UNIT 5: RECOGNITION AND DERECOGNITION OF FINANCIAL INSTRUMENTS

The concepts of recognition and derecognition of any asset or liability refer to the timing i.e. when is the financial instrument included in an entity's balance sheet (recognition) and when is it removed from the entity's balance sheet (derecognition).

5.1 INITIAL RECOGNITION

As per paragraph 3.1.1 of Ind AS 109, an entity shall recognise a financial asset or a financial liability in its balance sheet when, and only when, the entity becomes party to the contractual provisions of the instrument.

Paragraph B3.1.2 of Ind AS 109 provides certain examples of applying the aforementioned accounting principle:

Nature of contract	Recognition principle – when are assets or liabilities recognised?
Unconditional receivables and payables	When the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash
Firm commitment to purchase or sell goods or services	When at least one of the parties has performed under the agreement i.e. until the ordered goods or services have been shipped, delivered or rendered.
Firm commitment to purchase or sell goods or services designated as measured at fair value through profit or loss (refer note 2 below)	Net fair value is recognised as an asset or a liability on the commitment date
Forward contract	On the commitment date. When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero (refer note 1 below). If the net fair value of the right and obligation is not zero, the contract is recognised as an asset or liability.

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Option contracts	When the holder or writer becomes a party to the contract (refer note 1 below).
Planned future transactions	Never

Note 1: Generally, no upfront premium is paid by one party in a forward contract to the other at the inception of the contract. This is indicative of the fact that the fair value of a forward contract on inception is approximately zero. On the other hand, the option holder generally pays an upfront premium to the option writer at the inception of the option contract. This provides evidence that there is some fair value of the rights and obligations of the parties at the inception of an options contract.

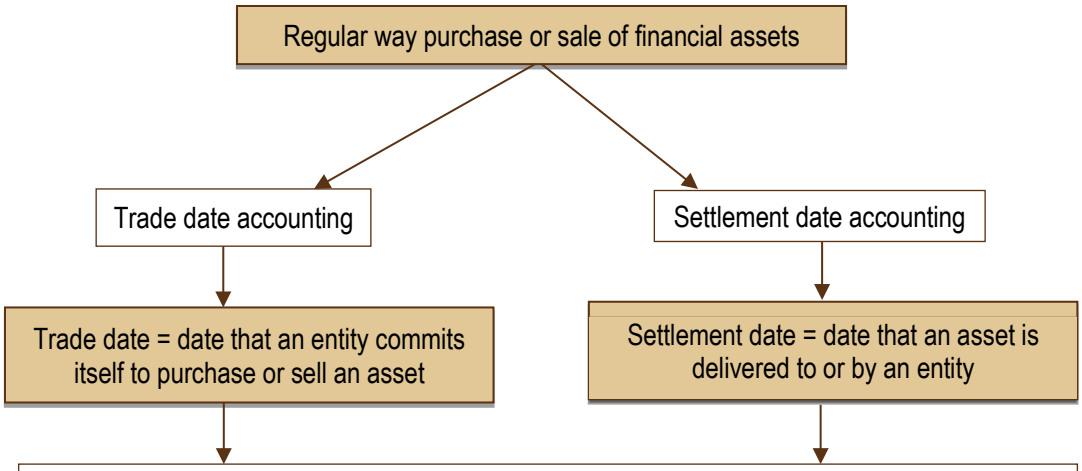
Note 2: Contracts to buy or sell non-financial assets that can be settled net or by exchanging financial instruments are treated as if they are financial instruments, that is, derivatives unless they were entered into and continued to be held to meet the entity's normal purchase, sale or usage requirements

5.2 REGULAR WAY PURCHASE OR SALE OF FINANCIAL ASSETS

Ind AS 109 defines a regular way purchase or sale as,

- a **purchase or sale** of a financial asset
- under a **contract**
- whose terms require **delivery** of the asset
- within the **time frame**
- established generally by **regulation or convention in the marketplace** concerned

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- Recognition of an asset to be received and the liability to pay for it
- Derecognition of an asset that is sold, recognition of any gain or loss on disposal and the recognition of a receivable from the buyer for payment

For instance, on the Bombay Stock Exchange in India, all transactions in all groups of securities in the Equity segment, Fixed Income securities and Government securities are settled on "T+2" basis. In this case, "T" is the trade date and "T+2" is the settlement date i.e. exchange of monies and securities between the buyers and sellers respectively takes place on second business day (excluding Saturdays, Sundays, bank and Exchange trading holidays) after the trade date.

It follows that if a contract is entered into with a broker for purchase or sale of securities which is normally traded on the Bombay Stock Exchange, with a settlement period that differs from the norms mentioned above, it would not be regarded as a regular way purchase or sale.

When trade date accounting is applied, the buyer of a financial asset recognises the financial asset and its liability to pay on the trade date itself. Correspondingly, the seller derecognises the financial asset and recognises any gain or loss on sale on the trade date. The buyer subsequently measures the financial asset in accordance with its classification category.

When settlement date accounting is applied, a **buyer of financial asset accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date** in the same way as it accounts for the acquired asset. In other words,

- ♦ assets measured at amortised cost - change in value is not recognised;
- ♦ assets classified as financial assets measured at fair value through profit or loss (whether mandatorily or designated) – change in value is recognised in profit or loss;
- ♦ financial assets measured at fair value through other comprehensive income (including investments in equity instruments for which irrevocable option is selected) – change in fair value is recognised in other comprehensive income.

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Correspondingly, the seller of a financial asset derecognises the same at the settlement date and does not recognise any fair value changes between the trade date and settlement date.

An entity shall apply the same method consistently for all purchases and sales of financial assets that are classified in the same way in accordance with Ind AS 109.

Illustration 1: Regular way contracts: forward contracts

ST Ltd. enters into a forward contract to purchase 10 lakh shares of ABC Ltd. in a month's time for ₹ 50 per share. This contract is entered into with a broker, Mr. AG and not through regular trading mode in a stock exchange. The contract requires Mr. AG to deliver the shares to ST Ltd. upon payment of agreed consideration. Shares of ABC Ltd. are traded on a stock exchange. Regular way delivery is two days. Assess the forward contract.

Solution

In this case, the forward contract is not a regular way transaction and hence must be accounted for as a derivative i.e. between the date of entering into the contract to the date of delivery, all fair value changes are recognised in profit or loss.

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Illustration 2: Regular way contracts: option contracts

NKT Ltd. purchases a call option in a public market permitting it to purchase 100 shares of VT Ltd. at any time over the next one month at a price of ₹ 1,000 per share. If NKT Ltd. exercises its option, it has 7 days to settle the transaction according to regulation or convention in the options market. VT Ltd.'s shares are traded in an active public market that requires two-day settlement.

Solution

In this case, the options contract is a regular way transaction as the settlement of the option is governed by regulation or convention in the marketplace for options. Fair value changes between the trade date and settlement date are recognised in profit or loss.

