>
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<tr>
<td></td>
<td>Financial Asset Dr.</td>
<td>103</td>
<td>100</td>
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<tr>
<td></td>
<td>To Cash</td>
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<td>3</td>
</tr>
<tr>
<td></td>
<td>To Fair Value Change</td>
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### Financial Asset at FVTOCI – Trade Date Accounting

<table>
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<th>Dates</th>
<th>Journal Entry</th>
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<th>Amount</th>
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<tbody>
<tr>
<td>30/3/2015</td>
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<td>100</td>
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<tr>
<td></td>
<td>To Payables</td>
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<td>31/3/2015</td>
<td>Financial Asset Dr.</td>
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<td>Financial Asset Dr.</td>
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<td>To OCI</td>
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<tr>
<td></td>
<td>Payables Dr.</td>
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</tr>
<tr>
<td></td>
<td>To Cash</td>
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### Financial Asset at FVTOCI – Settlement Date Accounting

<table>
<thead>
<tr>
<th>Dates</th>
<th>Journal Entry</th>
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<td>Financial Asset Dr.</td>
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<td></td>
<td>To Cash</td>
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<td>3</td>
</tr>
<tr>
<td></td>
<td>To Fair Value Change</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### 8. Measurement of Financial Instruments

#### 8.1 Initial measurement

At initial recognition, an entity shall measure a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not subsequently measured at Fair Value Through Profit or Loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.
Transaction Costs for Initial Recognition

Transaction Costs on Disposal or Transfer are not included in measurement of all categories of Financial Assets and Financial Liabilities. These are charged to Profit and Loss.

If the fair value of the financial asset or financial liability at initial recognition differs from the transaction price, an entity shall apply as under:

The best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price (i.e. the fair value of the consideration given or received - Ind AS 113, Fair Value Measurements).

If an entity determines that the fair value at initial recognition which differs from the transaction price as mentioned above, the entity shall account for that instrument at that date as follows:

a. At the measurement if that fair value is evidenced by a quoted price in an active market for an identical asset or liability (i.e. Level 1 input) or based on a valuation technique that uses only data from observable markets.

An entity shall recognise the difference between the fair value at initial recognition and the transaction price as a gain or loss.

b. In all other cases, Fair Value is adjusted to defer the difference between the fair value at initial recognition and the transaction price. i.e. Transaction Price is treated as Fair Value.
8.2 Subsequent Measurement of Financial Assets

8.2.1 Financial Asset Subsequently Measured at Amortised Cost
A financial asset shall be measured at amortised cost if both of the following conditions are met:
A. The financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows
And
B. The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding

8.2.2 A Financial Asset Subsequently Measured at Fair Value Through Other Comprehensive Income (FVTOCI)
(Applicable to Debt and Equity Instruments both)
A financial asset shall be measured at fair value through other comprehensive income if both of the following conditions are met:
(i) The financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets; and
(ii) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding

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8.2.3 A Financial Asset Subsequently Measured At Fair Value Through Profit or Loss (Residuary Category)

A financial asset shall be measured at fair value through profit or loss unless it is measured at amortised cost or at fair value through other comprehensive income.

However, an entity may make an irrevocable selection at initial recognition for particular investments in equity instruments that would otherwise be measured at fair value through profit or loss to present subsequent changes in fair value in other comprehensive income.

8.2.4 Option to designate a Financial Asset at Fair Value Through Profit or Loss

An entity may, at initial recognition, irrevocably designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an ‘accounting mismatch’) that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different basis.

Illustration 7 (Financial Asset Accounted as FVTPL)

A Company invested in Equity shares of another entity on 15th March for ₹10,000. Transaction Cost = ₹200 (not included in ₹10,000)

Fair Value on Balance Sheet date i.e. 31st March 2015 = ₹12,000. Pass necessary Journal Entries

Solution

<table>
<thead>
<tr>
<th>Date</th>
<th>Particulars</th>
<th>Dr</th>
<th>Cr</th>
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</thead>
<tbody>
<tr>
<td>15/3/2015</td>
<td>Investment A/c Dr. Dr. Transaction Cost A/c Dr. To Bank</td>
<td>10,000</td>
<td>200</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>10,200</td>
</tr>
<tr>
<td>31/3/2015</td>
<td>Investment A/c Dr. To Fair Value Gain A/c</td>
<td>2,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>2,000</td>
</tr>
<tr>
<td>31/3/2015</td>
<td>P&amp;L A/c Dr. To Transaction Cost A/c</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>200</td>
</tr>
<tr>
<td>31/3/2015</td>
<td>Fair Value Gain A/c Dr. To P&amp;L A/c</td>
<td>2,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>2,000</td>
</tr>
</tbody>
</table>

Illustration 8 (Financial Asset Accounted as FVTOCI)

A Company invested in Equity shares of another entity on 15th March for ₹10,000. Transaction Cost = ₹200 (not included in ₹10,000). Fair Value on Balance Sheet date i.e. 31st March 2015 = ₹12,000. Pass necessary Journal entries.

Solution

<table>
<thead>
<tr>
<th>Date</th>
<th>Particulars</th>
<th>Dr</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>15/3/2015</td>
<td>Investment A/c Dr. To Bank</td>
<td>10,200</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>10,200</td>
</tr>
</tbody>
</table>
Illustration 9 (Financial Asset Accounted as Amortised Cost)

A Company lends ₹100 lacs to another company @ 12% p.a. interest on 1/4/2015. It incurs ₹40,000 incremental costs for documentation. Loan tenure = 5 years with Interest charged annually. Fair Value of Loan = 99,40,000 (100 lacs – 1 lac + 40,000). Pass necessary Journal entries.

Solution

This is based on the assumption that interest rate is based on market rate of interest.

<table>
<thead>
<tr>
<th>Date</th>
<th>Particulars</th>
<th>Dr</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/4/2015</td>
<td>Loan A/c</td>
<td>100 lacs</td>
<td>100 lacs</td>
</tr>
<tr>
<td></td>
<td>To Bank A/c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1/4/2015</td>
<td>Loan Processing Expense A/c</td>
<td>40,000</td>
<td>40,000</td>
</tr>
<tr>
<td></td>
<td>To Bank A/c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1/4/2015</td>
<td>Loan A/c</td>
<td>40,000</td>
<td>40,000</td>
</tr>
<tr>
<td></td>
<td>To Loan Processing Expense A/c</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Subsequent entries would be explained under subsequent measurement basis.

8.3 Subsequent Measurement of Financial Liabilities

8.3.1 Financial Liabilities Subsequently Measured at Amortised Cost

An entity shall classify all financial liabilities as subsequently measured at amortised cost except as discussed below.

8.3.2 Financial Liabilities Subsequently Measured at Fair Value Through Profit or Loss (FVTPL)

b. Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the involvement approach applies.

c. Financial guarantee contracts.

d. Commitments to provide a loan at a below-market interest rate.
6.32 Financial Reporting

e. Contingent consideration recognised by an acquirer in a business combination to which Ind AS 103 applies. Such contingent consideration shall subsequently be measured at fair value with changes recognised in profit or loss.

8.3.3 Option to Designate a Financial Liability at Fair Value Through Profit or Loss

An entity may, at initial recognition, irrevocably designate a financial liability as measured at fair value through profit or loss when permitted, or when doing so results in more relevant information, because either:

a. it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or

b. a group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel (as defined in Ind AS 24 Related Party Disclosures).

For example: The entity's board of directors and chief executive officer.

Illustration 10

An entity is about to purchase a portfolio of fixed rate assets that will be financed by fixed rate debentures. Both financial assets and financial liabilities are subject to the same interest rate risk that gives rise to opposite changes in fair value that tend to offset each other. Comment?

Solution

In the absence of the fair value option, the entity may have classified the fixed rate assets as FVTOCI with gains and losses on changes in fair value recognised in other comprehensive income and the fixed rate debentures at amortised cost. Reporting both the assets and the liabilities at fair value through profit and loss i.e. FVTPL corrects the measurement inconsistency and produces more relevant information.

