UNIT 2: CLASSIFICATION AND MEASUREMENT OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

2.1 RECOGNITION AND SUBSEQUENT MEASUREMENT

All financial assets and financial liabilities are measured at their fair values upon initial recognition. Classification of the financial assets and financial liabilities drives their initial and subsequent measurement.

2.2 FINANCIAL ASSETS: KEY ELEMENTS TO DETERMINE CLASSIFICATION

Key essential elements that determine classification of financial assets are:

(A) Business model (BM) test:

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

Factors determining BM

- 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 and an entity will need to use judgement when it assesses its business model for managing financial assets.
- This assessment is not determined by a single factor or activity. Instead, the entity must consider all relevant evidence that is available. Such relevant evidence includes, but is not limited to:
  - (a) how the performance of business model and the financial assets held within that business model are evaluated & 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).

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Level of aggregation of assets for determining BM	❖ 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 and not based on management's intentions for an individual instrument. Accordingly, this condition is not an instrument-by-instrument approach to classification and should be determined at a higher level of aggregation. ❖ However, a single entity may have more than one business model for managing its financial instruments. Consequently, classification need not be determined at the reporting entity level. For example, an entity may hold a portfolio of investments that it manages in order to collect contractual cash flows and another portfolio of investments that it manages in order to trade to realise fair value changes.
Determining basis of realisation of contractual cash flows	❖ 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.
Difference in actual realisation from BM	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 (ie those assets that the entity recognised in prior periods and still holds) as long as the entity considered all relevant information that was available at the time that it made the business model assessment.

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➢ **Financial assets held for trading:**

Financial assets held for trading are defined as those that:

(a) are acquired or incurred principally for the purpose of sale or repurchase in the near term;

(b) on initial recognition are 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

(c) are derivatives (except for those that are financial guarantee contracts or are designated effective hedging instruments).

Trading generally reflects active and frequent buying and selling, and financial instruments held for trading are normally used with the objective of generating a profit from short-term fluctuations in price or a dealer's margin.

Illustration 1

An entity holds investments to collect their contractual cash flows. The funding needs of the entity are predictable and the maturity of its financial assets is matched to the entity's estimated funding needs.

The entity 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 entity's documented investment policy. In addition, infrequent sales have occurred as a result of unanticipated funding needs.

Reports to key management personnel focus on the credit quality of the financial assets and the contractual return. The entity also monitors fair values of the financial assets, among other information.

Evaluate the business model.

Solution

- Although the entity considers, among other information, the financial assets' fair values from a liquidity perspective (ie the cash amount that would be realised if the entity needs to sell assets), the entity'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 entity's documented investment policy.

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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.

Hence the business model of the company is to collect contractual cash flows and not realisation from sale of financial assets.

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Illustration 2

An entity's business model is to purchase portfolios of financial assets, such as loans. Those portfolios may or may not include financial assets that are credit impaired.

If payment on the loans is not made on a timely basis, the entity attempts to realise the contractual cash flows through various means—for example, by contacting the debtor by mail, telephone or other methods. The entity's objective is to collect the contractual cash flows and the entity does not manage any of the loans in this portfolio with an objective of realising cash flows by selling them.

In some cases, the entity enters into interest rate swaps to change the interest rate on particular financial assets in a portfolio from a floating interest rate to a fixed interest rate.

Evaluate the business model.

Solution

The objective of the entity's business model is to hold the financial assets in order to collect the contractual cash flows. The same analysis would apply even if the entity does not expect to receive all of the contractual cash flows (eg some of the financial assets are credit impaired at initial recognition).

Moreover, the fact that the entity enters into derivatives to modify the cash flows of the portfolio does not in itself change the entity's business model.

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Illustration 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 cash in accordance with the contractual cash flows of trade receivables and has no intention to dispose of the receivables.

Evaluate the business model.

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Solution

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

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Illustration 4

An entity anticipates capital expenditure in a few years. The entity 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 entity's anticipated investment period.

The entity 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.

Evaluate the business model.

Solution

The objective of the business model is achieved by both collecting contractual cash flows and selling financial assets. The entity 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 an entity 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 entity reinvests the cash in new short-term financial assets. The entity maintains this strategy until the funds are needed, at which time the entity 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.

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Illustration 5

An entity has a business model with the objective of originating loans to customers and subsequently selling those loans to a securitisation vehicle. The securitisation vehicle issues instruments to investors. The originating entity controls the securitisation vehicle and thus consolidates it.

The securitisation vehicle collects the contractual cash flows from the loans and passes them on to its investors. In the consolidated balance sheet, loans continue to be recognised because they are not derecognised by the securitisation vehicle.

Evaluate the business model.

Solution

The entity originating loans to customers has the objective of realising contractual cash flows on the loan portfolio only through sale to securitisation vehicle. However, the consolidated group originates loans with the objective of holding them to collect the contractual cash flows.

- Hence, the consolidated financial statements provide for a business model with the objective of collecting contractual cash flows by holding to maturity.
- And in separate financial statements of the entity originating loans to customers, business model is to collect cash flows through sale only.

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Illustration 6

A financial institution holds financial assets to meet liquidity needs in a 'stress case' scenario (eg, a run on the bank's deposits). The entity does not anticipate selling these assets except in such scenarios. The entity monitors the credit quality of the financial assets and its objective in managing the financial assets is to collect the contractual cash flows. The entity evaluates the performance of the assets on the basis of interest revenue earned and credit losses realised.

However, the entity also monitors the fair value of the financial assets from a liquidity perspective to ensure that the cash amount that would be realised if the entity needed to sell the assets in a stress case scenario would be sufficient to meet the entity's liquidity needs. Periodically, the entity makes sales that are insignificant in value to demonstrate liquidity.

Evaluate the business model.

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Solution

The objective of the entity's business model is to hold the financial assets to collect contractual cash flows. The analysis would not change –

- If during a previous stress case scenario the entity had sales that were significant in value in order to meet its liquidity needs; or
- Recurring sales activity that is insignificant in value is not inconsistent with holding financial assets to collect contractual cash flows.

If the entity is required by its regulator to routinely sell financial assets to demonstrate that the assets are liquid, and the value of the assets sold is significant, the entity's business model is not to hold financial assets to collect contractual cash flows. Whether a third party imposes the requirement to sell the financial assets, or that activity is at the entity's discretion, is not relevant to the analysis.

In contrast, if an entity holds financial assets to meet its everyday liquidity needs and meeting that objective involves frequent sales that are significant in value, the objective of the entity's business model is not to hold the financial assets to collect contractual cash flows.

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(B) Contractual cash flows characteristics 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 –

(i) within a business model whose objective is to hold assets to collect contractual cash flows; or

(ii) within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

To do so, an entity is required to determine whether the asset's 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.

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➢ The key characteristics of cash flows to test if they are solely payments of principal and interest are as follows:

What is principal?	❖ Principal is the fair value of the financial asset at initial recognition. ❖ However, that principal amount may change over the life of the
Components of 'interest element'	**Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with a basic lending arrangement**. An originated or a purchased financial asset can be a basic lending arrangement irrespective of whether it is a loan in its legal form. ❖ 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); ❖ costs (for example, administrative costs) associated with holding the financial asset for a particular period of time; and ❖ profit margin that is consistent with a basic lending arrangement. ❖ In extreme economic circumstances, interest can be negative if, for example, the holder of a financial asset either explicitly or implicitly pays for the deposit of its money for a particular period of time (and that fee exceeds the consideration that the holder receives for the time value of money, credit risk and other basic lending risks and costs). ❖ 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 & interest. ❖ Leverage is a contractual cash flow characteristic of some financial assets, that increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest. Stand-alone option, forward and swap contracts are examples of financial assets that include such leverage. Thus, such contracts cannot be said to have contractual cash flows that are only payments of principal & interest and hence, cannot be subsequently measured at amortised cost or fair value through other comprehensive income.

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- Following are **examples** of contractual terms that result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding:

(a) a variable interest rate on a financial instrument, where this rate consists of consideration for –

- time value of money,
- credit risk associated with the principal amount outstanding during a particular period of time (the consideration for credit risk may be determined at initial recognition only, and so may be fixed); and
- other basic lending risks and costs, as well as a profit margin.

This is because this variable interest rate is only to provide the lender with a return through 'interest' based on present market factors and no other form of return on the principal amount of the financial instrument. So, it has characteristics of return similar to one on a basic lending arrangement and thus, meets definition of contractual cash flows that are solely payments of principal and interest.

(b) a contractual term that permits the issuer (ie the debtor) to prepay a debt instrument or permits the holder (ie the creditor) to put a debt instrument back to the issuer before maturity and the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract;

Reasonable additional compensation' implies that the party choosing to exercise its option to terminate the contract compensates the other party.

Exception

Some prepayment options could result in other party being forced to accept negative compensation – e.g. the lender receives an amount less than the unpaid amounts of principal and interest if the borrower chooses to prepay.

Earlier, these instruments were measured at FVTPL. However, now after amendment, such financial assets could be measured at amortised cost or at FVOCI if they meet the other relevant requirements of Ind AS 109.

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To be eligible for the exception, the fair value of the prepayment feature would have to be insignificant on initial recognition of the asset. If this is impracticable to assess based on the facts and circumstances that existed on initial recognition of the asset, then the exception would not be available. Also, financial assets prepayable at current fair value would be measured at FVTPL. The same would apply if the prepayment amount includes the fair value cost to terminate a hedging instrument if the amount is inconsistent with the current Ind AS 109 prepayment rules. (The measurement principles given here have been explained in detail in the subsequent sections).

(c) a contractual term that permits the issuer or the holder to extend the contractual term of a debt instrument (ie an extension option) and the terms of the extension option result in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the extension of the contract.

Illustration 7

Instrument A 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.

Evaluate the Contractual cash flows characteristics test

Solution

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 (eg 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

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adjustment that only compensates the holder for changes in the credit risk of the instrument, such that contractual 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.

*****

Illustration 8

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

Solution

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; ie the return is linked to the value of the equity of the issuer.

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Illustration 9

Instrument H is a perpetual instrument but the issuer may call the instrument at any point and pay the holder the par amount plus accrued interest due.

Instrument H pays a market interest rate but payment of interest cannot be made unless the issuer is able to remain solvent immediately afterwards. Deferred interest does not accrue additional interest. Analyse the nature of cash flows.

Solution

The contractual cash flows are not payments of principal and interest on the principal amount outstanding. That is because the issuer may be required to defer interest payments and additional interest does not accrue on those deferred interest amounts. As a result, interest amounts are not consideration for the time value of money on the principal amount outstanding.

If interest accrued on the deferred amounts, the contractual cash flows could be payments of principal and interest on the principal amount outstanding.

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Illustration 10

Instrument D is loan with recourse and is secured by collateral. Does the collateral affect the nature of contractual cash flows?

Solution

The fact that a loan is collateralised (since with recourse) does not in itself affect the analysis of whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding. The collateral is only a security to recover dues.

*****

Illustration 11

Instrument G is a loan that pays an inverse floating interest rate (ie the interest rate has an inverse relationship to market interest rates). Analyse the nature of cash flows.

Solution

Here, interest on the instrument has an inverse relationship to the market rate of interest. Hence, it is unlike a basic lending arrangement which normally comprises of interest payable on any funds lent, as a consideration for the time value of money, credit risk and profit margin normally existing in such arrangements. This arrangement with an inverse floating interest rate provides the lender with a return which may be higher or lower to the market rate of interest and hence, is not necessarily a consideration for the time value of money on the principal amount outstanding.

Thus, these do not represent contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.