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The illustrations below explain the flow of journal entries in case of trade date accounting and settlement date accounting for regular way purchase and sale of financial assets.

Illustration 3: Regular way purchase of financial asset

On 1 January 20X1, X Ltd. enters into a contract to purchase a financial asset for ₹ 10 lakhs, which is its fair value on trade date. On 4 January 20X1 (settlement date), the fair value of the asset is ₹ 10.5 lakhs. The amounts to be recorded for the financial asset will depend on how it is classified and whether trade date or settlement date accounting is used. Pass necessary journal entries.

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Solution

Journal Entries in the Buyer's Books

Trade date accounting

Dr. / Cr.	Particulars	Amortised cost	Fair value through P&L	Fair value through OCI
1 January 20X1				
Dr.	Financial asset	10,00,000	10,00,000	10,00,000
Cr.	Financial liability (to pay)	(10,00,000)	(10,00,000)	(10,00,000)
4 January 20X1				
Dr.	Financial asset	-	50,000	50,000
Dr.	Financial liability (to pay)	10,00,000	10,00,000	10,00,000
Cr.	Profit or loss	-	(50,000)	-
Cr.	Other comprehensive income	-	-	(50,000)
Cr.	Cash	(10,00,000)	(10,00,000)	(10,00,000)

Settlement date accounting

Dr. / Cr.	Particulars	Amortised cost	Fair value through P&L	Fair value through OCI
4 January 20X1				
Dr.	Financial asset	10,00,000	10,50,000	10,50,000
Cr.	Profit or loss	-	(50,000)	-
Cr.	Other comprehensive income	-	-	(50,000)
Cr.	Cash	(10,00,000)	(10,00,000)	(10,00,000)

The above-mentioned accounting principles apply only to financial assets and Ind AS 109 does not contain any such principles for financial liabilities.

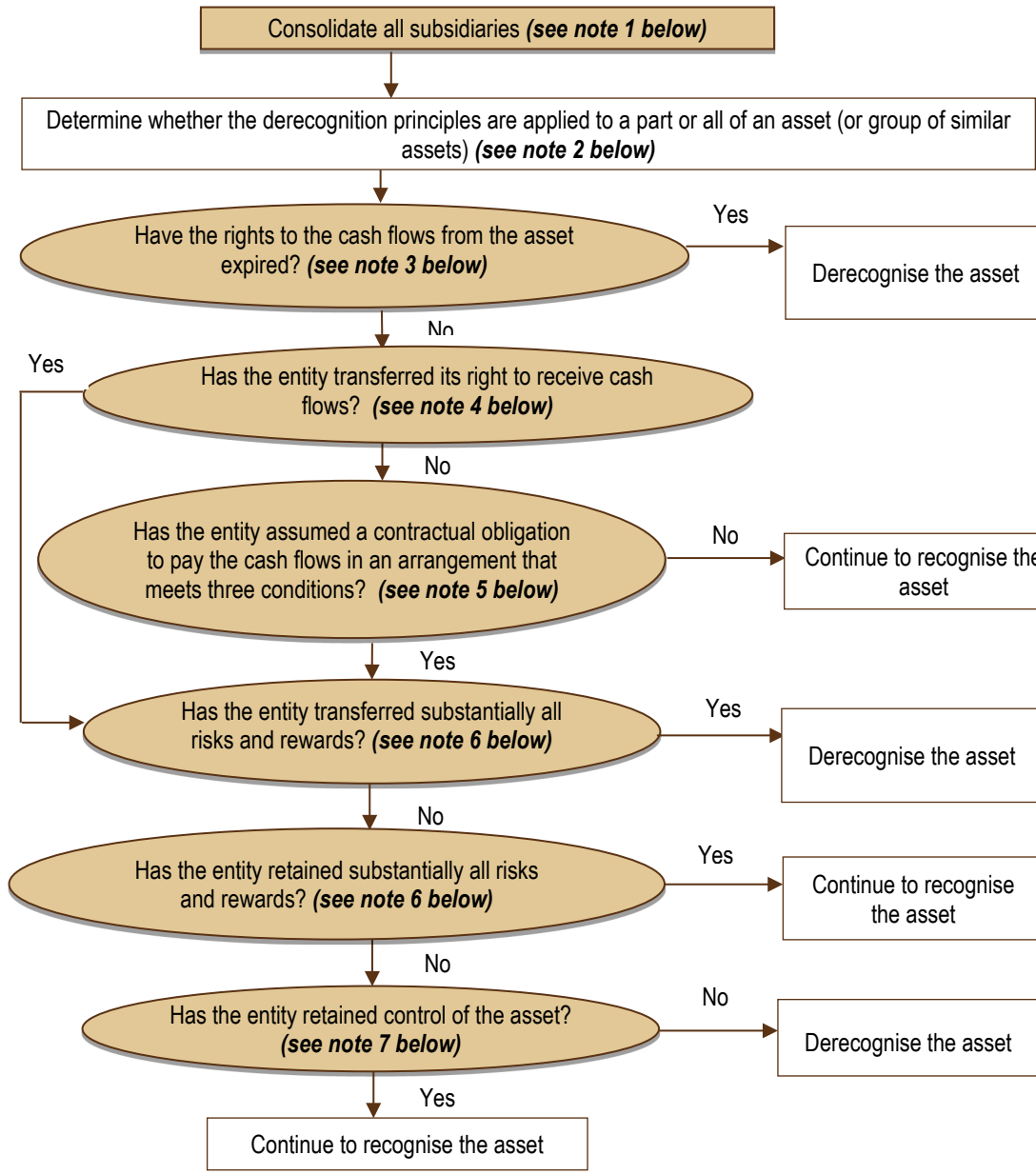
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5.3 DERECOGNITION OF FINANCIAL ASSETS

In simple words, derecognition refers to the timing of removing a financial asset from the balance sheet. To take an example, if a company gets its trade receivables discounted from a bank, it would need to determine whether it can remove those trade receivables from its balance sheet.

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Paragraph B3.2.1 of Ind AS 109 provides a step-by-step flowchart for making this determination.



Notes:

1. In consolidated financial statements, accounting principles for derecognition are applied at a consolidated level. Hence, an entity first consolidates all subsidiaries in accordance with Ind AS 110 and then applies those requirements to the resulting group. (Ind AS 109.3.2.1)

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The importance of this criteria is that sometimes sales of financial assets are made to entities which are specifically designed for this purpose. In those circumstances, it would be inappropriate to derecognise the financial asset if the purchaser entity is indirectly controlled by the seller entity.