FVTOCI Category for Debt Instrument and Equity – Significant Differences

There are significant differences between Debt and Equity being classified as FVTOCI.

| FVTOCI Categorisation | • For Debt compulsory if conditions met  
| | • For Equity it is Optional if not held for Trading  
| Recognition of Interest Income, Impairment Gain/Loss & Foreign Exchange Gain/Loss | • For Debt Recognised in P&L  
| | • For Equity only dividend income is recognised in P&L. All other gains or losses are recognised in OCI.  
| On Derecognition of FA, Cumulative Gains/Losses recognised in OCI are recycled from Equity to P&L | • For Debt - Yes  
| | • For Equity - No  

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### An Overview for Measurement of Financial Assets

<table>
<thead>
<tr>
<th>S.No.</th>
<th>Particulars</th>
<th>Amortised Cost</th>
<th>FVTOCI (Debt)</th>
<th>FVTPL</th>
<th>FVTOCI (Equity)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Debt</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>2.</td>
<td>Equity</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>3.</td>
<td>Derivatives</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>4.</td>
<td>On Balance sheet date</td>
<td>Amortised cost</td>
<td>Fair Value</td>
<td>Fair Value</td>
<td>Fair Value</td>
</tr>
<tr>
<td>5.</td>
<td>Transaction Cost on Initial Recognition</td>
<td>Added</td>
<td>Added</td>
<td>Charged to P&amp;L</td>
<td>Added</td>
</tr>
<tr>
<td>6.</td>
<td>Transaction Cost on Subsequent Accounting</td>
<td>Indirectly amortised to P&amp;L</td>
<td>Transferred to OCI and amortised to P&amp;L</td>
<td>NA</td>
<td>Transferred to OCI</td>
</tr>
<tr>
<td>7.</td>
<td>Revaluation on Balance Sheet (Changes in Fair Value)</td>
<td>No</td>
<td>Yes through OCI</td>
<td>Yes through P&amp;L</td>
<td>Yes Through OCI</td>
</tr>
<tr>
<td>8.</td>
<td>Interest and Dividends</td>
<td>P&amp;L</td>
<td>P&amp;L</td>
<td>NA</td>
<td>P&amp;L</td>
</tr>
<tr>
<td>9.</td>
<td>Impairment Losses</td>
<td>P&amp;L</td>
<td>P&amp;L</td>
<td>NA</td>
<td>OCI</td>
</tr>
<tr>
<td>10.</td>
<td>Foreign Exchange Gain or Loss</td>
<td>P&amp;L</td>
<td>P&amp;L</td>
<td>NA</td>
<td>OCI</td>
</tr>
<tr>
<td>11.</td>
<td>Gain or loss on de-recognition</td>
<td>P&amp;L</td>
<td>Transferred from OCI to P&amp;L</td>
<td>NA</td>
<td>OCI (Recycling not allowed)</td>
</tr>
</tbody>
</table>

### An Overview for Measurement of Financial Liabilities

<table>
<thead>
<tr>
<th>S.No.</th>
<th>Particulars</th>
<th>Amortised Cost</th>
<th>Held for Trading</th>
<th>Designated as FVTPL</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>On Balance Sheet Date</td>
<td>Amortised Cost</td>
<td>Fair Value</td>
<td>Fair Value</td>
</tr>
<tr>
<td>2.</td>
<td>Transaction Cost – on Initial Recognition</td>
<td>Deducted</td>
<td>Charged to P&amp;L</td>
<td>Charged to P&amp;L</td>
</tr>
<tr>
<td>3.</td>
<td>Transaction Cost – On Subsequent Accounting</td>
<td>Amortised to P&amp;L</td>
<td>NA</td>
<td>NA</td>
</tr>
</tbody>
</table>
6.34 Financial Reporting

<table>
<thead>
<tr>
<th></th>
<th>Gain or loss due to changes in own credit risk</th>
<th>NA</th>
<th>P&amp;L</th>
<th>OCI</th>
</tr>
</thead>
<tbody>
<tr>
<td>4</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Other gain or loss</td>
<td>NA</td>
<td>P&amp;L</td>
<td>P&amp;L</td>
</tr>
<tr>
<td>6</td>
<td>Interest</td>
<td>P&amp;L</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>7</td>
<td>Foreign Exchange Gain or Loss</td>
<td>P&amp;L</td>
<td>NA</td>
<td>NA</td>
</tr>
</tbody>
</table>


When, and only when, an entity changes its business model for managing financial assets it shall reclassify all affected financial assets.

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

Accordingly, a change in an entity's business model will occur only when an entity either begins or ceases to perform an activity that is significant to its operations;

For example:

When the entity has acquired, disposed of or terminated a business line.

Examples of a change in business model include the following:

a. An entity has a portfolio of commercial loans that it holds to sell in the short term. The entity acquires a company that manages commercial loans and has a business model that holds the loans in order to collect the contractual cash flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and all are held to collect the contractual cash flows.

b. A financial services firm decides to shut down its retail mortgage business. That business no longer accepts new business and the financial services firm is actively marketing its mortgage loan portfolio for sale.

The following are not changes in business model:

a. A change in intention related to particular financial assets (even in circumstances of significant changes in market conditions).

b. The temporary disappearance of a particular market for financial assets.

c. A transfer of financial assets between parts of the entity with different business models.

An entity shall not reclassify any financial liability.

Reclassification of Financial Asset

If an entity reclassifies financial assets, it shall apply the reclassification prospectively from the reclassification date.

The entity shall not restate any previously recognised gains, losses (including impairment gains or losses) or interest.
CASE I
AMORTISED COST TO FVTPL
➢ Its fair value is measured at the reclassification date.
➢ Any gain or loss arising from a difference between the previous amortised cost of the financial asset and fair value is recognised in profit or loss.

Example:
Bonds for ₹ 1,25,000 reclassified as FVTPL
Fair Value on reclassification ₹ 90,000

<table>
<thead>
<tr>
<th>Bonds (FVTPL) A/c</th>
<th>Dr.</th>
<th>90,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>P&amp;L A/c</td>
<td>Dr.</td>
<td>35,000</td>
</tr>
<tr>
<td>To Bonds (Amortised Cost) A/c</td>
<td></td>
<td>1,25,000</td>
</tr>
</tbody>
</table>

CASE II
AMORTISED COST TO FVTOCI
➢ Its fair value is measured at the reclassification date.
➢ Any gain or loss arising from a difference between the previous amortised cost of the financial asset and fair value is recognised in other comprehensive income.
➢ The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification.

Example:
Bonds for ₹ 1,25,000 reclassified as FVTOCI
Fair Value on reclassification ₹ 90,000

<table>
<thead>
<tr>
<th>Bonds (FVTOCI) A/c</th>
<th>Dr.</th>
<th>90,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>OCI A/c</td>
<td>Dr.</td>
<td>35,000</td>
</tr>
<tr>
<td>To Bonds (Amortised Cost) A/c</td>
<td></td>
<td>1,25,000</td>
</tr>
</tbody>
</table>
6.36 Financial Reporting

CASE III
FVTPL TO AMORTISED COST
- Its fair value at the reclassification date becomes its new gross carrying amount.
- Effective interest rate is calculated based on the new gross carrying amount.

Example:
Bonds for ₹ 1,25,000 reclassified as FVTPL
Fair Value on reclassification ₹ 90,000

<table>
<thead>
<tr>
<th>Account</th>
<th>Dr.</th>
<th>₹</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds (Amortised Cost) A/c</td>
<td></td>
<td>90,000</td>
</tr>
<tr>
<td>P&amp;L A/c</td>
<td></td>
<td>35,000</td>
</tr>
<tr>
<td>To Bonds (FVTPL) A/c</td>
<td></td>
<td>1,25,000</td>
</tr>
</tbody>
</table>

CASE IV
FVTPL TO FVTOCI
- The financial asset continues to be measured at fair value.
- The effective interest rate is determined on the basis of the fair value of the asset at the reclassification date.

Example:
Bonds for ₹ 1,25,000 reclassified as FVTOCI
Fair Value on reclassification ₹ 90,000

<table>
<thead>
<tr>
<th>Account</th>
<th>Dr.</th>
<th>₹</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds (FVTOCI) A/c</td>
<td></td>
<td>90,000</td>
</tr>
<tr>
<td>OCI A/c</td>
<td></td>
<td>35,000</td>
</tr>
<tr>
<td>To Bonds (Amortised Cost) A/c</td>
<td></td>
<td>1,25,000</td>
</tr>
</tbody>
</table>

CASE V
FVTOCI TO AMORTISED COST
- The financial asset is reclassified at its fair value at the reclassification date.
- However, the cumulative gain or loss previously recognised in other comprehensive income is removed from equity and adjusted against the fair value of the financial asset at the reclassification date.
- As a result, the financial asset is measured at the reclassification date as if it had always been measured at amortised cost. This adjustment affects other comprehensive income but does not affect profit or loss and therefore is not a reclassification adjustment.
- The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification.
Example:
Bonds for ₹ 1,25,000 reclassified as Amortised Cost
Fair Value on reclassification ₹ 90,000

<table>
<thead>
<tr>
<th></th>
<th>Dr.</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds (Amortised Cost) A/c</td>
<td></td>
<td>90,000</td>
<td></td>
</tr>
<tr>
<td>OCI A/c</td>
<td></td>
<td>35,000</td>
<td></td>
</tr>
<tr>
<td>To Bonds (FVTOCI) A/c</td>
<td></td>
<td></td>
<td>1,25,000</td>
</tr>
</tbody>
</table>

**CASE VI**

**FVTOCI TO FVTPL**

- The financial asset continues to be measured at fair value.
- The cumulative gain or loss previously recognised in other comprehensive income is reclassified from equity to profit or loss as a reclassification adjustment at the reclassification date.