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2.3 FINANCIAL ASSETS: CLASSIFICATION – OVERALL CONCEPT

Categorisation of financial assets (FA) is determined based on the business model that determines how cash flows of the financial asset are collected and the contractual cash flow characteristics; and can be:

(a) Measured at Amortised cost

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(b) Measured at fair value through comprehensive income (FVOCI)

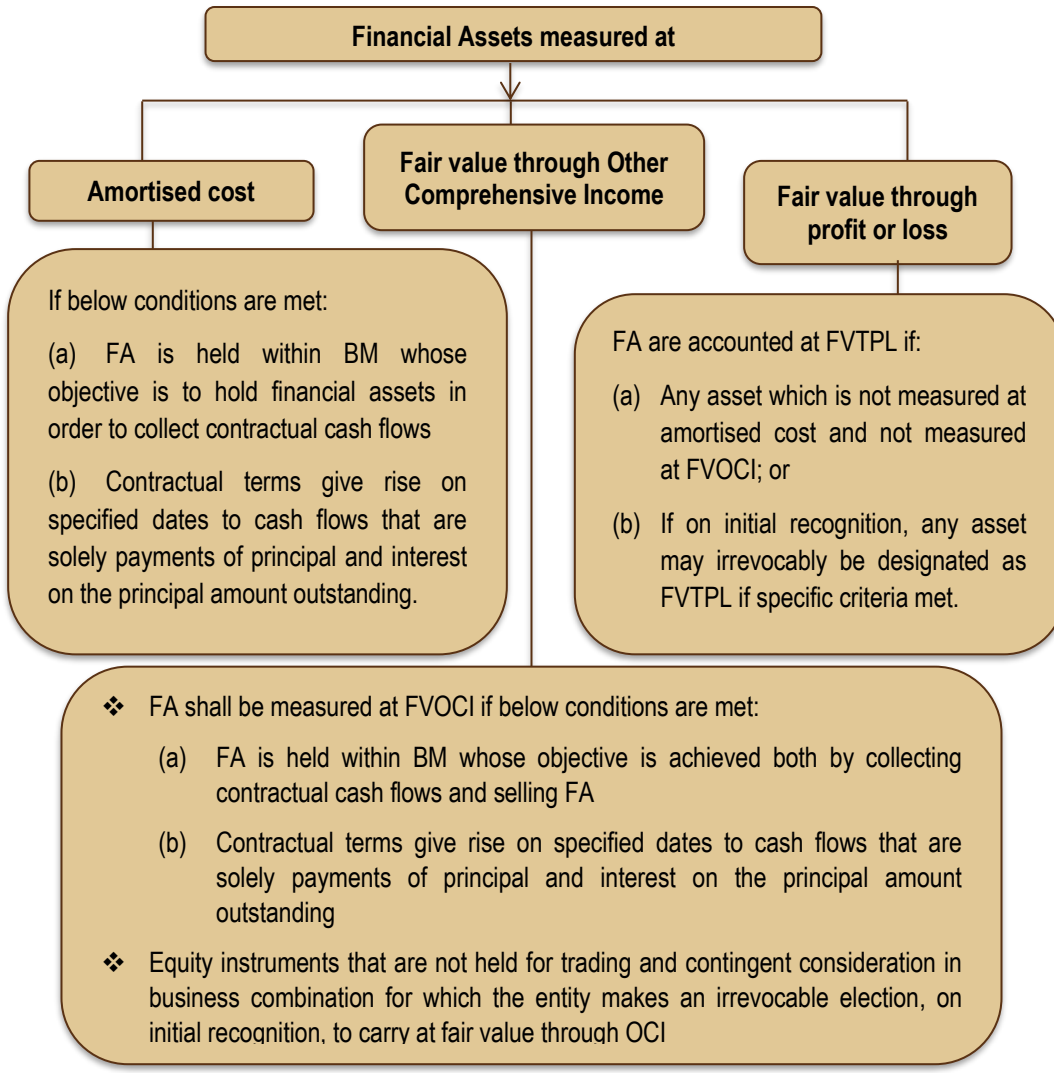
(c) Measured at fair value through profit or loss (FVTPL).

- As per Ind AS 109.4.1.1 – Except for financial assets designated as fair value through profit or loss (refer Ind AS 109.4.1.5), an entity shall classify financial assets as subsequently measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss on the basis of both:

  (a) Entity's **business model** (BM) for managing the financial assets and

  (b) **Contractual cash flow** characteristics of the financial asset.

- Categorisation of financial assets has been broadly laid out in the below flow chart:



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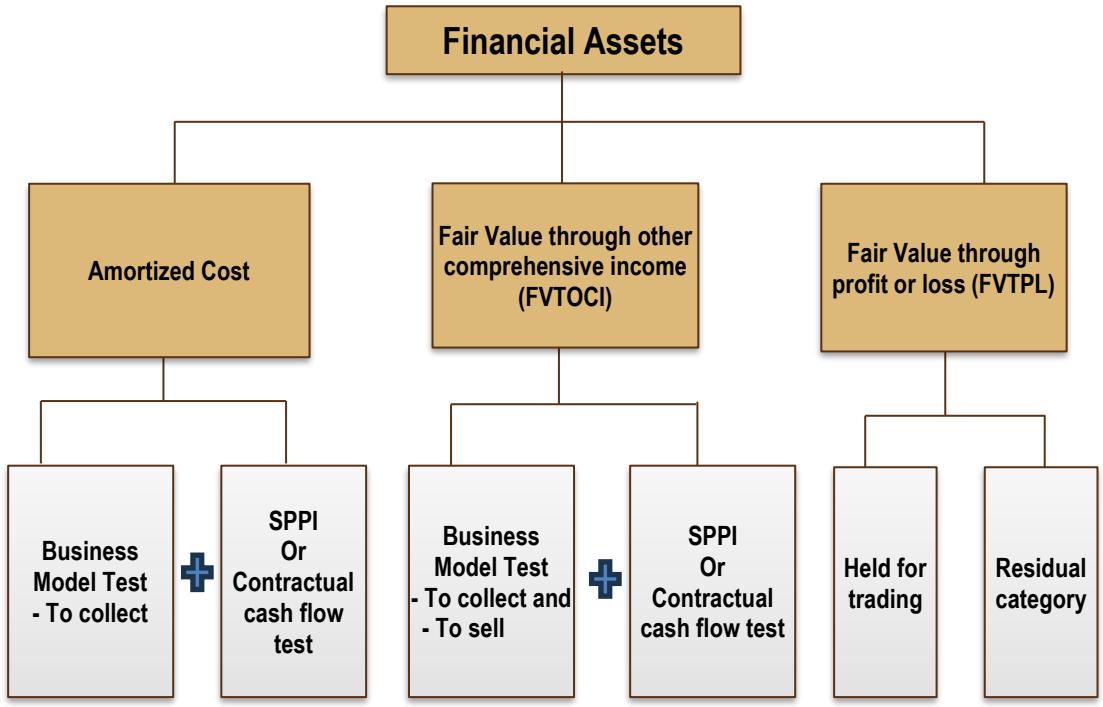
- **Exception to classification based on above criteria mentioned in para 109.4.1.1 – Option to designate at fair value through profit or loss:**

  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 bases

  The decision of an entity to designate a financial asset or financial liability as at fair value through profit or loss is similar to an accounting policy choice (although, unlike an accounting policy choice, it is not required to be applied consistently to all similar transactions). When an entity has such a choice, paragraph 14(b) of IAS 8 requires the chosen policy to result in the financial statements providing reliable and more relevant information about the effects of transactions, other events and conditions on the entity's financial position, financial performance or cash flows.



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1. Financial Assets at Amortised cost

➢ What is Amortised cost

❖ **Amortised cost** is the amount at which the financial asset is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the **effective interest method** of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance.

➢ **In applying effective interest method –**

(a) Entity identifies fees that are an integral part of the effective interest rate of a financial instrument. Fees that are an integral part of the effective interest rate of a financial instrument are treated as an adjustment to the effective interest rate, unless the financial instrument is measured at fair value, with the change in fair value being recognised in profit or loss. In those cases, the fees are recognised as revenue or expense when the instrument is initially recognised.

(b) Such fees adjusted in effective interest rate are then amortised over then expected life of the instrument. However, a shorter period may be used if such fee adjusted in effective interest rate pertains to such shorter period.

➢ **Financial asset (FA) shall be classified at amortised cost if it meets both of following criteria:**

1. **'Hold-to-collect' business model test -** Objective is to hold the financial asset in order to collect contractual cash flows;

AND

2. **'SPPI' contractual cash flow characteristics test** - Contractual terms give rise to cash flows that are **Solely Payments of Principal and Interest (SPPI)** on the principal amount outstanding.

➢ **Examples of Financial assets classified and accounted for at amortised cost:**

❖ Trade receivables

❖ Investments in government bonds (not held for trading)

❖ Investments in term deposits (at standard interest rates)

❖ Loan receivables with 'basic' features

Investment in Equity instrument can never be classified at amortized cost.

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Illustration 12 : Hold-to-collect' business model test

An entity purchased a debt instrument for 1,00,000.

The instrument pays interest of 6,000 annually and has 10 years to maturity when purchased. The entity intends to hold the asset to collect the contractual cash flows.

Evaluate the business model test.

Solution

Entity's objective is to hold the asset to collect the contractual cash flows and not to sell the assets before the maturity period.

Thus, the debt instrument would meet the 'hold-to-collect' business model test.

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Illustration 13 : Hold-to-collect' business model test

An entity purchased a debt instrument for 1,00,000.

The instrument pays interest of 6,000 annually and has 10 years to maturity when purchased. The entity intends to hold the asset to collect the contractual cash flows.

Six years have passed and the entity is suffering a liquidity crisis and needs to sell the asset to raise funds.

Evaluate the business model test.

Solution

Since the sale of financial assets was not expected on initial classification and therefore, does not affect the classification (i.e. there is no retrospective reclassification).

Thus, the debt instrument would still meet the 'hold-to-collect' business model test.

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Illustration 14 : SPPI or contractual cash flow test

SPPI test for loan with zero interest and no fixed repayment terms

Parent H Ltd. provides a loan to its Subsidiary S Ltd. The loan is classified as a current liability in Subsidiary S's financial statements and has the following terms:

- Interest free loan.
- No fixed repayment terms

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- Repayable on demand of Parent H Ltd.

Does the loan meet the 'SPPI' or contractual cash flows characteristic test?

Solution

Yes. The terms for the repayment of the principal amount of the loan on demand satisfies the criterion of SPPI.

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Illustration 15 : SPPI Test for loan with zero interest repayable in ten years

Parent H Ltd. provides a loan of INR 100 million to Subsidiary B. The loan has the following terms:

- *No interest*
- *Repayable in ten years.*

Does the loan meet the 'SPPI' or contractual cash flows characteristic test?

Solution

Yes. The terms for the repayment of the principal amount of the loan in 10 years satisfies the criterion of SPPI.

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Illustration 16 : SPPI Test for loan with interest rate

Entity A Ltd. lends Entity B Ltd. INR 5 million for ten years, subject to the following terms:

- *Interest is based on the prevailing variable market interest rate.*
- *Variable interest rate is capped at 10%.*
- *Repayable in ten years.*

Does the loan meet the 'SPPI' or contractual cash flows characteristic test?

Solution

Contractual cash flows of both a fixed rate instrument and a floating rate instrument are payments of principal and interest as long as the interest reflects consideration for the time value of money and credit risk.

Therefore, a loan that contains a combination of a fixed and variable interest rate meets the contractual cash flow characteristics test.

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Illustration 17: Trade receivables – Amortised cost

H Ltd. makes sale of goods to customers on credit of 60 days. The customers are entitled to earn a cash discount @ 5% per annum if payment is made before 60 days and an interest @ 12% per annum is charged for any payments made after 60 days. Company does not have a policy of selling its debtors and holds them to collect contractual cash flows.

Evaluate the financial instrument.

Solution

In the above case, since H Ltd. has a contractual right to receive cash flows from its customers and therefore such trade receivable are financial assets for H Ltd.

Further, H Ltd. business model test to collect will satisfy as the objective is to hold its trade receivable to collect contractual cash flows till the end of maturity period and such trade receivable recorded in books represents contractual cash flows that are solely payments of principal and interest if paid beyond credit period.

Hence such trade receivables are classified at amortised cost.

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Illustration 18: Security Deposits – Amortized Costs

A Ltd. (the 'Company') has obtained the premises from B Ltd. on lease to carry on its business. The lease contract period is 5 years. As per the lease agreement, A Ltd. has paid security deposits to B Ltd. amounting to ₹ 10 Lac which is refundable after the expiry of lease agreement.

How would such deposits be treated in books of the A Ltd. ?

Solution

In the above case, since A Ltd. has a contractual right to receive cash flows from its Lessor, B Ltd. and therefore such security deposits receivable are financial assets for A Ltd.

Further, A Ltd. business model test to collect will be satisfied as the objective is to hold its security deposits receivable to collect contractual cash flows till the end of maturity period. And such trade receivable recorded in books represents contractual cash flows that are solely payments of principal and interest.

Hence such security deposits receivables are classified at amortised cost.

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2. Financial Assets at Fair Value at Other Comprehensive Income

A. Accounting for debt instruments when it is classified as FVOCI

❖ **Financial asset (FA) is measured at fair value through OCI (FVOCI) if it meets both of following criteria:**

1. **'Hold-to-collect and sell' business model test -** Objective is achieved by both holding the financial asset in order to collect contractual cash flows and selling the financial asset i.e. Intention of the entity is to sell the instrument before the investment matures.

AND

2. **'SPPI' contractual cash flow characteristics test -** Contractual terms give rise to cash flows that are Solely Payments of Principal and Interest (SPPI) on the principal amount outstanding.

❖ **Examples of FA classified and accounted for at FVOCI:**

- Investments in government bonds where the investment period is likely to be shorter than its maturity period.
- Investments in corporate bonds where the investment period is likely to be shorter than its maturity period.

Illustration 19 : Hold-to-collect' or 'hold-to-collect & sell' business model test

Entity A has surplus funds – INR 50 million

A has not yet found suitable investment opportunity so it buys medium dated (5 year maturity) high quality government bonds in order to generate interest income.

If a suitable investment opportunity arises before the maturity date, the entity will sell the bonds and use the proceeds for the acquisition of a business operation. It is likely that a suitable business opportunity will be found before maturity date.

Whether the investment opportunity will meet the 'hold-to-collect' or 'hold-to-collect & sell business model test?

Solution

Government bonds would not meet the 'hold-to-collect' business model test because it is considered likely that the bonds will be sold well before their contractual maturity.

However, it is likely that such investment would meet the 'hold-to-collect and sell' business model test.