2. Let's understand this step using a few fact patterns:

Illustration 4: Part of a financial asset

State whether the derecognition principles will be applied or not.

i. Interest strip of an interest-bearing financial asset i.e. the part entitles its holder to interest cash flows of a financial asset

ii. Dividend strip of an equity share i.e. the part entitles its holder to only dividends arising from an equity share

iii. Cash flows (principal and asset) upto a certain tenure or first right on a proportion of cash flows of an amortising financial asset. Say, the part entitles its holder to first 80% of the cash flows or cash flows for first 4 of the 6 years' tenure.

Solution

Derecognition requirements are applied to a part of a financial asset if that part meets **any of the following three** conditions:

(a) The part comprises only **specifically identified cash flows** from a financial asset (or a group of similar financial assets).

For example, when an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash flows, but not the principal cash flows from a debt instrument, derecognition principles are applied to the interest cash flows

(b) The part comprises only a **fully proportionate (pro rata) share of the cash flows** from a financial asset (or a group of similar financial assets).

For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of all cash flows of a debt instrument, derecognition principles are applied to 90 per cent of those cash flows.

(c) The part comprises only a **fully proportionate (pro rata) share of specifically identified cash flows** from a financial asset (or a group of similar financial assets).

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For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of interest cash flows from a financial asset, derecognition principles are applied to 90 per cent of those interest cash flows.

The example of a part of a financial asset at (iii) in Illustration 4 above will not qualify conditions at (b) and (c) above since it does not represent pro rata share of all or specifically identified cash flows.

In (b) and (c) above, if there is more than one counterparty, each counterparty is not required to have a proportionate share of the cash flows provided that the transferring entity has a fully proportionate share.

In all other cases, derecognition principles are applied to the financial asset in its entirety (or to the group of similar financial assets in their entirety).

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Illustration 5: Part of a financial asset

State whether the derecognition principles will be applied or not.

i. Entity Y transfers the rights to the first or the last 90 per cent of cash collections from a financial asset (or a group of financial assets)

ii. Entity Z transfers the rights to 90 per cent of the cash flows from a group of receivables, but provides a guarantee to compensate the buyer for any credit losses up to 8 per cent of the principal amount of the receivables.

Solution

In the above circumstances, Entity Y and Entity Z need to apply the derecognition requirements to the financial asset (or a group of similar financial assets) in its entirety.

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3. Cash flows from a financial asset expire upon payment of entire due amount or the legal release of the debtor by the creditor from the obligation to pay. In case of derivatives, this condition is considered met when, for example, contractual exercise period of an option expires and option is not exercised.

Ind AS 109 contains elaborate guidance on when renegotiation of the terms of a financial liability results in derecognition thereof. Refer paragraph "Exchange of financial liability instruments" for more details on the same. However, in respect of financial assets, such elaborate guidance has not been provided.

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One may use the principles of quantitative and qualitative tests prescribed for financial liabilities to evaluate whether renegotiation of the terms of a financial asset results in derecognition or not.

We discuss below a few circumstances wherein renegotiation does result in "expiry of right to receive cash flows":

- Agreeing to a moratorium period for repayment of principal or extension of the overall tenor of the loan.
- Substantial reduction in the interest rates
- Agreeing to a right to convert loan or a part thereof into equity shares after a certain period of time

4. Examples of transfer of rights to receive cash flows include sale of a financial asset, such as an investment in a debenture or assignment of a receivable (like factoring arrangements with banks or financial institutions). Refer comprehensive examples below on debt factoring and invoice discounting.

5. In some situations, though an entity retains the contractual rights to receive cash flows of a financial asset ('original asset'), it does assume a contractual obligation to pay those cash flows to one or more entities ('eventual recipients').

   For example, securitisation arrangements are a common form of transfer of financial assets in India. In these arrangements, the originator of a financial asset, say a bank or a NBFC, settle a Trust and transfer a portfolio of financial assets to that Trust. Thereafter, securities of that Trust are issued to unrelated parties or investors. Such arrangements are often "pass through" arrangements, in the sense that the originator or the Trust retains the rights to receive cash flows from the financial asset, but they have a simultaneous obligation to pay those cash flows to a recipient.

   As per paragraph 3.2.5 of Ind AS 109, **all of the** following conditions need to be met in such situations for the transaction to qualify as a "transfer":

   - The entity has **no obligation to pay amounts** to the eventual recipients **unless it collects equivalent amounts** from the original asset.

     Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition. However, existence of guarantees or options that allow the transferee to transfer receivables back to the entity and other recourse arrangements are likely to conflict with this condition.

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- The entity is **prohibited** by the terms of the transfer contract **from selling or pledging the original asset** other than as security to the eventual recipients for the obligation to pay them cash flows.
- The entity has an **obligation to remit any cash flows** it collects on behalf of the eventual recipients **without material delay.**
- entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents during the short settlement period, and interest earned on such investments is passed to the eventual recipients.

  The standard does not define the word "material" in this condition. Therefore, the same should be understood in common trade parlance.

Illustration 6: Proportionate "pass through" arrangement

Entity A makes a five-year interest-bearing loan (the 'original asset') of ₹ 100 crores to Entity B. Entity A settles a Trust and transfers the loan to that Trust. The Trust issues participatory notes to an investor, Entity C, that entitle the investor to the cash flows from the asset.

As per Trust's agreement with Entity C, in exchange for a cash payment of ₹ 90 crores, Trust will pass to Entity C 90% of all principal and interest payments collected from Entity B (as, when and if collected). Trust accepts no obligation to make any payments to Entity C other than 90% of exactly what has been received from Entity B. Trust provides no guarantee to Entity C about the performance of the loan and has no rights to retain 90% of the cash collected from Entity B nor any obligation to pay cash to Entity C if cash has not been received from Entity B.

Compute the amount to be derecognised.

Solution

If the three conditions are met, the proportion sold is derecognised, provided the entity has transferred substantially all the risks and rewards of ownership. Thus, Entity A would report a loan asset of ₹ 10 crores and derecognise ₹ 90 crores.

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6. Let's illustrate the "risks and rewards" test with certain examples given in application guidance of Ind AS 109:

Examples of when an entity **has transferred** substantially all the risks and rewards of ownership are:

(a) an unconditional sale of a financial asset;

(b) a sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase; and

(c) a sale of a financial asset together with a put or call option that is deeply out of the money (ie an option that is so far out of the money it is highly unlikely to go into the money before expiry).