Example:
Bonds for ₹ 1,25,000 reclassified as FVTPL
Fair Value on reclassification ₹ 90,000

<table>
<thead>
<tr>
<th></th>
<th>Dr.</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds (FVTPL) A/c</td>
<td></td>
<td>90,000</td>
<td></td>
</tr>
<tr>
<td>OCI A/c</td>
<td></td>
<td>35,000</td>
<td></td>
</tr>
<tr>
<td>To Bonds (FVTOCI) A/c</td>
<td></td>
<td></td>
<td>1,25,000</td>
</tr>
</tbody>
</table>

**10. Derecognition of Financial Instruments**

**10.1 Derecognition of Financial Assets**

An entity shall derecognise a financial asset when, and only when:

a) the contractual rights to the cash flows from the financial asset expire, or

b) it transfers the financial asset as set out in paragraphs 3.2.4 and 3.2.5 and the transfer qualifies for derecognition in accordance with paragraph 3.2.6 of Ind AS 109.

On derecognition of a financial asset in its entirety, the difference between:

a) the carrying amount (measured at the date of derecognition) and

b) the consideration received (including any new asset obtained less any new liability assumed) shall be recognised in profit or loss.

**10.2 Derecognition of Financial Liabilities**

An entity shall remove a financial liability (or a part of a financial liability) from its balance sheet when, and only when, it is extinguished—i.e. when the obligation specified in the contract is discharged or cancelled or expired.
NOTE:

1. An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

2. The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss.

Illustration 11

Sea Ltd. has lent a sum of ₹ 10 lakhs @ 18% per annum for 10 years. The loan had a Fair Value of ₹ 12,23,960 at the effective interest rate of 13%. To mitigate prepayment risks but at the same time retaining control over the loan, Sea Ltd. transferred its right to receive the Principal amount of the loan on its maturity with interest, after retaining rights over 10% of principal and 4% interest that carries Fair Value of ₹ 29,000 and ₹ 1,84,620 respectively. The consideration for the transaction was ₹ 9,90,000. The interest component retained included a 2% fee towards collection of principal and interest that has a Fair Value of ₹ 65,160. Defaults, if any, are deductible to a maximum extent of the company’s claim on Principal portion. You are required to show the Journal Entries to record derecognition of the Loan.

Solution:

(i) Calculation of securitized component of loan

<table>
<thead>
<tr>
<th></th>
<th>₹</th>
<th>₹</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair Value</td>
<td>12,23,960</td>
<td></td>
</tr>
<tr>
<td>Less: Principal receivable (fair value)</td>
<td>29,000</td>
<td></td>
</tr>
<tr>
<td>Less: Interest receivable (fair value)</td>
<td>1,19,460</td>
<td></td>
</tr>
<tr>
<td>Less: Value of service asset (fair value)</td>
<td>65,160</td>
<td>1,84,620</td>
</tr>
<tr>
<td>(2,13,620)</td>
<td>10,10,340</td>
<td></td>
</tr>
</tbody>
</table>

(ii) Apportionment of carrying amount in the ratio of fair values

<table>
<thead>
<tr>
<th></th>
<th>Fair value (₹)</th>
<th>Apportionment (₹)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securitized component of loan</td>
<td>10,10,340</td>
<td></td>
</tr>
<tr>
<td>Principal strip receivable</td>
<td>29,000</td>
<td></td>
</tr>
<tr>
<td>Interest strip receivable</td>
<td>1,19,460</td>
<td></td>
</tr>
</tbody>
</table>

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Servicing asset | 65,160 | \( \frac{65,160 \times 10,00,000}{12,23,960} \) | 53,237

(iii) Entries to record the derecognition of the Loan

<table>
<thead>
<tr>
<th>₹</th>
<th>₹</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank A/c</td>
<td>Dr. 9,90,000</td>
</tr>
<tr>
<td>To Loan A/c</td>
<td></td>
</tr>
<tr>
<td>To Profit &amp; Loss A/c</td>
<td></td>
</tr>
<tr>
<td>(Being entry for securitization of 90% principal with 14% interest)</td>
<td></td>
</tr>
<tr>
<td>Interest strip A/c</td>
<td>Dr. 97,601</td>
</tr>
<tr>
<td>Servicing asset A/c</td>
<td>Dr. 53,237</td>
</tr>
<tr>
<td>Principal strip A/c</td>
<td>Dr. 23,694</td>
</tr>
<tr>
<td>To Loan A/c</td>
<td></td>
</tr>
<tr>
<td>(Being entry for interest, servicing asset and principal strips received)</td>
<td></td>
</tr>
</tbody>
</table>

Illustration 12 (Factoring with / without recourse)

Entity A (the transferor) holds a portfolio of receivables with a carrying value of ₹ 1,000,000. It enters into a factoring arrangement with entity B (the transferee) under which it transfers the portfolio to entity B in exchange for ₹ 900,000 of cash.

Entity B will service the loans after their transfer and debtors will pay amounts due directly to entity B. Entity A has no obligations whatsoever to repay any sums received from the factor and has no rights to any additional sums regardless of the timing or the level of collection from the underlying debts. Comment.

Solution

Entity A has transferred its rights to receive the cash flows from the asset via an assignment to entity B. Furthermore, as entity B has no recourse to entity A for either late payment risk or credit risk, entity A has transferred substantially all the risks and rewards of ownership of the portfolio.

Hence, entity A derecognises the entire portfolio. The difference between the carrying value of ₹ 1,000,000 and cash received of ₹ 900,000 i.e. ₹ 100,000 is recognised immediately as a loss on derecognition of assets classified at amortised cost in profit or loss.

Had Entity A not transferred its rights to receive the cash flows from the asset or there would have been any credit default guarantee given by entity A, then it would have not led to complete transfer of risk and rewards and entity A could not derecognise the portfolio due to the same. Hence, the asset is recognised to the extent of continuing involvement.
11. Impairment of Financial Assets

11.1 Recognition of expected credit losses

An entity shall recognise a loss allowance for expected credit losses:

- On a financial asset that is measured at Amortised Cost or FVTOCI
- A lease receivable
- A loan commitment and
- A financial guarantee contract to which the impairment requirements apply

11.2 Credit Loss

The difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e. all cash shortfalls), discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets). An entity shall estimate cash flows by considering all contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) through the expected life of that financial instrument. The cash flows that are considered shall include cash flows from the sale of collateral held or other credit enhancements that are integral to the contractual terms. There is a presumption that the expected life of a financial instrument can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the expected life of a financial instrument, the entity shall use the remaining contractual term of the financial instrument.

Measurement of expected credit losses

An entity shall measure expected credit losses of a financial instrument in a way that reflects:

a) an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;

b) the time value of money; and

c) Reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

CASE I

Credit Risk on that Financial Instrument has Increased Significantly since Initial Recognition

At each reporting date, an entity shall measure the loss allowance for a financial instrument at an amount equal to the lifetime expected credit losses if the credit risk on that financial instrument has increased significantly since initial recognition.
CASE II

Credit Risk on a Financial Instrument has not Increased Significantly Since Initial Recognition

If, at the reporting date, the credit risk on a financial instrument has not increased significantly since initial recognition, an entity shall measure the loss allowance for that financial instrument at an amount equal to 12-month expected credit losses.

12 MONTH EXPECTED CREDIT LOSS (ECL) MEASUREMENT - PROBABILITY OF DEFAULT (POD) APPROACH

Facts:
Entity as a lender – Single 10 year loan for ₹ 1 million
At initial recognition, the POD over the next 12 months is 0.5%
Loss given default (LGD) is determined to be 25% of gross carrying amount

Assessment:
At reporting date, no change in 12-month POD; and entity assesses that no significant increase in credit risk since initial recognition – therefore Lifetime ECL is not required to be recognised

| Loan   | ₹ 1,000,000 | A |
| LGD    | 25%         | B |
| POD - 12 months | 0.5%    | C |
| Loss allowance (for 12-month ECL) | ₹ 1,250   | A x B x C |

12 MONTH EXPECTED CREDIT LOSS (ECL) MEASUREMENT - LOSS RATE (LR) APPROACH

Facts:
Bank as a lender – 2,000 bullet loans with total gross carrying amount of ₹ 5,00,000
Portfolio segmented into borrower groups (X and Y) based on shared credit risk characteristics at initial recognition. Group X comprises 1,000 loans with a GCV per client of ₹ 200, for a total GCV of ₹ 200,000. Similarly, the GCV per client is ₹ 300 and the total GCV is ₹ 3,00,000 for Y.
Historical defaults per 1000 loans sample: 4 defaults (Grp X) and 2 defaults (Grp Y)

Assessment:
Bank considers forward looking information and expects an increase in defaults over the next 12 months compared to the historical rate: 5 defaults (Grp X) and 3 defaults (Grp Y)
At reporting date, the entity assesses that the expected increase in defaults does not represent a significant increase in credit risk since initial recognition for the portfolios – therefore Lifetime ECL is not considered.
These Loss rates are then used to estimate 12 month ECL on new loans in Group X and Group Y that originated during the year and for which the credit risk has not increased significantly since initial recognition.