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B. Equity instrument when it is classified as FVOCI

- ❖ Ind AS 109 requires all equity investments to be measured at fair value. The default approach is that all changes in fair value of instruments to be recognised in profit or loss.
- ❖ However, for equity investments that are not held for trading, entities can make an irrevocable election at initial recognition to classify the instruments as at FVOCI, with all subsequent changes in fair value being recognised in other comprehensive income.
- ❖ Under FVOCI category, fair value changes are recognised in OCI while dividends are recognised in profit or loss.
- ❖ On disposal of the investment the cumulative change in fair value is required to remain in OCI and is not reclassified to profit or loss. However, entities have the ability to transfer amounts between reserves within equity (i.e. between the FVOCI reserve and retained earnings).

3. Financial Assets at profit and loss

- ➢ **Fair value through profit or loss (FVTPL) is the residual category in Ind AS 109.**
- ➢ **Financial asset (FA) classified and measured at FVTPL if FA is:**
  - ❖ A held-for-trading financial asset
  - ❖ A debt instrument that does not qualify to be measured at amortised cost or FVOCI
  - ❖ An equity investment which the entity has not elected to classify as at FVOCI
- ➢ **Examples of Financial assets classified and accounted for at fair value through profit or loss (FVTPL):**
  - ❖ Derivatives that have not been designated in a hedging relationship, e.g.:
    - ▪ Interest rate swaps
    - ▪ Commodity futures/option contracts
    - ▪ Foreign exchange futures/option contracts
  - ❖ Investments in shares where the entity has not elected to account for at FVOCI.

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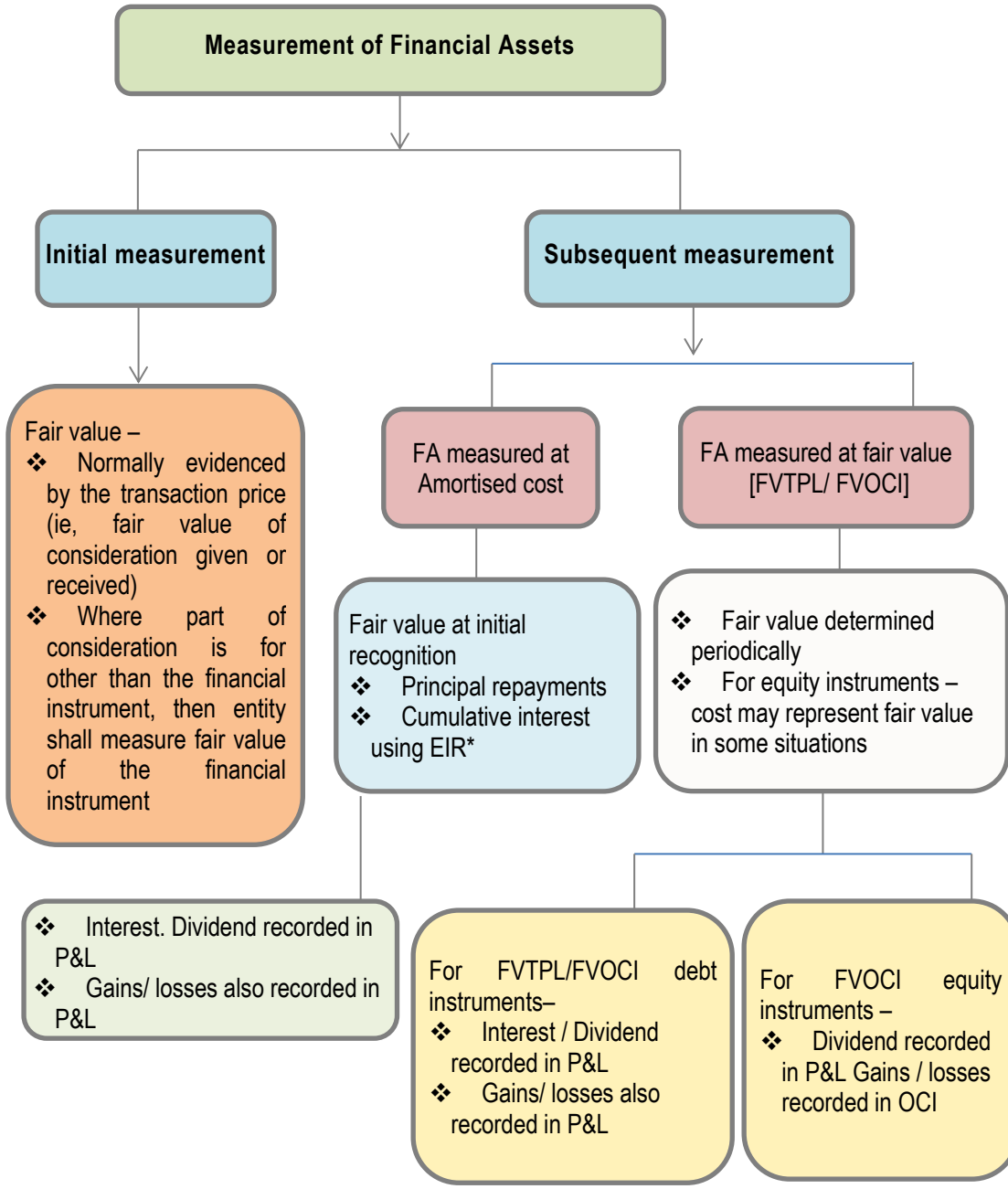
2.4 FINANCIAL ASSETS: MEASUREMENT

Measurement of financial assets is driven by their classification and can be broadly explained with the help of following diagrammatic presentation:



*EIR – Effective interest rate method

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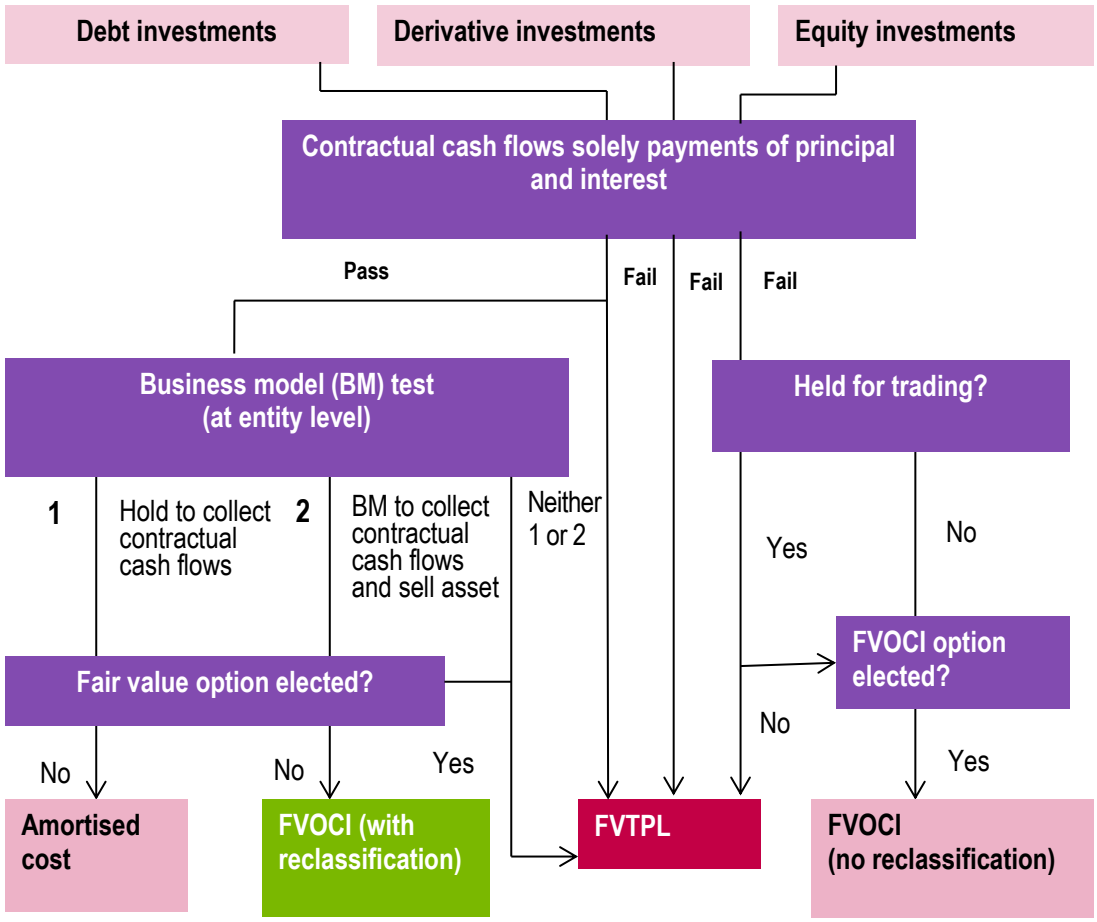
Based on the above mentioned guidance, the decision tree for classification of financial assets can be understood with the help of following flow chart:



Accounting for transaction costs for the purpose of Effective interest rate method

Fees that are integral part of effective interest rate	Fees that are not an integral part of effective interest rate
(a) **Origination fee** received by the entity relating to the creation or acquisition of a financial asset. Such fees may include compensation for activities such as evaluating the borrower's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting financial instrument.	(a) **Fee** charged for **servicing a loan**;

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Fees that are integral part of effective interest rate	Fees that are not an integral part of effective interest rate
(b) **Commitment fee** received by the entity **to originate a loan where it is probable that the entity will enter into a specific lending arrangement.** These fees are regarded as compensation for an ongoing involvement with the acquisition of a financial instrument. If the commitment expires without the entity making the loan, the fee is recognised as revenue on expiry.	(b) **Commitment fee** to originate a loan when it is **unlikely that a specific lending arrangement will be entered into**;
(c) **Origination fee** paid on issuing financial asset measured at amortised cost. These fees are an integral part of generating an involvement with a financial liability. An entity distinguishes fees and costs that are an integral part of the effective interest rate for the financial liability from origination fees and transaction costs relating to the right to provide services, such as investment management services.	(c) **Loan syndication fee** received by an entity that arranges a loan and retains no part of the loan package for itself (or retains a part at the same effective interest rate for comparable risk as other participants).

Illustration 20

ABC Bank gave loans to a customer – Target Ltd. that carry fixed interest rate @ 10% per annum for a 5 year term and 12% per annum for a 3 year term. Additionally, the bank charges processing fees @1% of the principal amount borrowed. Target Ltd borrowed loans as follows:

- 10 lacs for a term of 5 years
- 8 lacs for a term of 3 years.

Compute the fair value upon initial recognition of the loan in books of Target Ltd. and how will loan processing fee be accounted?

Solution

The loans from ABC Bank carry interest @ 10% and 12% for 5 year term and 3 year term respectively. Additionally, there is a processing fee payable @ 1% on the principal amount on date of transaction. It is assumed that ABC Bank charges all customers in a similar manner and hence this is representative of the market rate of interest.

Amortised cost is computed by discounting all future cash flows at market rate of interest. Further, any transaction fees that are an integral part of the transaction are adjusted in the effective interest rate and recognised over the term of the instrument.

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Hence loan processing fees shall be reduced from the principal amount to arrive the value on day 1 upon initial recognition.

Fair value (5 year term loan) = 10,00,000 – 10,000 (1% x 10,00,000) = 9,90,000

Fair value (3 year term loan) = 8,00,000 – 8,000 (1% x 8,00,000) = 7,92,000.

Now, effective interest rate shall be higher than the interest rate of 10% and 12% on 5 year loan and 3 year loan respectively, so that the processing fees gets recognised as interest over the respective term of loans.

*****

Fair value

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Per Ind AS 113.B2 – The objective of a fair value measurement is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions. A fair value measurement requires an entity to determine all the following:

(a) the particular asset or liability that is the subject of the measurement (consistently with its unit of account);

(b) for a non-financial asset, the valuation premise that is appropriate for the measurement (consistently with its highest and best use);

(c) the principal (or most advantageous) market for the asset or liability.

(d) the valuation technique(s) appropriate for the measurement, considering the availability of data with which to develop inputs that represent the assumptions that market participants would use when pricing the asset or liability and the level of the fair value hierarchy within which the inputs are categorised.

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Now, we go on to understand the key aspects of initial and subsequent measurement along with how classification of assets affects their measurement as explained in detail below:

2.5 FINANCIAL ASSETS: INITIAL MEASUREMENT

Fair value of a financial instrument at initial recognition is **normally the transaction price** (,ie, fair value of consideration given or received).

- **Instrument at off-market terms:** Sometimes certain type of instruments may be exchanged at off market terms (,ie, different from market terms for a similar instrument if exchanged between market participants),
  - For example, a long-term loan or receivable that carries no interest while similar instruments if exchanged between market participants carry interest, then fair value for such loan receivable will be lower from its transaction price owing to the loss of interest that the holder bears. In such cases where part of the consideration given or received is for something other than the financial instrument, an entity shall measure the fair value of the financial instrument.
  - In the aforementioned example, the fair value of the long-term loan or receivable can be measured as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. The additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset.
- **Transaction costs:**
  - Transaction costs include fees and commission paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and security exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.
  - Any transaction costs incurred for acquisition of the financial asset or issue of financial liability are adjusted upon initial recognition while determining fair value, if the financial asset or financial liability is not classified as subsequently measured at fair value through profit or loss.