Examples of when an entity has retained substantially all the risks and rewards of ownership are:

(a) a sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return;

(b) a securities lending agreement;

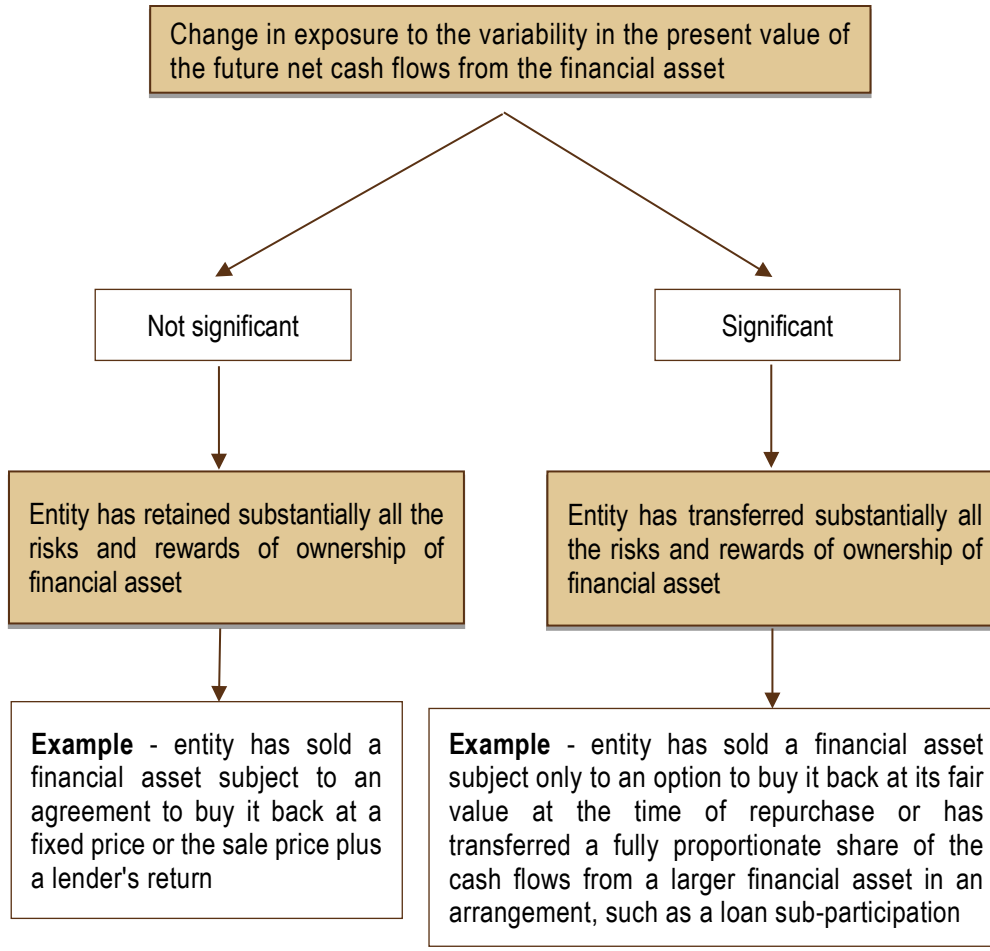
(c) a sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity;

(d) a sale of a financial asset together with a deep in-the-money put or call option (ie an option that is so far in the money that it is highly unlikely to go out of the money before expiry); and

(e) a sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.

Paragraph 3.2.7 of Ind AS 109 provides the guidance on **"risks and rewards" test**

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In evaluating the extent to which risks and rewards are transferred or retained, risks and rewards that are reasonably expected to be significant in practice should be considered.

So, what is the most significant risk in a portfolio of short-term receivables? It is usually credit risk i.e. the risk that the customer will default. Therefore, an **arrangement that involves the transferee having full recourse to the transferor for credit losses will "fail" the risks and rewards tests. An arrangement in which the transferee has no recourse to the transferor for credit losses will generally "pass" the risks and rewards tests**.

What are the most significant risks in longer term receivables? Well, interest rate risk and slow payment risk are fairly significant in those cases. An arrangement in which the entity continues to pay interest to the transferee until the underlying debtor settles involves the transferee retaining the risk of slow payment.

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7. Whether the entity has retained control of the transferred asset depends on the **transferee's ability to sell the asset**. If the transferee,

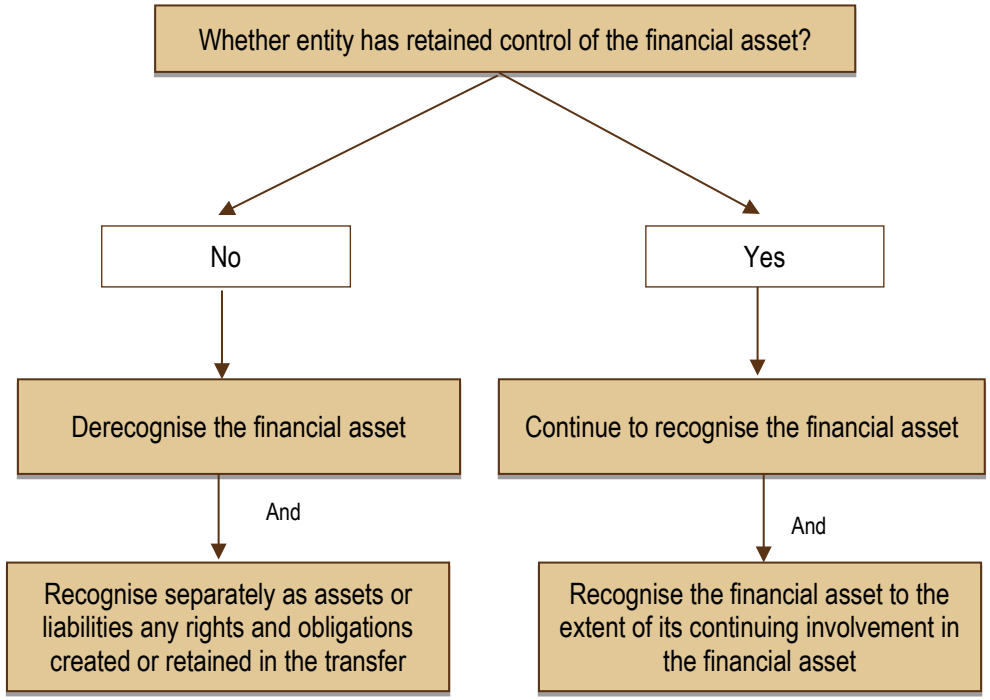
   i. has the practical ability to sell the asset in its entirety to an unrelated third party, and

   ii. is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer

   the entity has not retained control.

   In all other cases, the entity has retained control.

   The accounting treatment as a consequence of this decision is as below:



The critical question is what the transferee is able to do in practice, not what contractual rights the transferee has concerning what it can do with the transferred asset or what contractual prohibitions exist.

Paragraphs B3.2.7 and 3.2.8 give examples of certain situations in which transferee is evaluated to have such practical ability and situations in which it doesn't have.

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Example 1: Situation when transferee has practical ability to sell the financial asset

Transferred asset is subject to an option that allows the entity to repurchase it and it is traded in an active market: transferee has the practical ability to sell the financial asset as it can readily obtain the transferred asset in the market if the option is exercised.