**Note:** In accordance with the standard, expected credit losses should be discounted using the effective interest rate. However, for purposes of this example, the present value of the observed loss is assumed.

**LIFETIME EXPECTED CREDIT LOSS (LECL) MEASUREMENT - PROVISION MATRIX FOR SHORT TERM TRADE RECEIVABLES**

**Facts:**
Manufacturer M with a portfolio of short term trade receivables (no financing component) from a large number of small clients

**Assessment:**
Loss allowance at an amount equal to Lifetime ECL (simplified approach for trade receivables)
Entity creates a provision matrix that is based on its historical observed default rates over the expected life of trade receivables and adjusts it for forward looking estimates.

<table>
<thead>
<tr>
<th>Age</th>
<th>Default Rate (A)</th>
<th>Gross Carrying Amount (B)</th>
<th>LECL Allowance (AxB)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>0.3%</td>
<td>150,00,000</td>
<td>45,000</td>
</tr>
<tr>
<td>1-30 days</td>
<td>1.6%</td>
<td>75,00,000</td>
<td>1,20,000</td>
</tr>
<tr>
<td>31- 60 days</td>
<td>3.6%</td>
<td>40,00,000</td>
<td>1,44,000</td>
</tr>
<tr>
<td>61- 90 days</td>
<td>6.6%</td>
<td>25,00,000</td>
<td>1,65,000</td>
</tr>
<tr>
<td>90 + days</td>
<td>10.6%</td>
<td>10,00,000</td>
<td>1,06,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>300,00,000</td>
<td>5,80,000</td>
</tr>
</tbody>
</table>

### 12. Embedded Derivatives
An embedded derivative is a component of a hybrid contract that also includes a **non-derivative host**—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.
A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty, is not an embedded derivative, but a separate financial instrument.

### 12.1 Accounting Treatment of Embedded Derivatives

**CASE I**

If a hybrid contract contains a host that is an asset within the scope of this Standard, an entity shall apply the requirements of classification and measurement rules to the entire hybrid contract.

**CASE II**

If a hybrid contract contains a host that is not an asset within the scope of this Standard, an embedded derivative shall be separated from the host and accounted for as a derivative under this Standard if, and only if:

a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host;

b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

c) the hybrid contract is not measured at fair value with changes in fair value recognised in profit or loss (i.e. a derivative that is embedded in a financial liability at fair value through profit or loss is not separated).

1. If an embedded derivative is separated, the host contract shall be accounted for in accordance with the appropriate Standards. This Standard does not address whether an embedded derivative shall be presented separately in the balance sheet.

2. If an entity is required by this Standard to separate an embedded derivative from its host, but is unable to measure the embedded derivative separately either at acquisition or at the end of a subsequent financial reporting period, it shall designate the entire hybrid contract as at fair value through profit or loss.
13. Non-financial Contracts

Contracts to buy or sell non-financial items do not meet the definition of a financial instrument because the contractual right of one party to receive a non-financial asset or service and the corresponding obligation of the other party do not establish a present right or obligation of either party to receive, deliver or exchange a financial asset.

For example: Contracts that provide for settlement only by the receipt or delivery of a non-financial item (Example: An option, futures or forward contract on silver) are not financial instruments.

Many commodity contracts are of this type.

For example: A commodity futures contract may be bought and sold readily for cash because it is listed for trading on an exchange and may change hands many times. However, the parties buying and selling the contract are, in effect, trading the underlying commodity.

The ability to buy or sell a commodity contract for cash, the ease with which it may be bought or sold and the possibility of negotiating a cash settlement of the obligation to receive or deliver the commodity do not alter the fundamental character of the contract in a way that creates a financial instrument.

Nevertheless, some contracts to buy or sell non-financial items that can be settled net or by exchanging financial instruments, or in which the non-financial item is readily convertible to cash, are within the scope of the Standard as if they were financial instruments.

This Standard shall be applied to those contracts to buy or sell a non-financial item (Property, Plant and Equipment or Inventories) that can be as if the contracts were financial instruments.

Exception: Contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity’s expected purchase, sale or usage requirements.

This Standard shall be applied to those contracts that an entity designates as measured at fair value through profit or loss in accordance with Ind AS 109, Financial Instruments.

Illustration 13

Entity XYZ enters into a fixed price forward contract to purchase 10,00,000 kilograms of copper in accordance with its expected usage requirements.

The contract permits XYZ to take physical delivery of the copper at the end of 12 months or to pay or receive a net settlement in cash, based on the change in fair value of copper. Is the contract covered under Financial Instruments standard?

Solution

The above contract needs to be evaluated to determine whether it falls within the scope of the financial instruments standards.

The contract is a derivative instrument because there is no initial net investment, the contract is based on the price of copper and it is to be settled at a future date.
However, if XYZ intends to settle the contract by taking delivery and has no history for similar contracts of settling net in cash, or of taking delivery of the copper and selling it within a short period after delivery for the purpose of generating a profit from short term fluctuations in price or dealer's margin, the contract is not accounted for as a derivative under Ind AS 109.

Instead, it is accounted for as an executory contract and if it becomes onerous then Ind AS 37 would apply.

14. Compound Financial Instruments

IND AS 32 applies only to issuers of non-derivative compound financial instruments. It does not deal with compound financial instruments from the perspective of holders.

Ind AS 109 deals with the classification and measurement of financial assets that are compound financial instruments from the holder's perspective.

The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component.

An entity recognises separately the components of a financial instrument that
(a) creates a financial liability of the entity and
(b) grants an option to the holder of the instrument to convert it into an equity instrument of the entity.

For example: A bond or similar instrument convertible by the holder into a fixed number of ordinary shares of the entity is a compound financial instrument.

From the perspective of the entity, such an instrument comprises two components:
- A financial liability (a contractual arrangement to deliver cash or another financial asset) and
- An equity instrument (a call option granting the holder the right, for a specified period of time, to convert it into a fixed number of ordinary shares of the entity).

Accordingly, in all cases, the entity presents the liability and equity components separately in its balance sheet.

Accounting treatment:

Initial recognition:

The issuer of a bond convertible into ordinary shares:

Step I

Determines the carrying amount of the liability component by measuring the fair value of a similar liability that does not have an associated equity component

Explanation:

On initial recognition, the fair value of the liability component is the present value of the
contractually determined stream of future cash flows 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 conversion option.

**Step II**

The carrying amount of the equity instrument represented by the option to convert the instrument into ordinary shares is then determined by **deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole**

**Subsequent Recognition:**

On conversion of a convertible instrument at maturity, the entity derecognises the liability component and recognises it as equity. The original equity component remains as equity (although it may be transferred from one line item within equity to another). There is no gain or loss on conversion at maturity.

**Illustration 14**

On 1 April, 2015, Delta Ltd. issued ₹ 30,00,000, 6% convertible debentures of face value of ₹ 100 per debenture at par. The debentures are redeemable at a premium of 10% on 31.03.19 or these may be converted into ordinary shares at the option of the holder, the interest rate for equivalent debentures without conversion rights would have been 10%.

*Being compound financial instrument, you are required to separate equity and debt portion as on 01.04.15.*

**Solution:**

**Computation of Equity and Debt Component of Convertible Debentures as on 1.4.15**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Present value of the principal repayable after four years</td>
<td>22,44,000</td>
</tr>
<tr>
<td>[30,00,000 x 1.10 x 0.680 at 10% Discount factor]</td>
<td></td>
</tr>
<tr>
<td>Add: Present value of Interest</td>
<td>5,70,600</td>
</tr>
<tr>
<td>[1,80,000 x 3.17 (4 years cumulative 10% discount factor)]</td>
<td></td>
</tr>
<tr>
<td>Value of debt component</td>
<td>28,14,600</td>
</tr>
<tr>
<td>Value of equity component</td>
<td>1,85,400</td>
</tr>
<tr>
<td>Proceeds of the issue</td>
<td>30,00,000</td>
</tr>
</tbody>
</table>

**15. Treasury Shares (Entity's Own Equity Instruments)**

An entity’s own equity instruments are not recognised as a financial asset regardless of the reason for which they are reacquired.

However, when an entity holds its own equity on behalf of others, eg a financial institution holding its own equity on behalf of a client, there is an agency relationship and as a result those holdings are not included in the entity’s balance sheet.

- If an entity reacquires its own equity instruments, those instruments (‘treasury shares’) shall be deducted from equity.
- No gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity’s own equity instruments.

- Such treasury shares may be acquired and held by the entity or by other members of the consolidated group. Consideration paid or received shall be recognised directly in equity.

Example:
A Limited buys back 1,00,000 of its own equity shares in the market for ₹ 5 per share. The shares will be held as treasury shares to enable A Limited to satisfy its obligations under its employee share option scheme. The following entry will be made to recognise the purchase of the treasury shares as a deduction from equity:

Dr Equity ₹ 5,00,000
Cr Cash ₹ 5,00,000

16. Interest, Dividends, Losses and Gains

- Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss.

- Distributions to holders of an equity instrument shall be recognised by the entity directly in equity.