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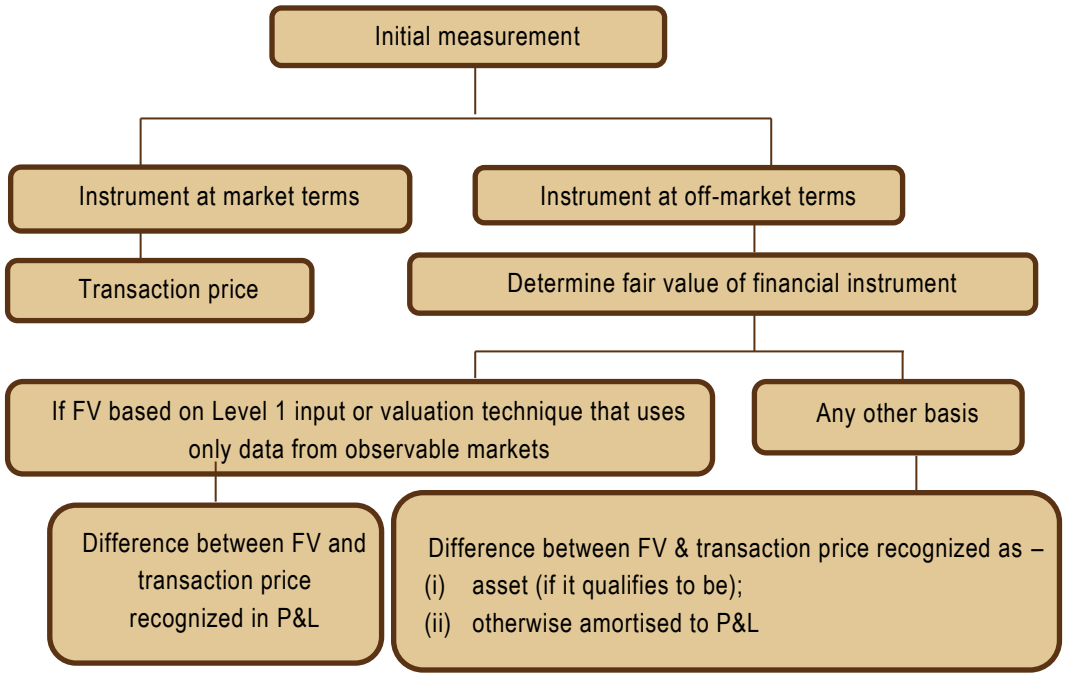
- If an entity originates a loan that bears an off-market interest rate (eg 5 per cent when the market rate for similar loans is 8 per cent), and receives an upfront fee as compensation, the entity recognises the loan at its fair value, ie net of the fee it receives.

The decision tree for the aforementioned basis to be applied in establishing fair value at initial recognition can be understood with following diagrammatic presentation:



- **Specific transactions:**

  - **Determining amortised cost for financial assets carrying floating rate of interest:**

    Per Application Guidance in Appendix B – B.5.4.5 – For floating rate financial instruments, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. To calculate the effective interest in each relevant period, the effective interest rate is applied to the amortised cost of the asset or liability at the previous reporting date. However, if the floating rate financial asset or financial liability is initially recognised at an amount equal to the principal receivable or payable on maturity, then this periodic re-estimation does not have a significant effect on the carrying amount of the asset or liability.

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Therefore, in such cases, for practical reasons the carrying amount of a floating rate instrument would not generally need to be adjusted at each repricing date because the impact would not generally be significant. In such case –

(a) Interest income or expense is recognised based on the current market rate.

(b) For a floating rate financial asset or financial liability that is initially recognised at a discount or premium, the interest income or expense is recognised based on the current market rate plus or minus amortisation or accretion of the discount or premium.

- **Revision of estimated cash flows:**

Per Application Guidance in Appendix B to Ind AS 109 – B.5.4.6 – If there is a change in the timing or amount of estimated future cash flows (other than due to impairment) –

- It shall adjust the gross carrying amount of the financial asset or amortised cost of a financial liability (or group of financial instruments) to reflect actual and revised estimated contractual cash flows.
- The entity recalculates the gross carrying amount of the financial asset or amortised cost of the financial liability as the present value of the estimated future contractual cash flows that are discounted at the financial instrument's **original effective interest rate** (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets)

Then the carrying amount of the instrument (or group of financial instruments) is adjusted in the period of change to reflect the actual and/or revised estimated cash flows, with a corresponding gain or loss being recognised in profit or loss.

This approach to changes in estimated cash flows should apply to changing prepayment expectations and other estimates of cash flows under the current terms of the financial instrument but not to a renegotiation of the contractual terms of an instrument.

- **Interest income after impairment recognition**

If a financial asset or a group of similar financial assets has been written down as a result of an impairment loss –

- Then interest income is thereafter recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.
- For assets measured at amortised cost, this interest rate would be the original effective interest rate.

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- **Loans between group companies**

(a) Repayable on demand:

As per Ind AS 113.47 – The fair value of a financial liability with a demand feature - e.g. a demand deposit - is not less than the amount payable on demand, discounted from the first date that the entity could be required to repay the amount. Accordingly –

- ❖ The fair value of an interest-free loan liability of which the lender can demand repayment of the face value at any time - i.e. a loan repayable on demand - is not less than its face value.
- ❖ This would evenly apply from the perspective of the lender, since a market participant acting in its best interest would be assumed to maximize value by demanding immediate repayment and hence, the fair value shall be equal to the amount payable on demand in books of lender.

(b) No fixed maturity:

If a loan has no fixed maturity date and is available in perpetuity, then in measuring its fair value, discounting should reflect these terms because a market participant acting in its best interest would not assume repayment of the loan. Similarly, the asset holder or lender would also measure fair value that should reflect a market participant's assumptions about the timing of the future cash flows.

In both of above cases–

- ❖ Any difference between the amount lent and the fair value of the instrument on initial recognition is recognized as a gain or a loss unless it qualifies for recognition as an asset or a liability.
- ❖ If a low-interest loan is given in anticipation of a right to receive goods or services at favourable prices, then the right may be recognised as an asset if it qualifies for recognition as an asset, for example: prepaid expenses, etc.

- **Demand deposits**

The fair value of a financial liability with a demand feature - e.g. a demand deposit - is not less than the amount payable on demand, discounted from the first date that the entity could be required to repay the amount.

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Hence, fair value of a demand deposit would be the amount payable on demand in books of the party making the deposit (ie, holder of financial asset) as well as in books of entity accepting the deposit (ie, bearer of financial liability).

Illustration 21: Deposits carrying off-market rate of interest:

Containers Ltd provides containers for use by customers for multiple purposes. The containers are returnable at the end of the service contract period (3 years) between Containers Ltd and its customers. In addition to the monthly charge, there is a security deposit that each customer makes with Containers Ltd for ₹ 10,000 per container and such deposit is refundable when the service contract terminates. Deposits do not carry any interest. Analyse the fair value upon initial recognition in books of customers leasing containers. Market rate of interest for 3 year loan is 7% per annum.

Solution

In the above case, lessee (ie, customers leasing the containers) make interest free deposits, which are refundable at the end of 3 years. Now, this money if it was to lent to a third party would fetch interest @ 7% per annum.

Hence, discounting all future cash flows (ie, ₹ 10,000)

Fair value on initial recognition = $10,000 / (1+0.07)^3$ = 8,163.

Differential on day 1 = 10,000 – 8,163 = 1,837

The differential on day 1 shall be treated as follows:

- **Scenario 1 –** If fair valuation is determined using level 1 inputs or other observable inputs, difference on day 1 recognised in profit or loss
- **Scenario 2 –** If fair valuation is determined using other inputs, difference on day 1 shall be recognised in profit or loss unless it meets definition of an asset or liability.

However, in case of security deposits level 1 fair value is not available. Therefore, in the above case, the fair valuation is made based on unobservable inputs and hence applying scenario 2, difference can be recognised as an asset if it meets the definition. Now, since the lessee gets to use the containers in return for making an interest free deposit plus monthly charges, the lost interest representing day 1 difference between value of deposit and its fair value is like ''prepaid lease rent' and can be recognised as such. Prepaid rent (ROU Asset) shall be charged off to profit or loss in a straight lined manner as depreciation as per Ind AS 16.

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2.6 FINANCIAL ASSETS: SUBSEQUENT MEASUREMENT

♦ As defined in the flow chart above, the subsequent measurement of financial assets is based on their classification as defined below:

(A) Assets measured at amortised cost

❖ Assets are classified as measured at amortised cost if below conditions are met (as explained in paragraph – Financial assets: classification):

(a) Financial asset is held with BM whose objective is to hold financial assets in order to collect contractual cash flows; and

(b) Contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding

❖ Where assets are classified as 'amortised cost' –

(a) They are initially measured at fair value plus or minus transaction costs as explained above

(b) Subsequently, the carrying value is adjusted for principal repayments and interest accrued using effective interest rate, as explained earlier.

(B) Assets measured at fair value

❖ For assets not carried at amortised cost, they shall be carried at fair value. Such assets can be categorised into –

(i) **Measured at fair value through other comprehensive income (FVOCI)**; if–

(a) Following criteria are satisfied:

- FA is held with BM whose objective is achieved both by collecting contractual cash flows and selling FA; and
- Contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding

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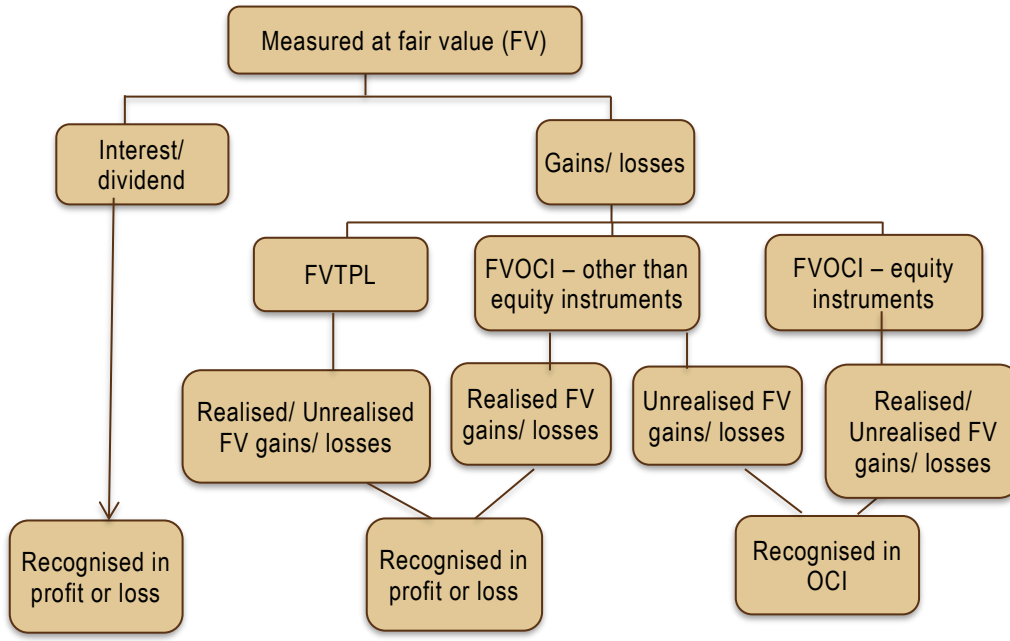
(b) An equity instrument, which otherwise shall be carried at fair value through profit or loss may be irrevocably recognised at fair value through other comprehensive income,

(ii) Measured at fair value through profit or loss (FVTPL):

All assets not classified as 'measured at amortised cost' or 'measured at fair value through OCI' shall be classified in this category.

Incomes and/ or expenses on assets measured at fair value shall be recognised as follows:



- If a financial instrument that was previously recognised as a financial asset is measured at fair value through profit or loss and its fair value decreases below zero, it is a financial liability measured at fair value.

- **Equity instruments – where FV not determinable**

  - All investments in equity instruments and contracts on those instruments must be measured at fair value. However, in limited circumstances, cost may be an appropriate estimate of fair value. That may be the case if insufficient more recent information is available to measure fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range

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- **Indicators that cost might not be representative of fair value include:**

  (a) a significant change in the performance of the investee compared with budgets, plans or milestones.

  (b) changes in expectation that the investee's technical product milestones will be achieved.

  (c) a significant change in the market for the investee's equity or its products or potential products.

  (d) a significant change in the global economy or the economic environment in which the investee operates.

  (e) a significant change in the performance of comparable entities, or in the valuations implied by the overall market.

  (f) internal matters of the investee such as fraud, commercial disputes, litigation, changes in management or strategy.

  (g) evidence from external transactions in the investee's equity, either by the investee (such as a fresh issue of equity), or by transfers of equity instruments between third parties.

- The list above is not exhaustive. An entity shall use all information about the performance and operations of the investee that becomes available after the date of initial recognition. To the extent that any such relevant factors exist, they may indicate that cost might not be representative of fair value. In such cases, the entity must measure fair value.