Example 2: Situations when transferee doesn't have practical ability to sell the financial asset

- Transferred asset is subject to an option that allows the entity to repurchase it and it is not traded in an active market: transferee doesn't have the practical ability to sell the financial asset as it cannot readily obtain the transferred asset in the market if the option is exercised.
- A put option or guarantee with respect to the transferred asset which is sufficiently valuable in the sense that it constrains the transferee from selling the transferred asset because the transferee would, in practice, not sell the transferred asset to a third party without attaching a similar option or other restrictive conditions. Instead, the transferee would hold the transferred asset so as to obtain payments under the guarantee or put option. In this situation, the transferor has retained control of the transferred asset.

Illustrations on application of derecognition principles

Paragraph B3.2.16 of Ind AS 109 provides certain illustrations which are summarised below:

Illustration 7: Repurchase agreements

A financial asset is sold under repurchase agreement. The repurchase price as per that agreement is (a) fixed price or (b) sale price plus a lender's return. Let's look at three alternate scenarios:

i. Repurchase agreement is for the same financial asset.

ii. Repurchase agreement is for substantially the same asset

iii. Repurchase agreement provides the transferee a right to substitute assets that are similar and of equal fair value to the transferred asset at the repurchase date.

State whether the derecognition principles will be applied or not.

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Solution

In each of these scenarios, the transferred financial asset is not derecognised because the transferor retains substantially all the risks and rewards of ownership.

Let's look at another scenario:

Repurchase agreement provides the transferor only a right of first refusal to repurchase the transferred asset at fair value if the transferee subsequently sells it

In this scenario, the transferred financial asset is derecognised because the transferor has transferred substantially all the risks and rewards of ownership.

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Illustration 8: Put options on transferred financial assets

A financial asset is sold and the transferee has a put option. Let's look at some alternate scenarios:

i. Put option is deeply in the money

ii. Put option is deeply out of the money.

State whether the derecognition principles will be applied or not.

Solution

In the first scenario, the transferred asset does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership. However, in the second scenario, the transferor has transferred substantially all the risks and rewards of ownership.

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Illustration 9: Call options on transferred financial assets

A financial asset is sold and the transferor has a call option. Let's look at some alternate scenarios:

i. Call option is deeply in the money

ii Call option is deeply out of the money.

What if the transferor holds a call option on an asset that is readily obtainable in the market?

iii Call option is neither deeply in the money nor deeply out of the money

State whether the derecognition principles will be applied or not.

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Solution

In the first scenario, the transferred asset does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership. However, in the second scenario, the transferor has transferred substantially all the risks and rewards of ownership.

In the third scenario, the asset is derecognised. This is because the entity (i) has neither retained nor transferred substantially all the risks and rewards of ownership, and (ii) has not retained control.

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Illustration 10: Amortising interest rate swaps

An entity may transfer to a transferee a fixed rate financial asset that is paid off over time and enter into an amortising interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount.

Scenarios:

i. Notional amount of the swap amortises so that it equals the principal amount of the transferred financial asset outstanding at any point in time.

ii. Amortisation of the notional amount of the swap is not linked to the principal amount outstanding of the transferred asset.

State whether the derecognition principles will be applied or not.

Solution

In the first scenario, the swap would generally result in the entity retaining substantial prepayment risk, in which case the entity either continues to recognise all of the transferred asset or continues to recognise the transferred asset to the extent of its continuing involvement.

Such a swap would not result in the entity retaining prepayment risk on the asset. Hence, it would not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on interest payments being made on the transferred asset and the swap does not result in the entity retaining any other significant risks and rewards of ownership on the transferred asset.

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5.3.1 Accounting treatment of transfers

5.3.1.1Transfers that qualify for derecognition

If the arrangement results in de-recognition of the financial asset in its entirety:

- in the case of assets included in the "fair value through other comprehensive income" category, any gain or loss previously recorded in equity is recycled to the statement of profit and loss as per the requirements of the standards;
- any new financial assets obtained, financial liabilities assumed and any servicing obligations are recognised at fair value. new asset is part of the proceeds of sale. Any liability assumed, even if it is related to the transferred asset, is a reduction of the sales proceeds.
- the difference between the carrying amount and the consideration received is recognised in the statement of comprehensive income.

Illustration 11: Assignment of receivables

ST Ltd. assigns its trade receivables to AT Ltd. The carrying amount of the receivables is ₹ 10,00,000. The consideration received in exchange of this assignment is ₹ 9,00,000. Customers have been instructed to deposit the amounts directly in a bank account for the benefit of AT Ltd. AT Ltd. has no recourse to ST Ltd. in case of any shortfalls in collections.

State whether the derecognition principles will be applied or not.

Solution

In this situation, ST Ltd. has transferred the rights to contractual cash flows and has also transferred substantially all the risks and rewards of ownership (credit risk being the most significant risk in this situation).

Accordingly, ST Ltd. derecognises the financial asset and recognises ₹ 1,00,000, the difference between consideration received and carrying amount, as an expense in the statement of profit or loss.

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5.3.1.2 Transfers that do not qualify for derecognition

If a transfer does not result in derecognition because the entity has retained substantially all the risks and rewards of ownership of the transferred asset (for example, in a situation when the transferor guarantees transferee against any default losses), the entity shall,

- continue to recognise the transferred asset in its entirety,

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- recognise a financial liability for the consideration received, recognised at fair value less any transaction costs incurred. The liability is subsequently measured at amortised cost using the effective interest method, and
- in subsequent periods, recognise any income on the transferred asset and any expense incurred on the financial liability.

5.3.1.3 Continuing involvement in transferred assets (partial de-recognition)

If an entity neither transfers nor retains substantially all the risks and rewards of ownership of a transferred asset, and retains control of the transferred asset,

- the entity **continues to recognise the transferred asset to the extent of its continuing involvement**. The extent of the entity's continuing involvement in the transferred asset is the extent to which it is exposed to changes in the value of the transferred asset.
  - *Guarantees for transferred asset*

    The extent of the entity's continuing involvement is the lower of

    (i) the amount of the asset, and

    (ii) the maximum amount of the consideration received that the entity could be required to repay ('the guarantee amount').

Illustration 12A: Debt factoring with recourse – continuing involvement asset

Entity C agrees with factoring company D to enter into a debt factoring arrangement. Under the terms of the arrangement, the factoring company D agrees to pay ₹ 91.5 crores, less a servicing charge of ₹ 1.5 crores (net proceeds of ₹ 90 crores), in exchange for 100% of the cash flows from short-term receivables.

The receivables have a face value of ₹ 100 crores and carrying amount of ₹ 95 crores.

The customers will be instructed to pay the amounts owed into a bank account of the factoring company. Entity C also writes a guarantee to the factoring company under which it will reimburse any credit losses upto ₹ 5 crores, over and above the expected credit losses of ₹ 5 crores. The guarantee is estimated to have a fair value of ₹ 0.5 crores. Calculate the amount of continuing involvement asset.