- Transaction costs of an equity transaction shall be accounted for as a deduction from equity.

- Income tax relating to distributions to holders of an equity instrument and to transaction costs of an equity transaction shall be accounted for in accordance with Ind AS 12, Income Taxes.

The classification of a financial instrument as a financial liability or an equity instrument determines whether interest, dividends, losses and gains relating to that instrument are recognised as income or expense in profit or loss.
Thus, dividend payments on shares wholly recognised as liabilities are recognised as expenses in the same way as interest on a bond.

- An entity typically incurs various costs in issuing or acquiring its own equity instruments. Those costs might include registration and other regulatory fees, amounts paid to legal, accounting and other professional advisers, printing costs and stamp duties. The transaction costs of an equity transaction are accounted for as a deduction from equity to the extent they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided. The costs of an equity transaction that is abandoned are recognised as an expense.

- Transaction costs that relate to the issue of a compound financial instrument are allocated to the liability and equity components of the instrument in proportion to the allocation of proceeds.

- Dividends classified as an expense may be presented in the statement of profit and loss either with interest on other liabilities or as a separate item.

{In some circumstances, because of the differences between interest and dividends with respect to matters such as tax deductibility, it is desirable to disclose them separately in the statement of profit and loss. Disclosures of the tax effects are made in accordance with Ind AS 12.}

- Gains and losses related to changes in the carrying amount of a financial liability are recognised as income or expense in profit or loss even when they relate to an instrument that includes a right to the residual interest in the assets of the entity in exchange for cash or another financial asset.

**Illustration 15**

*Entity B places its privately held ordinary shares that are classified as equity with a stock exchange and simultaneously raises new capital by issuing new ordinary shares on the stock exchange.*

*Transaction costs are incurred in respect of both transactions. Determine the treatment of the incurred transactions costs?*

**Solution**

Since the issue of new shares is the issue of an equity instrument, but the placing of the existing equity instruments with the exchange is not, the transaction costs will need to be allocated between the two transactions.

Transaction costs in respect of the new shares issued will be recognised in equity whereas the transaction costs incurred in placing the existing shares with the stock exchange will be recognised in profit or loss.

**Illustration 16**

*An entity issues a non-redeemable callable subordinated bond with a fixed 6% coupon. The coupon can be deferred in perpetuity at the issuer’s option. The issuer has a history of paying the coupon each year and the current bond price is predicated on the holder’s expectation that the coupon will continue to be*
paid each year. In addition, the stated policy of the issuer is that the coupon will be paid each year, which has been publicly communicated. Evaluate?

**Solution**

Although there is both pressure on the issuer to pay the coupon, to maintain the bond price, and a constructive obligation to pay the coupon, there is no contractual obligation to do so. Therefore, the bond is classified as an equity instrument.

**Illustration 17**

A zero coupon bond is an instrument where no interest is payable during the instrument’s life and that is normally issued at a deep discount to the value at which it will be redeemed. Evaluate?

**Solution**

Although there are no mandatory periodic interest payments, the instrument provides for mandatory redemption by the issuer for a determinable amount at a fixed or determinable future date. Since there is a contractual obligation to deliver cash for the value at which the bond will be redeemed, the instrument is classified as a financial liability.

### 17. Offsetting a Financial Asset and a Financial Liability

A financial asset and a financial liability shall be offset and the net amount presented in the balance sheet when, and only when, an entity:

- Currently has a legally enforceable right to set off the recognised amounts
- Intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously

**Example:** Company X owes Company Y Rs.20 million at the end of 31 March. As part of another contract, Company Y owes Company X Rs.15 million at 31 March. Company X has the legal right to set off the asset and liability but historically, Company X has settled one month after Company Y settles.

Can Company X offset the asset and liability?

No, since Company X cannot demonstrate the intention to settle net or simultaneously for all payments.
18. Analysis of Scope of Ind AS 32 and 109

<table>
<thead>
<tr>
<th>Financial Instrument</th>
<th>Whether out of Scope?</th>
<th>Which Ind AS is Applicable</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Ind AS 109</td>
<td>Ind AS 32</td>
</tr>
<tr>
<td>Subsidiaries</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Associates</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Joint Ventures</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Rights and Obligations under Leases</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Employers Rights and obligations under Employee Benefit Plans</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Financial Instruments that meet the definition of equity Instrument</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Issuer point of view</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Holders point of view</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Rights and Obligations under an Insurance Contract</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Financial Guarantee Contracts</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Forward contract to buy or sell an acquiree that will result in a business combination within the scope of Ind AS 103 Business Combinations at a future date</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Loan commitments</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Financial Instruments, Contracts and obligations under share based payment transactions</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Reimbursement rights in respect of Provisions</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Rights and obligations</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Commodity Contracts to buy or sell Non-Financial Items net</td>
<td></td>
<td></td>
</tr>
<tr>
<td>For expected purchase, sale or usage requirement</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Not for Expected purchase, sale or usage requirement</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

19. HEDGE ACCOUNTING

19.1 Objective and Scope of Hedge Accounting

The objective of hedge accounting is to represent, in the financial statements, the effect of an entity’s risk management activities that use financial instruments to manage exposures
arising from particular risks that could affect profit or loss (or other comprehensive income, in the case of investments in equity instruments for which an entity has elected to present changes in fair value in other comprehensive income).

**For the purpose of Hedge Accounting, an Entity should:**

<table>
<thead>
<tr>
<th>Step</th>
<th>Paragraph</th>
<th>Paragraph Range</th>
</tr>
</thead>
<tbody>
<tr>
<td>Identifies and designates Hedged Item</td>
<td>Paragraph 6.3</td>
<td>Paragraph B6.3.1 to B6.3.25</td>
</tr>
<tr>
<td>Designates Hedging Instruments</td>
<td>Paragraph 6.2</td>
<td>Paragraph B6.2.1 to B6.2.6</td>
</tr>
<tr>
<td>Verifies whether Hedging satisfies Qualifying Criteria for Hedge Accounting</td>
<td>Paragraph 6.4</td>
<td>Paragraph B6.4.1 to B6.4.19</td>
</tr>
<tr>
<td>Accounts for Qualifying Hedging Relationships</td>
<td>Paragraph 6.5</td>
<td>Paragraph B6.5.1 to B6.5.39</td>
</tr>
<tr>
<td>Consider whether it is a Hedge of a Group of Items i.e. Hedging Net Position</td>
<td>Paragraph 6.6</td>
<td>Paragraph B6.6.1 to B6.6.16</td>
</tr>
<tr>
<td>Evaluates the option to designate a credit exposure as measured at FVTPL</td>
<td>Paragraph 6.7</td>
<td></td>
</tr>
</tbody>
</table>

**Identifies and designates Hedged Item**

A hedged item can be:

- A Recognised Asset or Liability
- An Unrecognised Firm Commitment
- A Forecast Transaction
- A Net Investment in a Foreign Operation

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6.52 Financial Reporting

The hedged item can be:

- a single item; or
- a group of items

NOTE:

1. The hedged item must be reliably measurable.
2. If a hedged item is a forecast transaction (or a component thereof), that transaction must be highly probable.

19.2 Designation of Hedging Instruments

A *derivative* measured at fair value through profit or loss may be designated as a hedging instrument, *except for some written options* (Refer Paragraph B6.2.4).

A *non-derivative* financial asset or a non-derivative financial liability measured at fair value through profit or loss may be designated as a hedging instrument unless it is a financial liability designated as at fair value through profit or loss for which the amount of its change in fair value that is attributable to changes in the credit risk of that liability is presented in other comprehensive income.

For a hedge of foreign currency risk, the foreign currency risk component of a non-derivative financial asset or a non-derivative financial liability may be designated as a hedging instrument provided that it is not an investment in an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income.

NOTE: For hedge accounting purposes, only contracts with a party external to the reporting entity (i.e. external to the group or individual entity that is being reported on) can be designated as hedging instruments.

19.3 Qualifying Criteria For Hedge Accounting

A hedging relationship qualifies for hedge accounting *only if all of the following criteria are met*:

a) The hedging relationship consists *only of eligible hedging instruments and eligible hedged items*.

b) At the inception of the hedging relationship there is *formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge*. That documentation shall include identification of the hedging instrument, the hedged item, the nature of the risk being hedged and how the entity will assess whether the hedging relationship meets the hedge effectiveness requirements (including its analysis of the sources of hedge ineffectiveness and how it determines the hedge ratio).

c) The hedging relationship meets *all of the following hedge effectiveness requirements*:

(i) there is an economic relationship between the hedged item and the hedging instrument (Refer Paragraphs B6.4.4– B6.4.6);
(ii) the effect of credit risk does not dominate the value changes that result from that economic relationship (Refer Paragraphs B6.4.7–B6.4.8); and

(iii) the hedge ratio of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item. However, that designation shall not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting (Refer Paragraphs B6.4.9–B6.4.11).