Cost is never the best estimate of fair value for investments in quoted equity instruments (or contracts on quoted equity instruments).

Illustration 22: Accounting for transaction costs on initial and subsequent measurement of a financial asset measured at fair value with changes through other comprehensive income:

An entity acquires a financial asset for CU 100 plus a purchase commission of CU 2. Initially, the entity recognises the asset at CU 102. The reporting period ends one day later, when the quoted market price of the asset is CU 100. If the asset were sold, a commission of CU 3 would be paid. How would transaction costs be accounted in books of the entity?

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Solution

- On that date, the entity measures the asset at CU 100 (without regard to the possible commission on sale) and recognises a loss of CU 2 in other comprehensive income.
- If the financial asset is measured at fair value through other comprehensive income in accordance with Ind AS 109.4.1.2A, the transaction costs are amortised to profit or loss using the effective interest method.

*****

Illustration 23: Determining fair value upon initial measurement

The shareholders of Company C provide C with financing in the form of loan notes to enable it to acquire investments in subsidiaries. The loan notes will be redeemed solely out of dividends received from these subsidiaries and become redeemable only when C has sufficient funds to do so. In this context, 'sufficient funds' refers only to dividend receipts from subsidiaries. Analyse the initial measurement of loan notes.

Solution

In this case –

Loan notes are repayable only when C earns returns in form of dividends from subsidiaries. Hence, C cannot be forced to obtain additional external financing or to liquidate its investments to redeem the shareholder loans. Consequently, the loan notes are not considered payable on demand.

Accordingly –

- Loan notes shall be initially measured at their fair value, being the present value of the expected future cash flows, discounted using a market-related rate. The amount and timing of the expected future cash flows should be determined on the basis of the expected dividend flow from the subsidiaries. Also, the valuation would need to take into account possible early repayments of principal and corresponding reductions in interest expense.
- Since the loan notes are interest-free or bear lower-than-market interest, there will be a difference between the nominal value of the loan notes - i.e. the amount granted - and their fair value on initial recognition. Because the financing is provided by shareholders, acting in the capacity of shareholders, the resulting credit should be

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reflected in equity as a shareholder contribution in C's balance sheet. Conversely, in books of shareholders, the difference between amount invested and its fair value shall be recorded as 'investment in C Ltd' being representative of the underlying relationship between shareholders and C Ltd.

*****

Illustration 24 : Use of cost v/s fair value determination for equity instruments

Silver Ltd. has made an investment in optionally convertible preference shares (OCPS) of a Company – Bronze Ltd. at ₹ 100 per share (face value ₹ 100 per share). Silver Ltd. has an option to convert these OCPS into equity shares in the ratio of 1:1 and if such option not exercised till end of 9 years, then the shares shall be redeemable at the end of 10 years at a premium of 20%.

Analyse the measurement of this investment in books of Silver Ltd.

Solution

The classification assessment for a financial asset is done based on two characteristics:

(i) Whether the contractual cash flows comprise cash flows that are solely payments of principal and interest on the principal outstanding

(ii) Entity's business model (BM) for managing financial assets – Whether the Company's BM is to collect cash flows; or a BM that involves realisation of both contractual cash flows & sale of financial assets;

In all other cases, the financial assets are measured at fair value through profit or loss.

In the above case, the Holder can realise return either through conversion or redemption at the end of 10 years, hence it does not indicate contractual cash flows that are solely payments of principal and interest. Therefore, such investment shall be carried at fair value through profit or loss. Accordingly, the investment shall be measured at fair value periodically with gain/ loss recorded in profit or loss.

*****

Illustration 25 : Accounting for assets at amortised cost

A Ltd has made a security deposit whose details are described below. Make necessary journal entries for accounting of the deposit in the first year and last year. Assume market interest rate for a deposit for similar period to be 12% per annum.

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Particulars	Details
Date of Security Deposit (Starting Date)	*1-Apr-20X1*
Date of Security Deposit (Finishing Date)	*31-Mar-20X6*
Description	*Lease*
Total Lease Period	*5 years*
Discount rate	*12.00%*
Security deposit	*10,00,000*
Present value factor at the 5th year	*0.567427*

Solution

The above security deposit is an interest free deposit redeemable at the end of lease term for ₹ 10,00,000. Hence, this involves collection of contractual cash flows and shall be accounted at amortised cost.

Upon initial measurement –

Particulars	Details
Security deposit (A)	10,00,000
Total Lease Period (Years)	5
Discount rate	12.00%
Present value factor of 5th year end	0.56743
Present value of deposit at beginning (B)	5,67,427
Prepaid lease payment at beginning (A-B)	4,32,573

Journal Entries

Year – 1 beginning

Particulars		Amount	Amount
Security deposit A/c	Dr.	5,67,427	
Right-of-Use Asset	Dr.	4,32,573	
To Bank A/c			10,00,000

Subsequently, every annual reporting year, interest income shall be accrued @ 12% per annum and prepaid expenses shall be amortised on straight line basis over the lease term.

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Year 1 end

Particulars		Amount	Amount
Security deposit A/c (5,67,427 x 12%)	Dr.	68,091	
To Interest income A/c			68,091

At the end of 5th year, the security deposit shall accrue ₹ 10,00,000 and prepaid lease expenses shall be fully amortised (i.e. depreciated as per Ind AS 116, this prepaid lease rent would be shown as ROU asset). Journal entry for realisation of security deposit –

Particulars		Amount	Amount
Security deposit A/c	Dr.	1,07,143	
To Interest income A/c			1,07,143
Bank A/c	Dr.	10,00,000	
To Security deposit A/c			10,00,000

*****

Illustration 26 : Accounting for assets at FVTPL

A Ltd. invested in equity shares of C Ltd. on 15th March for ₹ 10,000. Transaction costs were ₹ 500 in addition to the basic cost of ₹ 10,000. On 31 March, the fair value of the equity shares was ₹ 11,200 and market rate of interest is 10% per annum for a 10 year loan. Pass necessary journal entries. Analyse the measurement principle and pass necessary journal entries.

Solution

The above investment is in equity shares of C Ltd and hence, does not involve any contractual cash flows that are solely payments of principal and interest. Hence, these equity shares shall be measured at fair value through profit or loss. Also, an irrecoverable option exists to designate such investment as fair value through other comprehensive income.

Journal Entries

Particulars		Amount	Amount
Upon initial recognition –			
Investment in equity shares of C Ltd.	Dr.	10,000	
Transaction cost	Dr.	500	
To Bank A/c			10,500
(Being investment recognized at fair value plus transaction costs upon initial recognition)			

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Profit and Loss A/c	Dr.	500	
To Transaction cost			500
(Being transaction cost incurred on assets measured at FVTPL transferred to P&L A/c)			

Subsequently –			
Investment in equity shares of C Ltd.	Dr.	1,200	
To Fair value gain on financial instruments			1,200
(Being fair value gain recognized at year end in P&L)			
Fair value gain on financial instruments	Dr.	1,200	
To Profit and Loss A/c			1,200
(Being fair value gain transferred to P&L A/c)			

*****

Illustration 27: Accounting for assets at FVOCI

Metallics Ltd. has made an investment in equity instrument of a company – Castor Ltd. for 19% equity stake. Significant influence not exercised. The investment was made for ₹ 5,00,000 for 10,000 equity shares on 01 April 20X1. On 30 June 20X1 the fair value per equity share is ₹ 45. The Company has taken an irrevocable option to measure such investment at fair value through other comprehensive income.

Solution

The Company has made an irrecoverable option to carry its investment at fair value through other comprehensive income. Accordingly, the investment shall be initially recognised at fair value and all subsequent fair value gains/ losses shall be recognised in other comprehensive income (OCI).

Journal Entries

Particulars		**Amount**	**Amount**
Upon initial recognition –			
Investment in equity shares of C Ltd.	Dr.	5,00,000	
To Bank a/c			5,00,000
(Being investment recognized at fair value plus transaction costs upon initial recognition)			

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Subsequently –			
Fair value loss on equity investment	Dr.	50,000	
To Investment in equity shares of C Ltd.			50,000
(Being fair value loss recognized in OCI section of the Statement of Profit and Loss under items that cannot be reclassified to profit or loss)			
Fair Value Reserve for Equity Investments	Dr.	50,000	
To Fair value loss on financial instruments			50,000
(Being fair value loss recognized in other comprehensive income accumulated in equity investments fair value reserve)			

*****

Illustration 28: Accounting for assets at Amortised Cost

XYZ Ltd. is a company incorporated in India. It provides INR 10,00,000 interest free loan to its wholly owned Indian subsidiary (ABC). There are no transaction costs.

How should the loan be accounted for, in the separate financial statements of XYZ, individual financial statements of ABC and consolidated financial statements of the group?

Consider the following scenarios:

a) The loan is repayable on demand.

b) The loan is repayable after 3 years. The current market rate of interest for similar loan is 10% p.a. for both holding and subsidiary.

c) The loan is repayable when ABC has funds to repay the loan.

Solution

Ind AS 109 requires that a financial assets and liabilities are recognized on initial recognition at its fair value, as adjusted for the transaction cost. In accordance with Ind AS 113 Fair Value Measurement, the fair value of a financial liability with a demand feature (e.g., a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

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Using the guidance, the loan will be accounted for as below in various scenarios:

Scenario (a)

Since the loan is repayable on demand, it has fair value equal to cash consideration given. The parent and subsidiary recognize financial asset and liability, respectively, at the amount of loan given. Going forward, no interest is accrued on the loan.

Upon repayment, both the parent and the subsidiary reverse the entries made at origination.

Scenario (b)

Both parent and subsidiary recognize financial asset and liability, respectively, at fair value on initial recognition. The difference between the loan amount and its fair value is treated as an equity contribution to the subsidiary. This represents a further investment by the parent in the subsidiary.

Accounting in the books of XYZ Ltd (Parent)

S. No.	Particulars		Amount	Amount
	On the date of loan			
1	Loan to ABC Ltd (Subsidiary)	Dr.	7,51,315	
	Deemed Investment (Capital Contribution) in ABC Ltd.	Dr.	2,48,685	
	To Bank			10,00,000
	(Being the loan is given to ABC Ltd and recognised at fair value)			
	Accrual of Interest income			
2	Loan to ABC Ltd	Dr.	75,131	
	To Interest income			75,131
	(Being interest income accrued) – Year 1			
3	Loan to ABC Ltd	Dr.	82,645	
	To Interest income			82,645
	(Being interest income accrued) – Year 2			

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4	Loan to ABC Ltd	Dr.	90,909	
	To Interest income			90,909
	(Being interest income accrued) – Year 3			
5	**On repayment of loan**			
	Bank	Dr.	10,00,000	
	To Loan to ABC Ltd (Subsidiary)			10,00,000

Accounting in the books of ABC Ltd (Subsidiary)

S. No.	Particulars		Amount	Amount
	On the date of loan			
1	Bank	Dr.	10,00,000	
	To Loan from XYZ Ltd (Payable)			751,315
	To Equity (Deemed Capital Contribution from XYZ Ltd)			2,48,685
	(Being the loan taken from XYZ Ltd. and recognised at Fair value)			
	Accrual of Interest			
2	Interest expense	Dr.	75,131	
	To Loan from XYZ Ltd (Payable)			75,131
	(Being interest expense recognised) – Year 1			
3	Interest expense	Dr.	82,645	
	To Loan from XYZ Ltd (Payable)			82,645
	(Being interest expense recognised) – Year 2			
4	Interest expense	Dr.	90,909	
	To Loan from XYZ Ltd (Payable)			90,909
	(Being interest expense recognised) – Year 3			
	On repayment of loan			
5	Loan from XYZ Ltd (Payable)	Dr.	10,00,000	
	To Bank			10,00,000

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Working Notes:-

1	**Computation of Present value of loan**	
	Rate	10%
	Amount of Loan	10,00,000
	Year	3
	Present Value	7,51,315
2	**Computation of interest for Year I**	
	Present Value	7,51,315
	Rate	10%
	Period of interest - for 1 year	1
	Closing value at the end of year 1	8,26,446
	Interest for 1st year	75,131
3	**Computation of interest for Year 2**	
	Value of loan as at the beginning of Year 2	8,26,446
	Rate	10%
	Period of interest - for 2nd year	1
	Closing value at the end of year 2	9,09,091
	Interest for 2nd year	82,645
4	**Computation of interest for Year 3**	
	Value of loan as at the beginning of Year 3	9,09,091
	Rate	10%
	Period of interest - for 3rd year	1
	Closing value at the end of year 3	10,00,000
	Interest for 3rd year	90,909

Scenario (c)

Generally, a loan, which is repayable when funds are available, can't be stated to be repayable on demand. Rather, the entities need to estimate repayment date and determine its measurement accordingly. If the loan is expected to be repaid in three years, its measurement will be the same as in scenario (b).

In the Consolidated Financial Statements (CFS), the loan and interest income/expense will get eliminated as intra-group transaction in all three scenarios. Hence the above

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accounting will not have any impact in the CFS. However, if the loan is in foreign currency, exchange difference will continue to impact the statement of profit and loss in accordance with the requirements of Ind AS 21.

