

Ind-AS - Financial Instruments Series

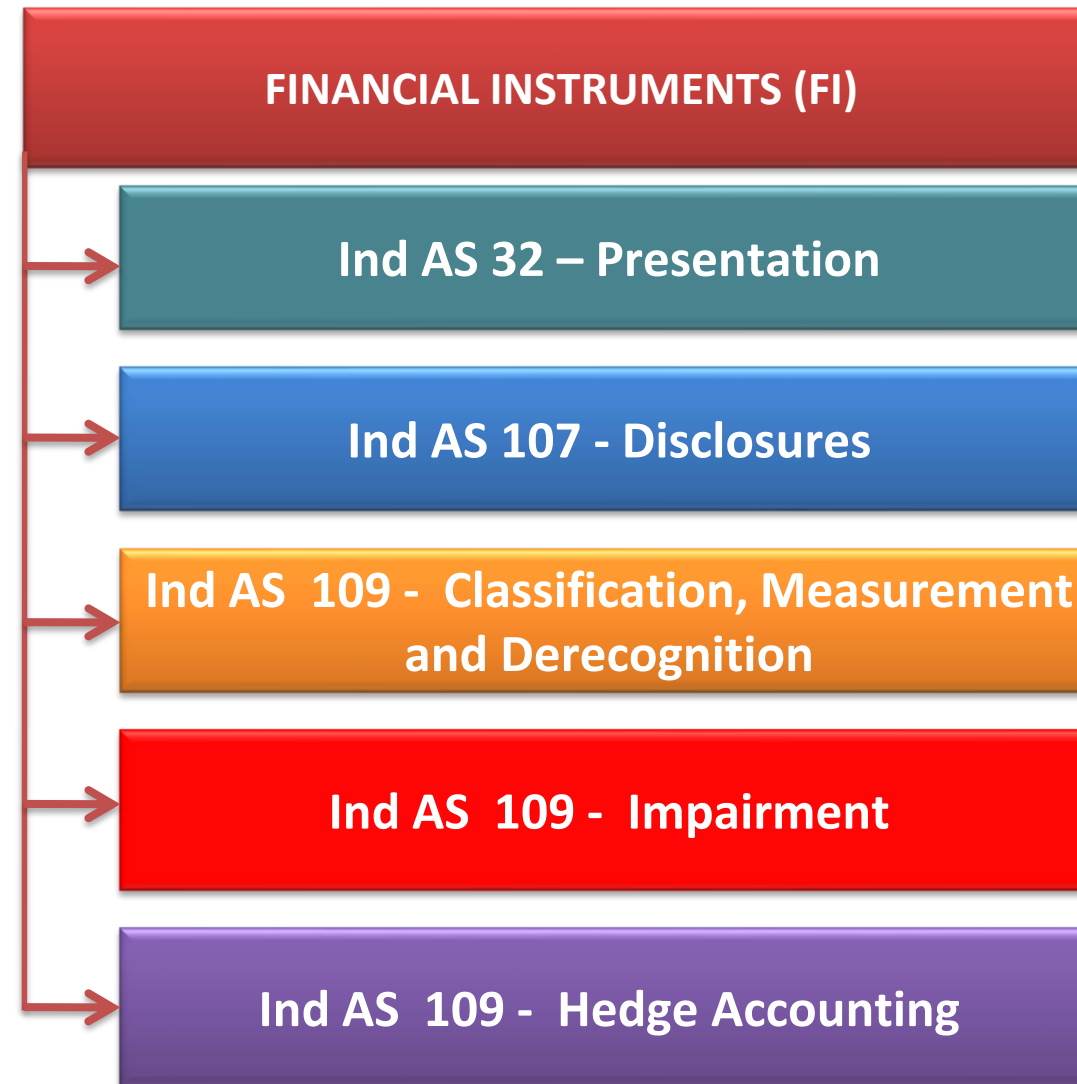


CA VIVEK AGARWAL
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Ind-AS 32, 107, 109 - Financial Instruments

“The more you learn, you
learn that you still have lot
to learn”

Introduction



Content

- 
- Definition
 - Liabilities vs. equity
 - Classification & Measurement
 - Reclassification
 - Derivatives and Embedded derivatives
 - De-recognition and Impairment
 - Hedge Accounting

Objective and Scope

Objective

To establish principles for presenting financial instruments as liability or equity and for offsetting financial assets and liabilities

Scope

- ☐ Classification of financial instruments, by their issuer, into financial assets, financial liabilities and equity instruments
- ☐ Settling a financial liability with an equity instrument
- ☐ Treasury shares – i.e. an entity's own equity instruments held by the entity
- ☐ Forward contracts or options for the receipt or delivery of the entity's own equity instruments
- ☐ The circumstances in which financial assets and financial liabilities should be offset

Financial instrument

A contract that gives rise to both:

- a **financial asset** of one entity and
- either a **financial liability** or an **equity instrument** of an another entity.