19.4 Types of Hedging Relationships

An entity applies hedge accounting to hedging relationships that meet the qualifying criteria. There are three types of hedging relationships:

19.4.1 Fair value hedge

A hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss.

If a fair value hedge meets the qualifying criteria, the hedging relationship shall be accounted for as follows:
Note:
1. If the hedging instrument hedges an equity instrument for which an entity has elected to present changes in fair value in OCI

2. Adjust the carrying amount of the hedged item (if applicable) and be recognised in profit or loss.

   If the hedged item is a financial asset (or a component thereof) that is measured at FVTOCI, the hedging gain or loss on the hedged item shall be recognised in profit or loss.

   If the hedged item is an equity instrument for which an entity has elected to present changes in FVTOCI, those amounts shall remain in other comprehensive income.

   When a hedged item is an unrecognised firm commitment (or a component thereof), the cumulative change in the fair value of the hedged item subsequent to its designation is recognised as an asset or a liability with a corresponding gain or loss recognised in profit or loss.

19.4.2 Cash flow hedge

A hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognised asset or liability (such as all or some future interest payments on variable-rate debt) or a highly probable forecast transaction, and could affect profit or loss.

As long as a cash flow hedge meets the qualifying criteria, the hedging relationship shall be accounted for as follows:

a) the separate component of equity associated with the hedged item (CASH FLOW HEDGE RESERVE) is adjusted to the lower of the following (in absolute amounts):

   (i) the cumulative gain or loss on the hedging instrument from inception of the hedge; and

   (ii) the cumulative change in fair value (present value) of the hedged item (i.e. the present value of the cumulative change in the hedged expected future cash flows) from inception of the hedge.

b) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (i.e. the portion that is offset by the change in the cash flow hedge reserve calculated in accordance with (a)) shall be recognised in other comprehensive income.

   (a) any remaining gain or loss on the hedging instrument (or any gain or loss required to balance the change in the cash flow hedge reserve calculated in accordance with (a)) is hedge ineffectiveness that shall be recognised in profit or loss.

   (b) the amount that has been accumulated in the cash flow hedge reserve in accordance with (a) shall be accounted for as follows:

      (i) if a hedged forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, or a hedged forecast transaction for a non-financial asset or a non-financial liability becomes a firm commitment for which fair
value hedge accounting is applied, the entity shall remove that amount from the cash flow hedge reserve and include it directly in the initial cost or other carrying amount of the asset or the liability.

[This is not a reclassification adjustment and hence it does not affect other comprehensive income.]

(ii) for cash flow hedges other than those covered by (i), that amount shall be reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment in the same period or periods during which the hedged expected future cash flows affect profit or loss.

For example: In the periods that interest income or interest expense is recognised or when a forecast sale occurs.

(iii) however, if that amount is a loss and an entity expects that all or a portion of that loss will not be recovered in one or more future periods, it shall immediately reclassify the amount that is not expected to be recovered into profit or loss as a reclassification adjustment.

19.5 Hedge of a Net Investment in a Foreign Operation as Defined in Ind AS 21

Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment (Refer Ind AS 21), shall be accounted for similarly to cash flow hedges:

Hedge of a net investment in a foreign operation

Portion of the gain or loss on the hedging instrument that is determined to be an Effective Hedge

Shall be recognised in OCI

Ineffective portion

Shall be recognised in P&L

The cumulative gain or loss on the hedging instrument relating to the effective portion of the hedge that has been accumulated in the foreign currency translation reserve shall be reclassified from equity to profit or loss as a reclassification adjustment (Refer Ind AS 1) in accordance with Ind AS 21 on the disposal or partial disposal of the foreign operation.
An entity shall disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance.

20.2 Balance Sheet

20.2.1 Categories of financial assets and financial liabilities

The carrying amounts of each of the following categories, as specified in Ind AS 109, shall be disclosed either in the balance sheet or in the notes:

(a) financial assets measured at fair value through profit or loss, showing separately
   (i) those designated as such upon initial recognition or subsequently in accordance with Ind AS 109 and
   (ii) those mandatorily measured at fair value through profit or loss in accordance with Ind AS 109.

(b) financial liabilities at fair value through profit or loss, showing separately
   (i) those designated as such upon initial recognition or subsequently in accordance with Ind AS 109 and
   (ii) those that meet the definition of held for trading in Ind AS 109.

(c) financial assets measured at amortised cost.

(d) financial liabilities measured at amortised cost.

(e) financial assets measured at fair value through other comprehensive income, showing separately
   (i) financial assets that are measured at fair value through other comprehensive income in accordance with Ind AS 109; and
   (ii) investment in equity instruments designated as such upon initial recognition in accordance with Ind AS 109.
20.2.2 Financial assets or financial liabilities at fair value through profit or loss

If the entity has designated as measured at fair value through profit or loss a financial asset (or group of financial assets) that would otherwise be measured at fair value through other comprehensive income or amortised cost, it shall disclose:

(a) the maximum exposure to credit risk of the financial asset (or group of financial assets) at the end of the reporting period.

(b) the amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk.

(c) the amount of change, during the period and cumulatively, in the fair value of the financial asset (or group of financial assets) that is attributable to changes in the credit risk of the financial asset determined either:

   (i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or

   (ii) using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset.

(d) the amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the financial asset was designated.

20.2.3 Investments in equity instruments designated at fair value through other comprehensive income

If an entity has designated investments in equity instruments to be measured at fair value through other comprehensive income, as permitted by Ind AS 109, it shall disclose:

(a) which investments in equity instruments have been designated to be measured at fair value through other comprehensive income.

(b) the reasons for using this presentation alternative.

(c) the fair value of each such investment at the end of the reporting period.

(d) dividends recognised during the period, showing separately those related to investments derecognised during the reporting period and those related to investments held at the end of the reporting period.

(e) any transfers of the cumulative gain or loss within equity during the period including the reason for such transfers.

20.2.4 Reclassification

An entity shall disclose if, in the current or previous reporting periods, it has reclassified any financial assets in accordance with Ind AS 109. For each such event, an entity shall disclose:
6.58 Financial Reporting

(a) the date of reclassification.
(b) a detailed explanation of the change in business model and a qualitative description of its effect on the entity’s financial statements.
(c) the amount reclassified into and out of each category.

20.2.5 Collateral
An entity shall disclose:
(a) the carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities, including amounts that have been reclassified in accordance with Ind AS 109; and
(b) the terms and conditions relating to its pledge.

20.2.6 Allowance account for credit losses
The carrying amount of financial assets measured at fair value through other comprehensive income in accordance with Ind AS 109 is not reduced by a loss allowance and an entity shall not present the loss allowance separately in the balance sheet as a reduction of the carrying amount of the financial asset. However, an entity shall disclose the loss allowance in the notes to the financial statements.

20.2.7 Compound financial instruments with multiple embedded derivatives
If an entity has issued an instrument that contains both a liability and an equity component and the instrument has multiple embedded derivatives whose values are interdependent (such as a callable convertible debt instrument), it shall disclose the existence of those features.

20.2.8 Defaults and breaches
For loans payable recognised at the end of the reporting period, an entity shall disclose:
(a) details of any defaults during the period of principal, interest, sinking fund, or redemption terms of those loans payable;
(b) the carrying amount of the loans payable in default at the end of the reporting period; and
(c) whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were approved for issue.

20.3 Statement of Profit and Loss

20.3.1 Items of Income, Expense, Gains or Losses
An entity shall disclose the following items of income, expense, gains or losses either in the statement of profit and loss or in the notes:
(a) net gains or net losses on:
   (i) financial assets or financial liabilities measured at fair value through profit or loss, showing separately those on financial assets or financial liabilities designated as such upon initial recognition or subsequently in accordance with Ind AS 109, and those on
financial assets or financial liabilities that are mandatorily measured at fair value through profit or loss in accordance with Ind AS 109 (e.g. financial liabilities that meet the definition of held for trading in Ind AS 109). For financial liabilities designated as at fair value through profit or loss, an entity shall show separately the amount of gain or loss recognised in other comprehensive income and the amount recognised in profit or loss.

(ii) financial liabilities measured at amortised cost.

(iii) financial assets measured at amortised cost.

(iv) investments in equity instruments designated at fair value through other comprehensive income in accordance with Ind AS 109.

(v) financial assets measured at fair value through other comprehensive income in accordance with Ind AS 109, showing separately the amount of gain or loss recognised in other comprehensive income during the period and the amount reclassified upon derecognition from accumulated other comprehensive income to profit or loss for the period.

(b) total interest revenue and total interest expense (calculated using the effective interest method) for financial assets that are measured at amortised cost or that are measured at fair value through other comprehensive income in accordance with Ind AS 109 (showing these amounts separately); or financial liabilities that are not measured at fair value through profit or loss.

(c) fee income and expense (other than amounts included in determining the effective interest rate) arising from:

(i) financial assets and financial liabilities that are not at fair value through profit or loss; and

(ii) trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions.

### 20.4 Other Disclosures

#### 20.4.1 Accounting policies

In accordance with Ind AS 1 Presentation of Financial Statements, an entity discloses, in the summary of significant accounting policies, the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements.