*****

2.7 FINANCIAL LIABILITIES: CLASSIFICATION

- Upon initial recognition, all financial liabilities are measured at fair value. Subsequently, per Ind AS 109.4.2.1 – the classification of financial liabilities shall be as follows:

  (A) Measured at amortised cost

  (B) Measured at fair value through profit or loss:

  - Liabilities that meet the definition of "held for trading"
  - Contingent consideration recognized by an acquirer in a business combination

  (C) Designated at fair value through profit or loss

  (D) Other specific measurement basis (with changes recognized in profit or loss):

  - financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies: refer paragraph 3.2.15 or 3.2.17 of Ind AS 109
  - financial guarantee contracts and commitments to provide a loan at a below-market interest rate are subsequently measured at higher of:
    - the amount of the loss allowance, and
    - the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of Ind AS 115."

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Irrespective of above classification, any financial liabilities may be designated at fair value through profit or loss if:

(i) It eliminates or significantly reduces a measurement or recognition inconsistency (**'accounting mismatch'**) that would otherwise arise from measuring assets or liabilities; or their gains on a different basis; or

(ii) A group of financial liabilities and financial assets is managed and its performance is evaluated on fair value basis, in accordance with a documented risk management or investment strategy, and information about that group is provided internally on that basis to the entity's key management personnel.

- **Financial assets and financial liabilities held for trading:**
  - Financial assets and liabilities held for trading are defined as those that:

    (a) are acquired or incurred principally for the purpose of sale or repurchase in the near term;

    (b) on initial recognition are 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

    (c) are derivatives (except for those that are financial guarantee contracts or are designated effective hedging instruments).

    Trading generally reflects active and frequent buying and selling, and financial instruments held for trading are normally used with the objective of generating a profit from short-term fluctuations in price or a dealer's margin.

  - In addition to derivatives that are not accounted for as hedging instruments, financial liabilities held for trading include:

    (a) obligations to deliver financial assets borrowed by a short seller (i.e. an entity that sells financial assets it has borrowed and does not yet own);

    (b) financial liabilities that are incurred with an intention to repurchase them in the near term, such as quoted debt instruments that the issuer may buy back in the near term depending on changes in fair value; and

    (c) financial liabilities that are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking.

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However, the fact that a liability is used merely to fund trading activities does not in itself make that liability one that is held for trading.

Illustration 29 : Trade creditors at market terms

A Company purchases its raw materials from a vendor at a fixed price of ₹ 1,000 per tonne of steel. The payment terms provide for 45 days of credit period, after which an interest of 18% per annum shall be charged. How would the creditors be classified in books of the Company?

Solution

In the above case, creditors for purchase of steel shall be carried at amortised cost, ie, fair value of amount payable upon initial recognition plus interest (if payment is delayed). Here, fair value upon initial recognition shall be the price per tonne. The transaction price is representative of fair value.

*****

Illustration 30

*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. Provide your comments.*

Solution

The fixed rate assets provide for contractual cash flows and based on business model of the entity, such fixed rate assets may be classified as 'amortised cost' (if entity collects contractual cash flows) or fair value through other comprehensive income (FVOCI) (if entity manages through collecting contractual cash and sale of financial assets).

In the absence of fair value option, the entity can classify the fixed rate assets as FVOCI with gains and losses on changes in fair value recognised in other comprehensive income and fixed rate debentures at amortised cost. However, reporting both assets and liabilities at fair value through profit and loss, ie, FVTPL corrects the measurement inconsistency and produces more relevant information.

Hence, it may be appropriate to classify the entire group of fixed rate assets and fixed rate debentures at fair value through profit or loss (FVTPL).

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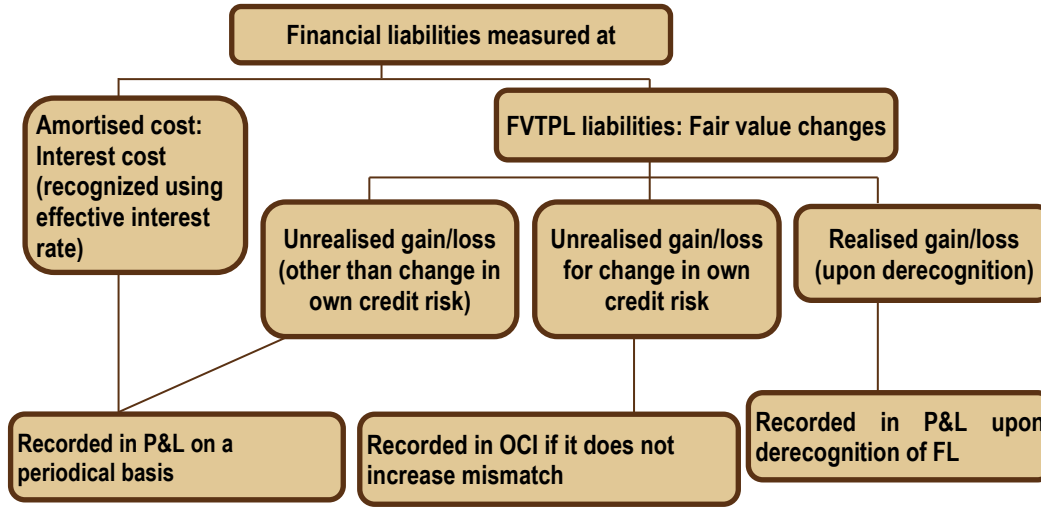
2.8 FINANCIAL LIABILITIES: MEASUREMENT

- Measurement of financial liabilities is driven by their classification upon initial recognition as follows:



- **Specific transactions – restructuring of financial liability**

If the terms of a financial liability are modified substantially, resulting in an extinguishment of the old financial liability, then the old liability is derecognised and the restructured financial instrument is treated as a new financial liability. If a modification of a financial liability results in derecognition of the financial liability, then the effective interest rate of the new financial liability is calculated based on the revised terms of the financial liability at the date of the modification. In this case, any costs or fees incurred are recognised as part of the gain or loss on extinguishment and do not adjust the carrying amount of the new liability.

If the exchange or modification is not accounted for as an extinguishment, then any costs and fees incurred are recognised as an adjustment to the carrying amount of the liability. For changes in future cash flows, the entity shall revised the amortised cost of the financial liability to reflect revised future cash flows by discounting them to their present value at the original effective interest rate. The difference between the carrying value and revised amortised cost is recognized as a gain or loss in profit or loss.

Modification is considered to be substantial if the discounted present value of the cash flows under the new terms including any fees paid net of any fees received and discounted

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using the original effective interest rate is at least 10% different from the discounted present value of the remaining cash flows of the original financial liability. Only fees paid or received between the borrower and the lender including fees paid or received by either the borrower or lender on the other's behalf are considered in this 10% test.

Illustration 31: Issue of borrowings with fixed rate of interest

A Ltd has borrowed from RBC Bank ₹ 10,000 at a fixed interest of 10% per annum. Loan processing fees were additionally paid for ₹ 500 and loan is payable after 5 years in bullet repayment of principal. Details are as follows:

Particulars	Details
Loan amount	*₹ 10,000*
Date of loan (Starting Date)	*1-Apr-20X1*
Date of repayment of principal amount (Finishing Date)	*31-March-20X6*
Interest rate	*10.00%*
Interest charge	*Interest to be charged and paid yearly*
Upfront fees	*₹ 500*

How would loan be accounted in books of A Ltd?

Solution

The loan taken by A Ltd shall be measured at amortised cost as follows:

- Initial measurement – At transaction price less processing fees

  = 10,000 – 500 = 9,500

- Subsequently – interest to be accrued using effective rate of interest as follows:

Year end	Opening balance	Interest @ 11.42%	Repayment of interest & principal	Closing balance
1	9,500	1,085	1,000	9,585
2	9,585	1,095	1,000	9,679
3	9,679	1,105	1,000	9,785
4	9,785	1,117	1,000	9,902
5	9,902	1,098*	11,000	-

* Difference due to approximation

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Computation of IRR

IRR would be the rate using which the present value of cash flow should come out to be ₹ 9,500 i.e. (₹ 10,000 less ₹ 500).

For this, we should first compute present value of cashflows using any two rates as follows:

Year end	Opening balance	Repayment /Cashflows	Closing balance	PVF @ 10%	Present Value at 10% rate	PVF @ 13%	Present Value at 13% rate
1	9,500	1,000	8,500	0.909	909	0.885	885
2	8,500	1,000	7,500	0.826	826	0.783	783
3	7,500	1,000	6,500	0.751	751	0.693	693
4	6,500	1,000	5,500	0.683	683	0.613	613
5	5,500	11,000	(5,500)	0.621	6,830	0.543	5,970*
					10,000		**8,945**

*Difference is due to approximation

Taking 10% as discount rate, present value (PV) comes out to be ₹ 10,000.

If rate is increased by 3% over a base rate of 10%, PV decreases by ₹ 1,055 (i.e. ₹ 10,000 less ₹ 8945).

To decrease PV by ₹ 1,055, rate should be increased = 3%

To decrease PV by Re.1, rate should be increased = $\frac{3\%}{1,055}$

To decrease PV by ₹ 500, rate should be increased = 3% x (500/1,055)

= 1.42%

This would mean that the discount rate to get present value of cashflows equivalent to ₹ 9,500 should be 11.42% (i.e. 10% + 1.42%).

Illustration 32: Issue of borrowings with fixed rate of interest

A Ltd has made a borrowing from RBC Bank for ₹ 10,000 at a fixed interest of 12% per annum. Loan processing fees were additionally paid for ₹ 500 and loan is payable 4 half-yearly instalments of ₹ 2,500 each. Details are as follows:

Particulars	Details
Loan amount	*₹ 10,000*
Date of loan (Starting Date)	*1-Apr-20X1*

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Date of loan (Finishing Date)	*31-March-20X3*
Description of repayment	*Repayment of loan starts from 30-Sept-20X1 (To be paid half yearly)*
Installment amount	*₹ 2,500*
Interest rate	*12.00%*
Interest charge	*Interest to be charged quarterly*
Upfront fees	*₹ 500*

How would loan be accounted in books of A Ltd?

Consider IRR is 16.60% p.a.

Solution

The loan taken by A Ltd shall be measured at amortised cost as follows:

- Initial measurement – At transaction price less processing fees

  = 10,000 – 500 = 9,500

- Subsequently – interest to be accrued using effective rate of interest as follows:

Date	Amount of Loan	Re-payment	Upfront fees paid	Amount of Interest	Days	IRR Calcula-tion	Revised Interest computed	Loan Balance
1-Apr-20X1	10,000	-	500	-	-	9,500	-	-
30-Jun-20X1	-	-	-	300	90	(300)	389	9,589
30-Sep-20X1	-	2500	-	300	92	(2,800)	401	7,190
31-Dec-20X1	-	-	-	225	92	(225)	301	7,266
31-Mar 20X2	-	2500	-	225	90	(2,725)	297	4,838
30-Jun-20X2	-	-	-	150	91	(150)	200	4,888
30-Sep-20X2	-	2500	-	150	92	(2,650)	204	2,442
31-Dec-20X2	-	-	-	75	92	(75)	102	2,473
31-Mar-20X3	-	2500	-	75	91	(2,575)	102	-
					IRR	**16.60%**		

*****

Illustration 33: Accounting treatment of processing fees belonging to undisbursed loan amount

X Ltd. had taken 6 year term loan in April 20X0 from bank and paid processing fees at the time of sanction of loan.

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The term loan is disbursed in different tranches from April 20X0 to April 20X6. On the date of transition to Ind AS, i.e. 1.4.20X5, it has calculated the net present value of term loan disbursed upto 31.03.20X5 by using effective interest rate and proportionate processing fees has been adjusted in disbursed amount while calculating net present value.

What will be the accounting treatment of processing fees belonging to undisbursed term loan amount?

Solution

Processing fee is an integral part of the effective interest rate of a financial instrument and shall be included while calculating the effective interest rate.

(a) Accounting treatment in case future drawdown is probable

It may be noted that to the extent there is evidence that it is probable that the undisbursed term loan will be drawn down in the future, the processing fee is accounted for as a transaction cost under Ind AS 109, i.e., the fee is deferred and deducted from the carrying value of the financial liabilities when the draw down occurs and considered in the effective interest rate calculations.

(b) Accounting treatment in case future drawdown is not probable

If it is not probable that the undisbursed term loan will be drawn down in the future, then the fees is recognised as an expense on a straight-line basis over the term of the loan.

*****

Illustration 34: Accounting treatment of prepayment premium and processing fees for obtaining new loan to prepay old loan

PQR Limited had obtained term loan from Bank A in 20X1-20X2 and paid loan processing fees and commitment charges.

In May 20X5, PQR Ltd. has availed fresh loan from Bank B as take-over of facility i.e. the new loan is sanctioned to pay off the old loan taken from Bank A. The company paid prepayment premium to Bank A to clear the old term loan and paid processing fees to Bank B for the new term loan.

Whether the prepayment premium and the processing fees both will be treated as transaction cost (as per Ind AS 109, Financial Instruments) of obtaining the new loan, in the financial statements of PQR Ltd?