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Solution

In this situation, the "continuing involvement asset" will be recognised at ₹ 5.5 crores i.e. lower of:

(i) the amount of the asset – ₹ 95 crores

(ii) the guarantee amount – ₹ 5.5 crores

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- the entity also **recognises an associated liability** that is measured in such a way that the net carrying amount of the transferred asset and the associated liability is:
  - the amortised cost of the rights and obligations retained by the entity, if the transferred asset is measured at amortised cost, or
  - equal to the fair value of the rights and obligations retained by the entity when measured on a stand-alone basis, if the transferred asset is measured at fair value.
- Recognised changes in the fair value of the transferred asset and the associated liability are accounted for consistently with each other and shall not be offset.
- If the transferred asset is measured at amortised cost, the option in this Standard to designate a financial liability as at fair value through profit or loss is not applicable to the associated liability.
- In case of guarantees, as per the application guidance in Ind AS 109, the associated liability is initially measured at
  - the guarantee amount plus
  - the fair value of the guarantee (which is normally the consideration received for the guarantee).

Illustration 12B: Debt factoring with recourse – associated liability

Continuing illustration 12A, calculate the amount of associated liability.

Solution

The amount of associated liability is recognised at ₹ 5.5 crores, as below:

i. the guarantee amount (i.e. ₹ 5 crores) plus

ii. the fair value of the guarantee (i.e. ₹ 0.5 crores).

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- If an entity's continuing involvement is in only a part of a financial asset, the entity **allocates the previous carrying amount of the financial asset between the part it continues to recognise under continuing involvement, and the part it no longer recognises** on the basis of the relative fair values of those parts on the date of the transfer. The difference between:
  - the carrying amount (measured at the date of derecognition) allocated to the part that is no longer recognised and
  - the consideration received for the part no longer recognised

  shall be recognised in profit or loss.
- the entity shall **continue to recognise any income arising on the transferred asset to the extent of its continuing involvement** and shall recognise any expense incurred on the associated liability

Illustration 12C: Debt factoring with recourse – gain or loss on derecognition

Continuing illustration 12A and 12B, pass the necessary Journal Entry.

Solution

The journal entries passed by Entity C on the date of derecognition is as below:

Cash	Dr.	₹ 90 crores	
Loss on derecognition	Dr.	₹ 5 crores	
Continuing involvement asset	Dr.	₹ 5.5 crores	
To Receivables			₹ 95 crores
To Associated liability			₹ 5.5 crores

The guarantee liability of ₹ 0.5 crores shall be amortised in profit or loss over the underlying period.

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5.4 DERECOGNITION OF FINANCIAL LIABILITIES

5.4.1 General principles

5.4.1.1 Timing of derecognition

An entity shall remove a financial liability (or a part of a financial liability) from its balance sheet when, and only when, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires. (Paragraph 3.3.1 of Ind AS 109)

A financial liability (or part of it) is extinguished when the debtor either:

(a) discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or

(b) is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (If the debtor has given a guarantee this condition may still be met.)

(Paragraph B3.3.1 of Ind AS 109)

If a debtor pays a third party to assume an obligation and notifies its creditor that the third party has assumed its debt obligation, the debtor does not derecognise the debt obligation unless the condition in paragraph B3.3.1(b) is met. If the debtor pays a third party to assume an obligation and obtains a legal release from its creditor, the debtor has extinguished the debt. However, if the debtor agrees to make payments on the debt to the third party or direct to its original creditor, the debtor recognises a new debt obligation to the third party. (Paragraph B3.3.4 of Ind AS 109)

Some entities operate, either internally or externally, an investment fund that provides investors with benefits determined by units in the fund and recognise financial liabilities for the amounts to be paid to those investors. Similarly, some entities issue groups of insurance contracts with direct participation features and those entities hold the underlying items. Some such funds or underlying items include the entity's financial liability (for example, a corporate bond issued). Despite the other requirements in this Standard for the derecognition of financial liabilities, an entity may elect not to derecognise its financial liability that is included in such a fund or is an underlying item when, and only when, the entity repurchases its financial liability for such purposes. Instead, the entity may elect to continue to account for that instrument as a financial liability and to account for the repurchased instrument as if the instrument were a financial asset and measure it at fair value through profit or loss in accordance with this Standard. That election is irrevocable and made on an

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instrument-by-instrument basis. For the purposes of this election, insurance contracts include investment contracts with discretionary participation features. (Paragraph 3.3.5 of Ind AS 109)

5.4.1.2 Accounting treatment for extinguishment

The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss. (Paragraph 3.3.3 of Ind AS 109)

Further, in some cases, a creditor releases a debtor from its present obligation to make payments, but the debtor assumes a guarantee obligation to pay if the party assuming primary responsibility defaults. In these circumstances the debtor:

(a) recognises a new financial liability based on the fair value of its obligation for the guarantee, and

(b) recognises a gain or loss based on the difference between (i) any proceeds paid and (ii) the carrying amount of the original financial liability less the fair value of the new financial liability.

5.4.2 Exchange of financial liability instruments

Many times, entities re-negotiate terms of their existing debt with the lenders. In India, this is popularly known as "Strategic Debt Restructuring" or SDR. Sometimes, entities approach their lenders to renegotiate terms of their debt, when they want to take advantage of the falling interest rate regime.

In accounting terms, such situations need to be evaluated to determine whether the original debt is extinguished.

As per paragraph 3.3.2 of Ind AS 109, an exchange between an existing borrower and lender of debt instruments with **substantially different terms** shall be accounted for as:

- an extinguishment of the original financial liability, and
- the recognition of a new financial liability.

Similarly, a **substantial modification** of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted as mentioned above.

As per application guidance in paragraph B3.3.6 of Ind AS 109, the **terms are substantially different if:**

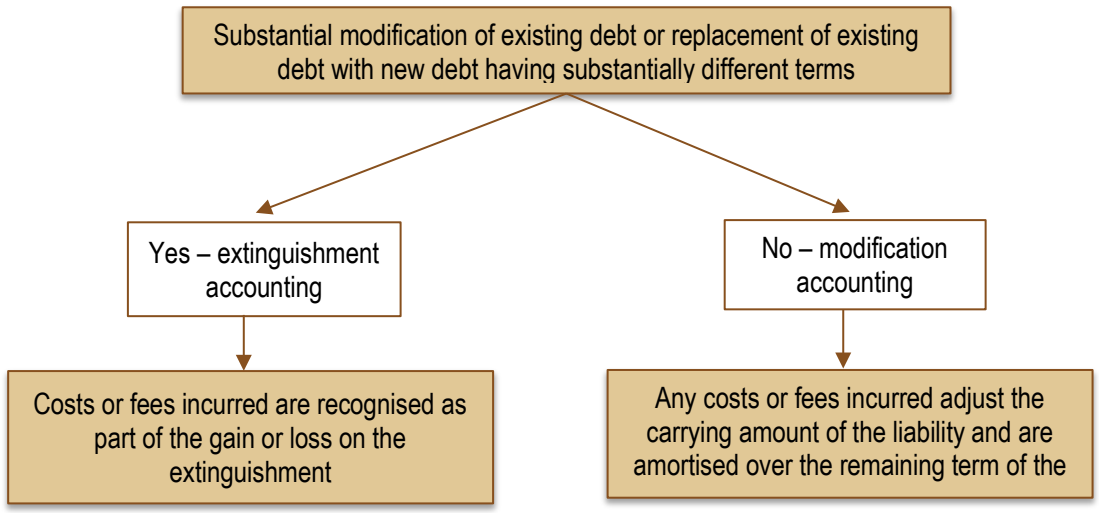
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(A)		(B)	
Present value of: • cash flows under the new terms, • any fees paid • net of any fees received discounted using the original effective interest rate	LESS	Discounted present value of the remaining cash flows of the original financial liability	Is greater than or equal to 10% of (B)