#### 20.4.2 Hedge accounting

An entity shall apply the disclosure requirements for those risk exposures that an entity hedges and for which it elects to apply hedge accounting. Hedge accounting disclosures shall provide information about:

(i) an entity's risk management strategy and how it is applied to manage risk;
(ii) how the entity’s hedging activities may affect the amount, timing and uncertainty of its future cash flows; and

(iii) The effect that hedge accounting has had on the entity’s balance sheet, statement of profit and loss and statement of changes in equity.

20.4.3 Fair value

For each class of financial assets and financial liabilities, an entity shall disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount.

Disclosures of fair value are not required:

(a) when the carrying amount is a reasonable approximation of fair value, for example, for financial instruments such as short-term trade receivables and payables;

(b) For a contract containing a discretionary participation feature (as described in Ind AS 104) if the fair value of that feature cannot be measured reliably.

20.4.4 Nature and Extent of Risks Arising from Financial Instruments

An entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period.

Qualitative disclosures

For each type of risk arising from financial instruments, an entity shall disclose:

(a) the exposures to risk and how they arise;

(b) its objectives, policies and processes for managing the risk and the methods used to measure the risk; and

(c) Any changes in (a) or (b) from the previous period.

Quantitative disclosures

For each type of risk arising from financial instruments, an entity shall disclose:

(a) Summary quantitative data about its exposure to that risk at the end of the reporting period. This disclosure shall be based on the information provided internally to key management personnel of the entity (as defined in Ind AS 24, Related Party Disclosures), for example the entity’s board of directors or chief executive officer.

(b) the disclosures required by paragraphs 36–42, to the extent not provided in accordance with (a).

(c) concentrations of risk if not apparent from the disclosures made in accordance with (a) and (b).
21. Miscellaneous Illustrations

Illustration 18

XYZ Ltd. grants loans to its employees at 4% amounting to ₹10,00,000 at the beginning of 2015-16. The principal amount is repaid over a period of 5 years whereas the accumulated interest computed on reducing balance at simple interest is collected in 2 equal annual instalments after collection of the principal amount.

Assume the benchmark interest rate is 8%.

Show the accounting entries on 1-4-2015 and 31-3-2016.

Solution

Computation of Fair Value at Initial Recognition

<table>
<thead>
<tr>
<th>Year</th>
<th>Estimated Cash Flows</th>
<th>PVIF @8%</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/4/2015</td>
<td>₹</td>
<td>1</td>
<td>Nil</td>
</tr>
<tr>
<td>31/3/2016</td>
<td>2,00,000</td>
<td>0.9259</td>
<td>1,85,185</td>
</tr>
<tr>
<td>31/3/2017</td>
<td>2,00,000</td>
<td>0.8573</td>
<td>1,71,468</td>
</tr>
<tr>
<td>31/3/2018</td>
<td>2,00,000</td>
<td>0.7938</td>
<td>1,58,766</td>
</tr>
<tr>
<td>31/3/2019</td>
<td>2,00,000</td>
<td>0.7350</td>
<td>1,47,006</td>
</tr>
<tr>
<td>31/3/2020</td>
<td>2,00,000</td>
<td>0.6806</td>
<td>1,36,117</td>
</tr>
<tr>
<td>31/3/2021</td>
<td>60,000</td>
<td>0.6302</td>
<td>37,810</td>
</tr>
<tr>
<td></td>
<td>See Working note</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31/3/2022</td>
<td>60,000</td>
<td>0.5835</td>
<td>35,009</td>
</tr>
<tr>
<td></td>
<td>See Working note</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Fair Value of Loan 8,71,361

Working Notes:

Computation of Interest to be paid on 31/3/2021 and 31/3/2022

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Flows</th>
<th>Principal outstanding</th>
<th>Interest</th>
<th>Cumulative Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>31/3/2016</td>
<td>2,00,000</td>
<td>8,00,000</td>
<td>40,000</td>
<td>40,000</td>
</tr>
<tr>
<td>31/3/2017</td>
<td>2,00,000</td>
<td>6,00,000</td>
<td>32,000</td>
<td>72,000</td>
</tr>
<tr>
<td>31/3/2018</td>
<td>2,00,000</td>
<td>4,00,000</td>
<td>24,000</td>
<td>96,000</td>
</tr>
<tr>
<td>31/3/2019</td>
<td>2,00,000</td>
<td>2,00,000</td>
<td>16,000</td>
<td>1,12,000</td>
</tr>
<tr>
<td>31/3/2020</td>
<td>2,00,000</td>
<td>Nil</td>
<td>8,000</td>
<td>1,20,000</td>
</tr>
<tr>
<td>31/3/2021</td>
<td>60,000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
6.62 Financial Reporting

<table>
<thead>
<tr>
<th>Date</th>
<th>Particulars</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/4/2015</td>
<td>Loans to Employee A/c</td>
<td>8,71,361</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Employee Benefits A/c</td>
<td></td>
<td>1,28,639</td>
</tr>
<tr>
<td></td>
<td>To Bank A/c</td>
<td></td>
<td>10,00,000</td>
</tr>
</tbody>
</table>

Note: The fair value measurement is of other than level 1. Therefore, as per paragraph B5.1.2A of Ind AS 109, an entity should defer the day 1 gain/loss over the term of the financial asset. Therefore, ₹1,28,369 will be amortised over a period of 7 years. There is no guidance on how to amortise the same. The simplest way is to amortise the difference in line with the interest accruals so that there is no impact on Profit or Loss.

Employee benefit is transferred to Statement of Profit and Loss.

## Computation of Interest on Amortised Cost

<table>
<thead>
<tr>
<th>Year</th>
<th>Opening Balance (1)</th>
<th>Interest @ 8% (2)</th>
<th>Repayment (3)</th>
<th>Closing Balance (1+2-3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/4/2015</td>
<td>8,71,361</td>
<td>69,709</td>
<td>2,00,000</td>
<td>8,71,361</td>
</tr>
<tr>
<td>31/3/2016</td>
<td>7,41,070</td>
<td>59,286</td>
<td>2,00,000</td>
<td>6,00,356</td>
</tr>
<tr>
<td>31/3/2017</td>
<td>6,00,356</td>
<td>48,028</td>
<td>2,00,000</td>
<td>4,48,384</td>
</tr>
<tr>
<td>31/3/2018</td>
<td>4,48,384</td>
<td>35,871</td>
<td>2,00,000</td>
<td>2,84,255</td>
</tr>
<tr>
<td>31/3/2019</td>
<td>2,84,255</td>
<td>22,740</td>
<td>2,00,000</td>
<td>1,06,995</td>
</tr>
<tr>
<td>31/3/2020</td>
<td>1,06,995</td>
<td>8,560</td>
<td>60,000</td>
<td>55,555</td>
</tr>
<tr>
<td>31/3/2021</td>
<td>55,555</td>
<td>4,445</td>
<td>60,000</td>
<td>Nil</td>
</tr>
</tbody>
</table>
Journal Entry on 31/3/2016

<table>
<thead>
<tr>
<th>Date</th>
<th>Particulars</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>31/3/2016</td>
<td>Loans to Employee A/c</td>
<td></td>
<td>69,709</td>
</tr>
<tr>
<td></td>
<td>To Interest Accrued A/c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31/3/2016</td>
<td>Bank A/c</td>
<td></td>
<td>2,00,000</td>
</tr>
<tr>
<td></td>
<td>To Loan to Employees</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: Similar entries would be done at the end of each year.

Illustration 19

ABC Ltd. issued Debentures amounting to ₹100 lacs.

As per the terms of the issue it has been agreed to issue equity shares amounting to ₹150 lacs to redeem the debentures at the end of 3rd year.

Assume comparable market yield is 10% for year 0 and 1, and 10.5% for Year 2 end.

Show accounting entries.