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Solution

(a) Accounting treatment of prepayment premium

Ind AS 109, provides that if an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment in the statement of profit and loss.

Since the original loan was prepaid, the prepayment would result in extinguishment of the original loan. The difference between the CV of the financial liability extinguished and the consideration paid shall be recognised in profit or loss as per Ind AS 109.

Accordingly, the prepayment premium shall be recognised as part of the gain or loss on extinguishment of the old loan.

(b) Accounting treatment of unamortised processing fee of old loan

Processing fees are not amortised separately from the loan. Processing fees are part of EIR and therefore are amortised with the loan. Therefore, the accounting treatment of unamortised processing fee will be the same as for the loan that is derecognised from financial liability and recognised in profit or loss. In other words, unamortised processing fee related to the old loan will also be required to be charged to the statement of profit and loss.

(c) Accounting treatment of processing fee for new loan

Transaction costs are "Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument."

It is assumed that the loan processing fees solely relates to the origination of the new loan (i.e. does not represent loan modification/renegotiation fees). Hence, the processing fees paid to avail fresh loan from Bank B will be considered as transaction cost in the nature of origination fees of the new loan and will be included while calculating effective interest rate as per Ind AS 109.

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Illustration 35: Accounting treatment of share held as stock in trade

A share broking company is dealing in sale/purchase of shares for its own account and therefore is having inventory of shares purchased by it for trading.

How will these instruments be accounted for in the financial statements?

Solution

Ind AS 2, Inventories, states that this Standard applies to all inventories, except financial instruments (Ind AS 32, Financial Instruments: Presentation and Ind AS 109, Financial Instruments).

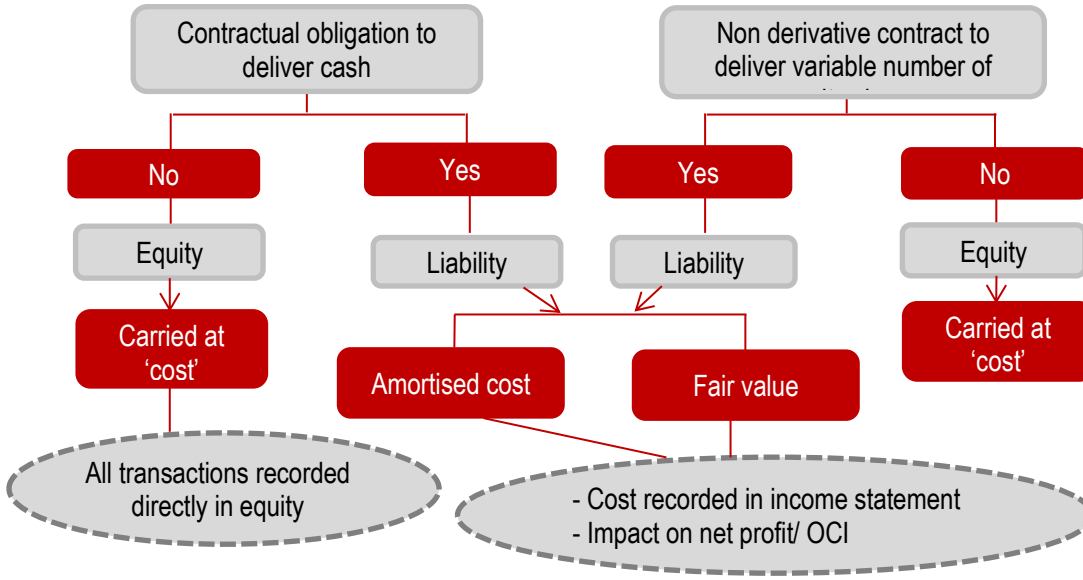
Accordingly, the principles of recognising and measuring financial instruments are governed by Ind AS 109, its presentation is governed by Ind AS 32 and disclosures are in accordance with Ind AS 107, Financial Instruments: Disclosures, even if these instruments are held as stock-in trade by a company.

Further Ind AS 101, First-time Adoption of Indian Accounting Standards does not provide any transitional relief from the application of the above standards.

Accordingly, in the given case, the relevant requirements of Ind AS 109, Ind AS 32 and Ind AS 107 shall be applied retrospectively.

*****

Difference between measurement requirements of financial liability and equity and their comparison can be understood with the help of following diagrammatic presentation –



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2.9 RECLASSIFICATION OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Per Ind AS 109.4.4.1 – An entity shall reclassify financial assets, *only* if the entity changes its business model for managing those 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.

- **Accounting for reclassification of financial assets:**
  - A change in the objective of the entity's business model must be effected before the reclassification date. For example, if a financial services firm decides on 15 February to shut down its retail mortgage business and hence must reclassify all affected financial assets on 1 April (ie the first day of the entity's next reporting period), the entity must not accept new retail mortgage business or otherwise engage in activities consistent with its former business model after 15 February.
  - If an entity reclassifies any financial asset, it must do so **prospectively from reclassification date.**
  - The entity shall **not restate** any previously recognised gains, losses (including impairment gains or losses) or interest.

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- **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.

- **Following changes in circumstances are not reclassifications:**

  (a) an item that was previously a designated and effective hedging instrument in a cash flow hedge or net investment hedge no longer qualifies as such;

  (b) an item becomes a designated and effective hedging instrument in a cash flow hedge or net investment hedge; and

  (c) changes in measurement for a financial instrument, if the entity takes credit derivative that is measured at fair value through profit or loss to manage the credit risk of all, or part of such financial instrument and consequently, the underlying financial instrument is also designated at fair value through profit or loss.

- **Financial liabilities are not permitted to be reclassified.**

Illustrative examples:

➢ **Case 1:** Amortised cost to FVTPL

- ❖ It is measured at fair value on reclassification date.
- ❖ Any gain or loss arising from difference between the previous amortised cost of the financial asset and fair value is recognised in profit or loss.

Illustration 36

Bonds for ₹ 1,00,000 reclassified as FVTPL. Fair value on reclassification is ₹ 90,000. Pass the required journal entry.

Solution

Particulars		Amount	Amount
Bonds at FVTPL	Dr.	90,000	
Loss on reclassification	Dr.	10,000	
To Bonds at amortised cost			1,00,000

*****

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➢ **Case 2:** Amortised cost to FVOCI

- ❖ It is measured at fair value on reclassification date.
- ❖ Any gain or loss arising from difference between the previous amortised cost of the financial asset and fair value is recognised in other comprehensive income
- ❖ Effective interest rate and measurement of expected credit losses are not adjusted as a result of reclassification.

Illustration 37

Bonds for ₹ 1,00,000 reclassified as FVOCI. Fair value on reclassification is ₹ 90,000. Pass the required journal entry.

Solution

Particulars		Amount	Amount
Bonds at FVOCI	Dr.	90,000	
OCI (Loss on reclassification)	Dr.	10,000	
To Bonds at amortised cost			1,00,000

*****

➢ **Case 3:** FVTPL to Amortised cost

- ❖ It is measured at fair value on reclassification date and this fair value becomes the new gross carrying amount. Effective interest rate is computed based on this new gross carrying amount.
- ❖ Any gain or loss arising from difference between the previous amortised cost of the financial asset and fair value is recognised in profit or loss.

Illustration 38

Bonds for ₹ 100,000 reclassified as Amortised cost. Fair value on reclassification is ₹ 90,000. Pass the required journal entry.

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Solution

Particulars		Amount	Amount
Bonds at Amortised cost	Dr.	90,000	
Loss on reclassification	Dr.	10,000	
To Bonds at FVTPL			1,00,000

*****

➢ **Case 4:** FVTPL to FVOCI

- ❖ The financial asset continues to be measured at fair value.
- ❖ The effective interest rate is determined on the basis of fair value of asset at reclassification date.

Illustration 39

Bonds for ₹ 100,000 reclassified as FVOCI. Fair value on reclassification is ₹ 90,000. Pass the required journal entry.

Solution

Particulars		Amount	Amount
Bonds at FVOCI	Dr.	90,000	
Loss on reclassification	Dr.	10,000	
To Bonds at FVTPL			1,00,000

*****

➢ **Case 5:** FVOCI to Amortised cost

- ❖ The financial asset is measured at fair value on reclassification date.
- ❖ However, cumulative gain or loss previously recognised in other comprehensive income (OCI) is removed from equity and adjusted against fair value of financial asset at reclassification date.
- ❖ As a result, the financial asset is measured at reclassification date as if it had always been measured at amortised cost. This adjustment affects OCI but does not affect profit or loss and therefore, is not a reclassification adjustment.
- ❖ Effective interest rate and measurement of expected credit losses are not adjusted as a result of reclassification.

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Illustration 40

Bonds for ₹ 100,000 reclassified as Amortised cost. Fair value on reclassification is ₹ 90,000 and ₹ 10,000 loss was recognised in OCI till date of reclassification. Pass required journal entry.

Solution

Particulars		Amount	Amount
Bonds at FVOCI	Dr.	10,000	
To OCI - Loss on reclassification			10,000
[Being loss recognized in OCI now reversed prior to reclassification]			
Bonds (Amortised cost)	Dr.	1,00,000	
To Bonds at FVOCI			1,00,000
[Being bonds reclassified from FVOCI to Amortised cost]			

*****

➢ **Case 6:** FVOCI to FVTPL

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

Illustration 41

Bonds for ₹ 100,000 reclassified as FVTPL. Fair value on reclassification is ₹ 90,000. Pass the required journal entry.

Solution

Particulars		Amount	Amount
P&L - Loss on reclassification	Dr.	10,000	
To Bonds at FVTOCI			10,000
Bonds at FVTPL	Dr.	90,000	
To Bonds at FVOCI			90,000

*****

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2.10 IMPAIRMENT

- **Scope of impairment**

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

  (a) a financial asset that is measured at amortised cost

  (b) a financial asset that is measured at fair value through other comprehensive income

  (c) a lease receivable,

  (d) a contract asset or a loan commitment; and

  (e) a financial guarantee contract

- **The impairment model does not apply to:**

  (a) All financial assets that are equity instruments (because these are measured either at FVTPL or FVTOCI),

  (b) Financial assets that are debt instruments and are measured as at FVTPL,

  (c) Any other financial instrument measured as at FVTPL.

- **What is a credit loss allowance?**

  - For financial assets, a credit loss is the present value of the difference between:

    (a) the contractual cash flows that are due to an entity under the contract; and

    (b) the cash flows that the entity expects to receive (i.e,, cash short falls) discounted at original effective interest rate (or credit adjusted effective interest rate in case of purchased or originated credit-impaired financial assets).

  - An entity shall estimate cash flows by considering all contractual terms of the financial instrument (for eg.: prepayment, extension, call and similar options) through the expected life of the financial instrument.

  - The cash flows that are considered shall include cash flows from sale of collateral held or other credit enhancements that are integral to the contractual terms. There is a presumption that the expected life of the financial instrument can be estimated reliably. In those rare cases when it is no possible to reliably estimate the expected life of a financial instrument, the entity shall use the remaining contractual term of the financial instrument.

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- **Different approaches for impairment of financial assets.**

(a) General Approach

- ❖ The general approach requires an entity to recognise, at each reporting date, an impairment loss allowance using either 12 month ECL or lifetime ECL.
- ❖ 12 month ECL typically results in lower impairment since it focuses only on probability of default (PD) within next 12 month period, as against PD over the life of an instrument.
- ❖ The use of ECL depends on whether there has been a significant increase in credit risk on the instrument since its initial recognition.
- ❖ This approach is applicable to all financial instruments covered by impairment requirements of Ind AS 109, except instruments covered in the following two approaches.

(b) Simplified Approach

- ❖ This approach does not require an entity to track changes in credit risk. Rather, each entity recognises impairment loss allowance based on lifetime ECLs at each reporting date, right from its initial recognition.
- ❖ The application of simplified approach is mandatory for trade receivables or any contractual right to receive cash or another financial asset that result from transactions that are within the scope of Ind AS 115 having no significant financing component.

(c) Purchased or originated credit-impaired (POCI) financial assets approach

- ❖ This approach is applicable to financial assets which are credit impaired on purchase/origination.

- **What is 12-month expected credit losses and lifetime expected credit losses?**

- ➢ Lifetime expected credit loss is the expected credit losses that result from all possible default events over the expected life of a financial instrument.
- ➢ 12-Month expected credit loss is the portion of the lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date.

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- **How the entity determine whether it should apply 12-month ECL or lifetime ECL?**

The decision tree to be applied in determining whether the entity needs to provide for 12-month expected credit losses or life time expected credit losses is applied as follows:

Three Stage Model for Impairment			
Particular	**Stage 1**	**Stage 2**	**Stage 3**
	Initial Recognition	**Significant increase in credit risk**	**Credit Impaired**
Credit Risk	Low	Moderate to High	Significant
ECL Model	12 Month ECL	Life-time ECL	Life-time ECL
Interest recognition	Interest on gross carrying amount	Interest on gross carrying amount	Interest on amortised cost

- **Appendix A of Ind AS 109 defines gross carrying amount of a financial asset as** the amortised cost of a financial asset, before adjusting for any loss allowance.