5.4.2.1 Accounting treatment

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 determining those fees paid net of any fees received, a borrower includes 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.

If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability. It may be noted here that the costs or fees considered for this purpose differs from the costs or fees considered for the purpose of 10% test. In the case where modification does not result in derecognition, any costs or fees incurred is considered to adjust the effective interest rate whereas for the 10% test 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.



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1. Extinguishment accounting

If the 10% test is passed, principle of "extinguishment accounting" are applied, that is:

- de-recognition of the existing liability
- recognition of the new or modified liability at its fair value (net of any fees incurred directly related to the new liability)
- recognition of a gain or loss equal to the difference between the carrying value of the old liability and the fair value of the new one
- recognising any incremental costs or fees incurred for modification (and not for the new liability), and any consideration paid or received, in profit or loss
- calculating a new effective interest rate for the modified liability, which is then used in future periods.

Fair value of the new or modified liability is estimated based on the expected future cash flows of the modified liability, discounted using the interest rate at which the entity could raise debt with similar terms and conditions in the market.

Example 3: Extinguishment accounting

On 1 January 20X0, XYZ Ltd. issues 10 year bonds for ₹ 10,00,000, bearing interest at 10% (payable annually on 31st December each year). The bonds are redeemable on 31 December 20X9 for ₹ 10,00,000. No costs or fees are incurred. The effective interest rate is therefore 10%. On 1 January 20X5 (i.e. after 5 years) XYZ Ltd. and the bondholders agree to a modification in accordance with which:

- the term is extended to 31 December 20Y1;
- interest payments are reduced to 5% p.a.;
- the bonds are redeemable on 31 December 20Y1 for ₹ 15,00,000; and
- legal and other fees of ₹ 1,00,000 are incurred.

XYZ Ltd. determines that the market interest rate on 1 January 20X5 for borrowings on similar terms is 11%.

The repayment schedule for the original debt till the date of renegotiation is as below:

Date / year ended	Opening balance	Interest accrual	Cash flows	Closing balance
1 January 20X0	10,00,000	1,00,000	(100,000)	10,00,000

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31 December 20X0	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X1	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X2	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X3	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X4	10,00,000	1,00,000	(1,00,000)	10,00,000

On 1 January 20X5, the discounted present value of the remaining cash flows of the original financial liability is ₹ 10,00,000.

On this date, XYZ Ltd. will compute the present value of:

- cash flows under the new terms – i.e. ₹ 15,00,000 payable on 31 December 20Y1 and ₹ 50,000 payable for each of the 7 years ending 31 December 20Y1.
- fees paid by the borrower to the lender – i.e. ₹ 1,00,000 using the original effective interest rate of 10%

The total of these amounts to ₹ 11,13,158 (Refer Working Note). This differs from the discounted present value of the remaining cash flows of the original financial liability by 11.32% i.e. by more than 10%. Hence, extinguishment accounting applies.

The next step is to estimate the fair value of the modified liability. This is determined as the present value of the future cash flows (interest and principal), using an interest rate of 11% (the market rate at which XYZ Ltd. could issue new bonds with similar terms). The estimated fair value on this basis is ₹ 958,097 (Refer Working Note). A gain or loss on modification is then determined as:

Gain (loss) = carrying value of existing liability - fair value of modified liability - fees and costs incurred i.e. ₹ 10,00,000 – ₹ 9,58,097 – ₹ 1,00,000 = Loss of ₹ 58,097

Working Note:

Year	Discount factor @ 10%	Discount factor @ 11%
1	0.909091	0.900901
2	0.826446	0.811622
3	0.751315	0.731191
4	0.683013	0.658731
5	0.620921	0.593451
6	0.564474	0.534641
7	0.513158	0.481658
Annuity	4.868419	4.712196

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Amount	Discounting factor @ 10%	Present value	Discounting factor @ 11%	Present value
15,00,000	0.513158	7,69,737	0.481658	7,22,487
1,00,000		1,00,000		
50,000 for 7 years	4.868419	2,43,421	4.712196	2,35,610
		11,13,158		9,58,097
PV of original cash flows @ original EIR		(10,00,000)		
Difference		1,13,158		
Difference %		11.32%		

Modification accounting

Ind AS 109 is not clear as to the accounting treatment if the 10% test is failed. Two alternate approaches are therefore possible:

Amortisation of any cost or fees incurred on modification

Under this approach,

- the fees or costs incurred are netted against the existing liability;
- the effective interest rate is recalculated. This is the rate which discounts the future cash flows as per modified contractual terms to the adjusted carrying amount mentioned above
- the adjusted effective interest rate is used to determine the amortised cost and interest expense in future periods

Example 4: Modification accounting

On 1 January 20X0, XYZ Ltd. issues 10 year bonds for ₹ 1,000,000, bearing interest at 10% (payable annually on 31st December each year). The bonds are redeemable on 31 December 20X9 for ₹ 1,000,000. No costs or fees are incurred. The effective interest rate is therefore 10%. On 1 January 20X5 (i.e. after 5 years) XYZ Ltd. and the bondholders agree to a modification in accordance with which:

- no further interest payments are made
- the bonds are redeemed on the original due date (31 December 20X9) for ₹ 1,600,000;
- fees paid by the borrower to lender ₹ 50,000

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The repayment schedule for the original debt till the date of renegotiation is as below:

Date / year ended	Opening balance	Interest accrual	Cash flows	Closing balance
1 January 20X0	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X1	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X2	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X3	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X4	10,00,000	1,00,000	(1,00,000)	10,00,000
31 December 20X5	10,00,000	1,00,000	(1,00,000)	10,00,000

On 1 January 20X5, the discounted present value of the remaining cash flows of the original financial liability is ₹ 10,00,000.