Solution:

Value of Debentures to be recorded at initial year:

Present Value of 150 lacs at 10%

= 150 lacs x PVIF (10% at the end of 3rd year)

= 150 lacs x 0.7513

= 112,69,500

Journal Entries at Inception:

<table>
<thead>
<tr>
<th>Date</th>
<th>Particulars</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st Year Beg</td>
<td>Bank A/c</td>
<td>100,00,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Profit &amp; Loss A/c</td>
<td>12,69,500</td>
<td></td>
</tr>
<tr>
<td></td>
<td>To Debentures</td>
<td></td>
<td>112,69,500</td>
</tr>
</tbody>
</table>

Journal Entries at 1st Year End:

<table>
<thead>
<tr>
<th>Date</th>
<th>Particulars</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st Year End</td>
<td>Interest A/c</td>
<td>11,26,950</td>
<td></td>
</tr>
<tr>
<td></td>
<td>To Debentures A/c (10% of 112,69,500)</td>
<td></td>
<td>11,26,950</td>
</tr>
</tbody>
</table>

Journal Entries at 2nd Year End:

<table>
<thead>
<tr>
<th>Date</th>
<th>Particulars</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2nd Year End</td>
<td>Interest A/c</td>
<td>11,78,550</td>
<td></td>
</tr>
<tr>
<td></td>
<td>To Debentures A/c</td>
<td></td>
<td>11,78,550</td>
</tr>
</tbody>
</table>
Working Note:
Present Value of 150 lacs at 10.5% compared to Book Value
i.e. 150 lacs x 0.905 = 135,75,000 compared to 123,96,450 = 11,78,550

Journal Entries at 3rd Year End:

<table>
<thead>
<tr>
<th>Date</th>
<th>Particulars</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>3rd Year End</td>
<td>Interest A/c To Debentures A/c</td>
<td>14,25,000</td>
<td>14,25,000</td>
</tr>
</tbody>
</table>

Working Note:
Present Value of 150 lacs at 10.5% compared to Book Value
i.e. 150 lacs x 1 = 150,00,000 compared to 135,75,000 = 14,25,000

On conversion to Equity Shares

<table>
<thead>
<tr>
<th>Date</th>
<th>Particulars</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>3rd Year End</td>
<td>Debentures A/c To Equity Share Capital To Securities Premium</td>
<td>150,00,000</td>
<td>100,00,000 50,00,000</td>
</tr>
</tbody>
</table>

Illustration 20

As point of staff welfare measures, Y Co. Ltd. has contracted to lend to its employees sums of money at 5 percent per annum rate of interest. The amounts lent are to be repaid along with the interest in five equal annual instalments. The market rate of interest is 10 per cent per annum.

Y lent ₹16,00,000 to its employees on 1st January, 2015.

Following the principles of recognition and measurement as laid down in Ind AS 109, you are required to record the entries for the year ended 31st December, 2015 for the transaction and also calculate the value of the loan initially to be recognized and the amortized cost for all the subsequent years.

For purposes of calculation, the following discount factors at interest rate of 10 percent may be adopted

At the end of year

1  .909
2  .827
3  .751
4  .683
5  .620
Solution:

(i) Calculation of initial recognition amount of loan to employees

<table>
<thead>
<tr>
<th>Year end</th>
<th>Cash Inflow</th>
<th>Total</th>
<th>P.V. factor @10%</th>
<th>Present value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Principal</td>
<td>Interest @ 5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td>3,20,000</td>
<td>80,000</td>
<td>4,00,000</td>
<td>3,63,600</td>
</tr>
<tr>
<td>2016</td>
<td>3,20,000</td>
<td>64,000</td>
<td>3,84,000</td>
<td>3,17,568</td>
</tr>
<tr>
<td>2017</td>
<td>3,20,000</td>
<td>48,000</td>
<td>3,68,000</td>
<td>2,76,368</td>
</tr>
<tr>
<td>2018</td>
<td>3,20,000</td>
<td>32,000</td>
<td>3,52,000</td>
<td>2,40,416</td>
</tr>
<tr>
<td>2019</td>
<td>3,20,000</td>
<td>16,000</td>
<td>3,36,000</td>
<td>2,08,320</td>
</tr>
<tr>
<td>Present value or Fair value</td>
<td></td>
<td></td>
<td></td>
<td>14,06,272</td>
</tr>
</tbody>
</table>

(ii) Calculation of amortised cost of loan to employees

<table>
<thead>
<tr>
<th>Year</th>
<th>Amortised cost (Opening balance) [1]</th>
<th>Interest to be recognised@10% [2]</th>
<th>Repayment (including interest) [3]</th>
<th>Amortised Cost (Closing balance) [4]=[1]+ [2]-[3]</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>14,06,272</td>
<td>1,40,627</td>
<td>4,00,000</td>
<td>11,46,899</td>
</tr>
<tr>
<td>2016</td>
<td>11,46,899</td>
<td>1,14,690</td>
<td>3,84,000</td>
<td>8,77,589</td>
</tr>
<tr>
<td>2017</td>
<td>8,77,589</td>
<td>87,759</td>
<td>3,68,000</td>
<td>5,97,348</td>
</tr>
<tr>
<td>2018</td>
<td>5,97,348</td>
<td>59,735</td>
<td>3,52,000</td>
<td>3,05,083</td>
</tr>
<tr>
<td>2019</td>
<td>3,05,083</td>
<td>30,917*</td>
<td>3,36,000</td>
<td>Nil</td>
</tr>
</tbody>
</table>

* ₹ 3,05,083 x 10% = ₹ 30,508. The difference of ₹ 409 (₹ 30,917 – ₹ 30,508) is due to approximation in computation.

(iii) Journal Entries in the books of Y Ltd.

For the year ended 31st December, 2015 (regarding loan to employees)

<table>
<thead>
<tr>
<th>Dr. Amount (₹)</th>
<th>Cr. Amount (₹)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Staff loan A/c</td>
<td>16,00,000</td>
</tr>
<tr>
<td>To Bank A/c</td>
<td>16,00,000</td>
</tr>
<tr>
<td>(Being the disbursement of loans to staff)</td>
<td></td>
</tr>
<tr>
<td>Staff cost A/c</td>
<td>1,93,728</td>
</tr>
<tr>
<td>(16,00,000 –14,06,272) [Refer part (ii)]</td>
<td>Dr.</td>
</tr>
<tr>
<td>To Staff loan A/c</td>
<td>1,93,728</td>
</tr>
<tr>
<td>(Being the write off of excess of loan balance over present value thereof in order to reflect the loan at its present value of ₹ 14,06,272)</td>
<td></td>
</tr>
</tbody>
</table>

* This is a level 2 measurement and therefore should be deferred as per paragraph 5.1.2A instead of recognising on day 1.
6.66 Financial Reporting

<table>
<thead>
<tr>
<th>Staff loan A/c</th>
<th>Dr.</th>
<th>1,40,627</th>
<th>1,40,627</th>
</tr>
</thead>
<tbody>
<tr>
<td>To Interest on staff loan A/c</td>
<td>1,40,627</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Being the charge of interest @ market rate of 10% on the loan)</td>
<td>1,40,627</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Bank A/c</th>
<th>Dr.</th>
<th>4,00,000</th>
<th>4,00,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>To Staff loan A/c</td>
<td>4,00,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Being the repayment of first instalment with interest for the year)</td>
<td>4,00,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Interest on staff loan A/c</th>
<th>Dr.</th>
<th>1,40,627</th>
<th>1,40,627</th>
</tr>
</thead>
<tbody>
<tr>
<td>To Profit and loss A/c</td>
<td>1,40,627</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Being transfer of balance of staff loan Interest account to profit and loss account)</td>
<td>1,40,627</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Illustration 21
K Ltd. issued 5,00,000, 6% Convertible Debentures of ₹ 10 each on the 1st April 2015. The debentures are due for redemption on 31st March, 2019 at a premium of 10% convertible into equity shares to the extent of 50% and the balance to be settled in cash to the debenture holders. The interest rate on equivalent debentures without conversion rights was 10%. You are required to separate the debt & equity components at the time of the issue and show the accounting entry in the company’s books at initial recognition.

The following Present Values of ₹ 1 at 6% and at 10% are supplied to you.

<table>
<thead>
<tr>
<th>Interest Rate</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>6%</td>
<td>0.94</td>
<td>0.89</td>
<td>0.84</td>
<td>0.79</td>
</tr>
<tr>
<td>10%</td>
<td>0.91</td>
<td>0.83</td>
<td>0.75</td>
<td>0.68</td>
</tr>
</tbody>
</table>

Solution
Computation of Debt Component of Convertible Debentures as on 1.4.2015

<table>
<thead>
<tr>
<th>Particulars</th>
<th>₹</th>
</tr>
</thead>
<tbody>
<tr>
<td>Present value of the principal repayable after four years ( [50,00,000 \times 50% \times 1.10 \times 0.68 \text{(10% Discount factor)}] ) (a)</td>
<td>18,70,000</td>
</tr>
<tr>
<td>Present value of Interest ( [3,00,000 \times 3.17 \text{(4 years cumulative 10% discount factor)}] ) (b)</td>
<td>9,51,000</td>
</tr>
<tr>
<td>Total present Value of debt component ( (I) ) (a + b)</td>
<td>28,21,000</td>
</tr>
<tr>
<td>Issue proceeds from convertible debenture ( (II) )</td>
<td>50,00,000</td>
</tr>
<tr>
<td>Value of equity component ( (II – I) )</td>
<td>21,79,000</td>
</tr>
</tbody>
</table>

Journal entry at initial recognition

<table>
<thead>
<tr>
<th>Dr. (₹)</th>
<th>Cr. (₹)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash / Bank A/c</td>
<td>50,00,000</td>
</tr>
<tr>
<td>To 6% Debenture (Liability component) A/c</td>
<td>28,21,000</td>
</tr>
<tr>
<td>To 6% Debenture (Equity component) A/c</td>
<td>21,79,000</td>
</tr>
<tr>
<td>(Being the disbursement recorded at fair value)</td>
<td></td>
</tr>
</tbody>
</table>