- **Appendix A of Ind AS 109 defines amortised cost of a financial asset or financial liability as** the amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance.

- **Determining whether credit risk has increased significantly:**

Ind AS 107 defines **credit risk** as 'the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation'.

➢ When determining whether the recognition of lifetime expected credit losses is required, an entity shall consider reasonable and supportable information that is available without undue cost or effort and that may affect the credit risk on a financial instrument.

➢ The following non-exhaustive list of information may be relevant in assessing changes in credit risk:

(a) significant changes in internal price indicators of credit risk as a result of a change in credit risk since inception, including, but not limited to, the credit

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spread that would result if a particular financial instrument or similar financial instrument with the same terms and the same counterparty were newly originated or issued at the reporting date.

(b) other changes in the rates or terms of an existing financial instrument that would be significantly different if the instrument was newly originated or issued at the reporting date (such as more stringent covenants, increased amounts of collateral or guarantees, or higher income coverage) because of changes in the credit risk of the financial instrument since initial recognition.

(c) significant changes in external market indicators of credit risk for a particular financial instrument or similar financial instruments with the same expected life. Changes in market indicators of credit risk include, but are not limited to:

(i) the credit spread;

(ii) the credit default swap prices for the borrower;

(iii) the length of time or the extent to which the fair value of a financial asset has been less than its amortised cost; and

(iv) other market information related to the borrower, such as changes in the price of a borrower's debt and equity instruments.

(d) an actual or expected significant change in the financial instrument's external credit rating.

(e) an actual or expected internal credit rating downgrade for the borrower or decrease in behavioural scoring used to assess credit risk internally.

(f) existing or forecast adverse changes in business, financial or economic conditions that are expected to cause a significant change in the borrower's ability to meet its debt obligations, such as an actual or expected increase in interest rates or an actual or expected significant increase in unemployment rates

(g) an actual or expected significant change in the operating results of the borrower, for eg.: actual or expected declining revenues or margins, increasing operating risks, working capital deficiencies, decreasing asset quality, increased balance sheet leverage, liquidity, management problems or changes in the scope of business or organisational structure, etc. that results in a significant change in the borrower's ability to meet its debt obligations

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(h) significant increases in credit risk on other financial instruments of the same borrower

(i) an actual or expected significant adverse change in the regulatory, economic, or technological environment of the borrower

(j) significant changes in the value of the collateral supporting the obligation or in the quality of third-party guarantees or credit enhancements;

(k) a significant change in the quality of the guarantee provided by a shareholder (or an individual's parents) if the shareholder (or parents) have an incentive and financial ability to prevent default by capital or cash infusion

(l) significant changes, such as reductions in financial support from a parent entity or other affiliate or an actual or expected significant change in the quality of credit enhancement, that are expected to reduce the borrower's economic incentive to make scheduled contractual payments

(m) expected changes in the loan documentation including an expected breach of contract that may lead to covenant waivers or amendments, interest payment holidays, interest rate step-ups, requiring additional collateral or guarantees, or other changes to the contractual framework of the instrument

(n) significant changes in the expected performance and behaviour of the borrower, including changes in the payment status of borrowers in the group

(o) changes in the entity's credit management approach in relation to the financial instrument; ie based on emerging indicators of changes in the credit risk of the financial instrument, the entity's credit risk management practice is expected to become more active or to be focused on managing the instrument, including the instrument becoming more closely monitored or controlled, or the entity specifically intervening with the borrower.

(p) Other past due information.

- **30 days past due rebuttable presumption:**

Regardless of the way in which an entity assesses significant increases in credit risk, there is a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due.

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- An entity can rebut this presumption if the entity has reasonable and supportable information that is available without undue cost or effort, that demonstrates that the credit risk has not increased significantly since initial recognition even though the contractual payments are more than 30 days past due.
- When an entity determines that there have been significant increases in credit risk before contractual payments are more than 30 days past due, the rebuttable presumption does not apply.

◆ **What is credit impaired financial assets:**

- A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. Evidence that a financial asset is credit-impaired include observable data about the following events:

  (a) Significant financial difficulty of the issuer or the borrower;

  (b) Breach of contract, such as a default or past due event;

  (c) Lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider;

  (d) It is becoming probable that the borrower will enter bankruptcy or other financial reorganisation;

  (e) the disappearance of an active market for that financial asset because of financial difficulties; or

  (f) the purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses.

  It may not be possible to identify a single discrete event-instead, the combined effect of several events may have caused financial assets to become credit-impaired.

◆ **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;

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(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.

- When measuring expected credit losses, an entity need not necessarily identify every possible scenario. However, it shall consider the risk or probability that a credit loss occurs by reflecting the possibility that a credit loss occurs and the possibility that no credit loss occurs, even if the possibility of a credit loss occurring is very low.
- The maximum period to consider when measuring expected credit losses is the maximum contractual period (including extension options) over which the entity is exposed to credit risk and not a longer period, even if that longer period is consistent with business practice.

♦ **An entity may use practical expedients when measuring expected credit losses.**

- An example of a practical expedient is the calculation of the expected credit losses on trade receivables using a provision matrix. The entity would use its historical credit loss experience for trade receivables to estimate the 12-month expected credit losses or the lifetime expected credit losses on the financial assets as relevant. A provision matrix might, for example, specify fixed provision rates depending on the number of days that a trade receivable is past due (for example, 1 per cent if not past due, 2 per cent if less than 30 days past due, 3 per cent if more than 30 days but less than 90 days past due, 20 per cent if 90–180 days past due etc).
- Depending on the diversity of its customer base, the entity would use appropriate groupings if its historical credit loss experience shows significantly different loss patterns for different customer segments. Examples of criteria that might be used to group assets include geographical region, product type, customer rating, collateral or trade credit insurance and type of customer (such as wholesale or retail).

Illustration 42 :12 month expected credit loss – Probability of default approach

Entity A originates a single 10 year amortising loan for CU1 million. Taking into consideration the expectations for instruments with similar credit risk (using reasonable and supportable information that is available without undue cost or effort), the credit risk of the borrower, and the economic outlook for the next 12 months, Entity A estimates that the loan at initial recognition has a probability of default (PoD) of 0.5 per cent over the next 12 months. Entity A also determines that changes in the 12-month PoD are a

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reasonable approximation of the changes in the lifetime PoD for determining whether there has been a significant increase in credit risk since initial recognition. Loss given default (LGD) is estimated as 25% of the balance outstanding. Calculate loss allowance.

Solution

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

Particulars	Details
Loan	₹ 1,000,000 (A)
LGD	25% (B)
PoD – 12 months	0.5% (C)
Loss allowance (for 12-months ECL)	₹ 1,250 (A*B*C)

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Illustration 43: 12 month expected credit loss – Loss rate approach

Bank A originates 2,000 bullet loans with a total gross carrying amount of CU 500,000. Bank A segments its portfolio into borrower groups (Groups X and Y) on the basis of shared credit risk characteristics at initial recognition. Group X comprises 1,000 loans with a gross carrying amount per client of CU 200, for a total gross carrying amount of CU 200,000. Group Y comprises 1,000 loans with a gross carrying amount per client of CU 300, for a total gross carrying amount of CU 300,000. There are no transaction costs and the loan contracts include no options (for example, prepayment or call options), premiums or discounts, points paid, or other fees. Calculate loss rate when

Group	Historic per annum average defaults	Present value of observed loss assumed
X	4	CU 600
Y	2	CU 450

Solution

- Bank A measures expected credit losses on the basis of a loss rate approach for Groups X and Y. In order to develop its loss rates, Bank A considers samples of its own historical default and loss experience for those types of loans.
- In addition, Bank A considers forward-looking information, and updates its historical information for current economic conditions as well as reasonable and supportable forecasts of future economic conditions. Historically, for a population of 1,000 loans in each group, Group X's loss rates are 0.3 per cent, based on four defaults, and historical loss rates for Group Y are 0.15 per cent, based on two defaults.

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	Number of clients in sample	Estimated per client gross carrying amount at default	Total estimated gross carrying amount at default	Historic per annum average defaults	Estimated total gross carrying amount at default	Present value of observed loss assumed	Loss rate
Group	A	B	C = A × B	D	E = B × D	F	G = F ÷ C
X	1,000	CU 200	CU 2,00,000	4	CU 800	CU 600	0.3%
Y	1,000	CU 300	CU 3,00,000	2	CU 600	CU 450	0.15%

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Illustration 44: Life time expected credit losses (provision matrix for short term receivables)

Company M, a manufacturer, has a portfolio of trade receivables of CU 30 million in 20X1 and operates only in one geographical region. The customer base consists of a large number of small clients and the trade receivables are categorised by common risk characteristics that are representative of the customers' abilities to pay all amounts due in accordance with the contractual terms. The trade receivables do not have a significant financing component in accordance with Ind AS 115. In accordance with paragraph 5.5.15 of Ind AS 109 the loss allowance for such trade receivables is always measured at an amount equal to lifetime expected credit losses.

Please use the following information of debtors outstanding:

	Gross carrying amount
Current	*CU 15,000,000*
1–30 days past due	*CU 7,500,000*
31–60 days past due	*CU 4,000,000*
61–90 days past due	*CU 2,500,000*
More than 90 days past due	*CU 1,000,000*
	CU 30,000,000

Company M uses following default rates for making provisions:

	Current	***1–30 days past due***	***31–60 days past due***	***61–90 days past due***	***More than 90 days past due***
Default rate	*0.3%*	*1.6%*	*3.6%*	*6.6%*	*10.6%*

Determine the expected credit losses for the portfolio

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Solution

To determine the expected credit losses for the portfolio, Company M uses a provision matrix. The provision matrix is based on its historical observed default rates over the expected life of the trade receivables and is adjusted for forward-looking estimates. At every reporting date the historical observed default rates are updated and changes in the forward-looking estimates are analysed. In this case it is forecast that economic conditions will deteriorate over the next year.

On that basis, Company M estimates the following provision matrix:

	Current	1–30 days past due	31–60 days past due	61–90 days past due	More than 90 days past due
Default rate	0.3%	1.6%	3.6%	6.6%	10.6%

The trade receivables from the large number of small customers amount to CU 30 million and are measured using the provision matrix.

	Gross carrying amount	Lifetime expected credit loss allowance (Gross carrying amount x lifetime expected credit loss rate)
Current	CU 15,000,000	CU 45,000
1–30 days past due	CU 7,500,000	CU 120,000
31–60 days past due	CU 4,000,000	CU 144,000
61–90 days past due	CU 2,500,000	CU 165,000
More than 90 days past due	CU 1,000,000	CU 106,000
	CU 30,000,000	**CU 580,000**

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QUICK RECAP

- The classification and measurement of financial instruments are summarized as below :

	Financial Assets			Financial Liabilities		Equity
Classification	**Amortised Cost**	**FVTOCI**	**FVTPL**	**Amortised Cost**	**FVTPL**	**-**
Basis of Classification	▪ BM test to collect ▪ SPPI test	▪ BM test to collect & sell ▪ SPPI test	▪ Held for trading (SPPI or BM test fail)	▪ Default criterial	▪ If held for trading ▪ Entity elects FVTPL (using fair value option)	-
Initial recognition	▪ Fair Value plus or minus transaction costs	▪ Fair Value plus or minus transaction costs	▪ Fair Value	▪ Fair Value plus or minus transaction costs	▪ Fair Value	▪ Fair Value
Subsequent recognition	▪ Amortised Cost	▪ Fair Value	▪ Fair Value	▪ Amortised cost	▪ Fair Value	▪ No Re-measurement

- Financial asset (FA) will be classified as amortised cost if the objective is to hold the financial asset in order to collect contractual cash flows and contractual terms give rise to cash flows that are Solely Payments of Principal and Interest (SPPI) on the principal amount outstanding.

- Contractual terms give rise to cash flows that are Solely Payments of Principal and Interest on the principal amount outstanding. Contractual cash flows must be consistent with a basic lending arrangement. In respect of Interest element, factors such as time value of money, Credit risk, Liquidity, profit margin, service or administrative costs etc. should be considered. Contractual cash flows linked to features such as changes in equity or commodity prices, would not pass the SPPI test because they introduce exposure to risks or volatility. SPPI Test will be met if there is a prepayment penalty i.e. additional compensation for early termination or extension of contract.

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- An entity may have one of the following models for its debt instruments :
  (a) Hold to collect contractual cash flows
  (b) Hold to collect contractual cash flows and selling financial assets
  (c) Other business model – Actively buying & Selling
- Financial asset (FA) in debt instruments is measured at fair value through OCI (FVTOCI) if it meets both 'Hold-to-collect and sell' business model test and 'SPPI' contractual cash flow characteristics test.
- In respect of Financial asset (FA) in equity instruments, Ind AS 109 requires all equity investments to be measured at fair value. All changes in fair value to be recognised in profit or loss. However, Entities can make an irrevocable election at initial recognition to classify the instruments as at FVOCI. Such option is available instrument by instrument i.e. (item by item) and all subsequent changes in fair value being recognised in OCI. Dividends received on equity investments to be recognised in profit or loss.
- Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial instrument

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