On this date, XYZ Ltd. will compute the present value of:

i. cash flows under the new terms – i.e. ₹ 16,00,000 payable on 31 December 20X9

ii. any fees paid (net of any fees received) – i.e. ₹ 50,000

using the original effective interest rate of 10%.

The total of these amounts to ₹ 10,43,474 (Refer Working Note). This differs from the discounted present value of the remaining cash flows of the original financial liability by 4.35% i.e. by less than 10%. Hence, modification accounting applies.

On this basis:

i. the fees paid of ₹ 50,000 are netted against the existing liability of ₹ 10,00,000, resulting in an adjusted carrying amount of ₹ 9,50,000;

ii. the effective interest rate (EIR) is recalculated. This is the rate which discounts the future cash flows (₹ 16,00,000 in five years' time) to the adjusted carrying amount of ₹ 9,50,000. The adjusted EIR is 10.99%

iii. the adjusted EIR is used to determine the amortised cost and interest expense in future periods.

Working Note:

For testing extinguishment -

Cash flows under new terms	16,00,000
PV as at 01 January 20X5	
Revised cash flows@ original EIR	9,93,474
Fees incurred	50,000

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PV of revised cash flows @ original EIR	10,43,474
PV of original cash flows @ original EIR	(10,00,000)
Difference	43,474
Difference %	4%
Less than 10% - Indicates modification	

Accounting for revised cash flows @ original EIR

Year	Opening balance	Interest	Payment	Closing balance
0	10,00,000	-	-50,000	9,50,000
1	9,50,000	1,04,405	0	10,54,405
2	10,54,405	1,15,879	0	11,70,284
3	11,70,284	1,28,614	0	12,98,898
4	12,98,898	1,42,749	0	14,41,647
5	14,41,647	1,58,353*	-16,00,000	-
* Difference is due to approximation				

Illustration 13: Renegotiation of terms of (defaulted) borrowings subsequent to the year-end

Ind AS 109, Financial Instruments requires recognition of renegotiation gain/loss subject to fulfillment of certain conditions as mentioned in the standard. If there has been a renegotiation of terms of (defaulted) borrowings subsequent to the year end, but before the date of approval of financial statements, then should such modification gain/loss be recognised in the current year financial statements itself or in the next year when the terms of (defaulted) borrowings have been renegotiated in accordance with Ind AS 109?

Solution

As per paragraph 5.4.3 of Ind AS 109, Financial Instruments, whenever contractual cash flows of a financial instrument are renegotiated or otherwise modified and the renegotiation or modification does not result in the derecognition of that financial asset in accordance with this Standard, an entity shall recalculate the gross carrying amount of the financial asset and shall recognise a modification gain or loss in profit or loss.

In accordance with the above, modification gain or loss should be recognised in profit or loss in the period in which the renegotiation has contractually taken place. Accordingly, in the given case, if the terms of the (defaulted) borrowings have been renegotiated in the next year, then the related gain/loss should also be recognised in the next year.

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5.4.3 Debt for equity swaps

A debtor and creditor might renegotiate the terms of a financial liability with the result that the debtor extinguishes the liability fully or partially by issuing equity instruments to the creditor. These transactions are sometimes referred to as 'debt for equity swaps'.

Appendix D to Ind AS 109, "Extinguishing Financial Liabilities with Equity Instruments" deals with accounting for such situations.

It must be noted that these accounting principles do not apply in following situations:

- the creditor is also a direct or indirect shareholder and is acting in its capacity as a direct or indirect existing shareholder
- the creditor and the entity are controlled by the same party or parties before and after the transaction and the substance of the transaction includes an equity distribution by, or contribution to, the entity
- extinguishing the financial liability by issuing equity shares is in accordance with the original terms of the financial liability

The accounting principles are summarised below:

- An entity shall **remove a financial liability** (or part of a financial liability) from its balance sheet when, and only **when, it is extinguished** in accordance with derecognition principles mentioned above
- When **equity instruments issued to a creditor** to extinguish all or part of a financial liability are recognised initially, an entity shall **measure them at the fair value** of the equity instruments issued, unless that fair value cannot be reliably measured.
- **If the fair value of the equity instruments issued cannot be reliably measured** then the equity instruments shall be measured to reflect the **fair value of the financial liability** extinguished.
- **If only part of the financial liability is extinguished**, the entity shall assess whether some of the consideration paid relates to a modification of the terms of the liability that remains outstanding. If part of the consideration paid **does relate to a modification of the terms** of the remaining part of the liability, the entity shall allocate the consideration paid between the part of the liability extinguished and the part of the liability that remains outstanding.
- The consideration allocated to the remaining liability shall form part of the assessment of whether the terms of that remaining liability have been substantially modified. **If the**

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remaining liability has been substantially modified, the entity shall account for the modification as the extinguishment of the original liability and the recognition of a new liability.

- The **difference** between the carrying amount of the financial liability (or part of a financial liability) extinguished, and the consideration paid, shall be **recognised in profit or loss.**

Example 5: Extinguishment of part of a financial liability through issue of equity instruments

JK Ltd. has an outstanding unsecured loan of ₹ 90 crores to a bank. The effective interest rate (EIR) of this loan is 10%. Owing to financial difficulties, JK Ltd. is unable to service the debt and approaches the bank for a settlement.

The bank offers the following terms which are accepted by JK Ltd.:

- 2/3rd of the debt is unsustainable and hence will be converted into 70% equity interest in JK Ltd. The fair value of net assets of JK Ltd. is ₹ 80 crores.
- 1/3rd of the debt is sustainable and the bank agrees to certain moratorium period and decrease in interest rate in initial periods. The present value of cash flows as per these revised terms calculated using original EIR is ₹ 25 crores. The fair value of the cash flows as per these revised terms is ₹ 28 crores.

Fair value of the consideration paid is ₹ 56 crores (70% of ₹ 80 crores) plus ₹ 28 crores i.e. ₹ 84 crores.

Accordingly, 2/3rd of the original financial liability is extinguished through issue of equity shares and terms of 1/3rd of the original financial liability have been modified. JK Ltd. will need to evaluate if this modification tantamount to "substantial modification" or not.

Applying the guidance contained in Appendix D to Ind AS 109:

- Difference between the fair value of equity instruments (₹ 56 crores) and 2/3rd of the original financial liability (2/3rd of ₹ 90 crores = ₹ 60 crores) i.e. ₹ 4 crores will be recognised as a gain in the statement of profit and loss
- Carrying amount of original financial liability which is not extinguished (1/3rd of ₹ 90 crores = ₹ 30 crores) is compared with the present value of cash flows as per these revised terms (₹ 25 crores)
- As the difference is more than 10%, this results in substantial modification of the original financial liability. Resultantly, the existing financial liability (₹ 30 crores) will be extinguished and the new financial liability will be recognised at its fair value i.e. ₹ 28 crores.
- The difference i.e. ₹ 2 crores will be recognised as a gain in the statement of profit and loss.

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