For example, a receivable of one entity (financial asset) will represent a payable (financial liability) of another entity.

An **equity instrument** is a financial asset for an investor holding the instrument and is equity of the issuer of the instrument

Financial asset

An asset that is:

- ☐ Cash (examples include bank accounts)
- ☐ An equity instrument of another entity (Examples include ordinary shares in another entity)
- ☐ A contractual right:
 - ☐ To receive cash or another financial asset from another entity (Examples include receivables or bonds held); or
 - ☐ To exchange financial assets or financial liabilities under potentially favourable conditions; or (Examples include purchased call options, purchased put options and other derivatives in an asset position at the balance sheet date)
- ☐ A contract that will or may be settled in the entity's own equity instruments and is:
 - ☐ A non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
 - ☐ A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments

Exercise – identify financial assets?

1. Shares of subsidiary companies
2. Advance given for purchase of goods
3. Investment in perpetual debt carrying interest at fixed rate
4. Prepaid expense
5. Deferred tax asset
6. CENVAT credit receivable
7. Lease deposit paid
8. Shares of the entity held by consolidated ESOP Trust
9. USD-INR option held by the entity. The entity is buyer of the option
10. Gold bullion: Whether a financial instrument (like cash) or a commodity

Response

1. **Yes.** However, investment in subsidiary is generally not covered under Ind AS 109.
2. **No.** There is no contractual right to receive cash/other financial assets
3. **Yes.** Instrument contains contractual right to receive interest at stated rate
4. **No.** There is no contractual right to receive cash/other financial assets
5. **No.** Not arising because of contractual arrangement
6. **No.** Not arising because of contractual arrangement
7. **Yes.** The lessee has contractual right to receive lease deposit at the end of lease term
8. **No.** Own equity instruments are not financial asset for the entity
9. **Yes.** Financial instruments include not only primary financial instruments but also derivatives instruments. Since the entity is option buyer, it is potentially favourable to the entity
10. **No.** Commodity. Although gold bullion is highly liquid, there is no contractual right to receive cash or another financial asset

Financial liability

Any liability that is

- ❑ a contractual obligation:

- ❑ to deliver cash or another financial asset to another entity; (Examples include amounts due to creditors)

- ❑ to exchange financial assets/ liabilities under potentially unfavourable conditions; or

Examples include **written call options**, **written put options** and other derivatives in a liability position at the balance sheet date.

A **written call option** represents the obligation, if exercised, to sell an item at a specific price. A **written put option** represents the obligation if exercised, to purchase an item at a specified price

- ❑ a contract that will or may be settled in the entity's own equity instruments and is:

- ❑ a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

- ❑ a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments

Exercise — identify financial liabilities?

1. Tax liability
2. Finance lease obligations
3. Non-refundable revenue received in advance
4. Non-refundable advance received against sale of government securities
5. Liability for damages under a lawsuit
6. Financial guarantees given

Response

1. No. Tax liability arises as per the requirements of law and not because of contractual arrangement
2. Yes. However, accounting for financial lease obligations, except derecognition, is not covered under Ind AS 109. It is covered under Ind AS 17.
3. No. There is no contractual obligation to pay cash/other financial assets
4. Yes. Instrument contains contractual obligation to deliver other financial asset, viz., government securities
5. No. Not arising because of contractual arrangement
6. Yes. The entity has contractual right to pay cash if the original debtor fails to pay. For an instrument to be classified as financial liability, it is not necessary that the entity should have an unconditional obligation to pay. Contractual obligation to pay which are contingent upon future events are also financial liability

Definition – equity instrument

Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

An instrument is an equity instrument if, and only if, **both** of the conditions below are met:

- ☐ Instrument includes no contractual obligation
 - ☐ to deliver cash or another financial asset to another entity;
 - ☐ to exchange financial assets/ liabilities with another entity under potentially unfavourable conditions
- ☐ If the instrument will or may be settled in the issuer's own equity instrument, it is
 - ☐ a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments or
 - ☐ a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments

Equity instruments

Examples

- ☐ Equity shares
- ☐ Preference shares (if certain criteria are met)
- ☐ Warrants
- ☐ Written call options to issue fixed number of equity shares for a fixed price

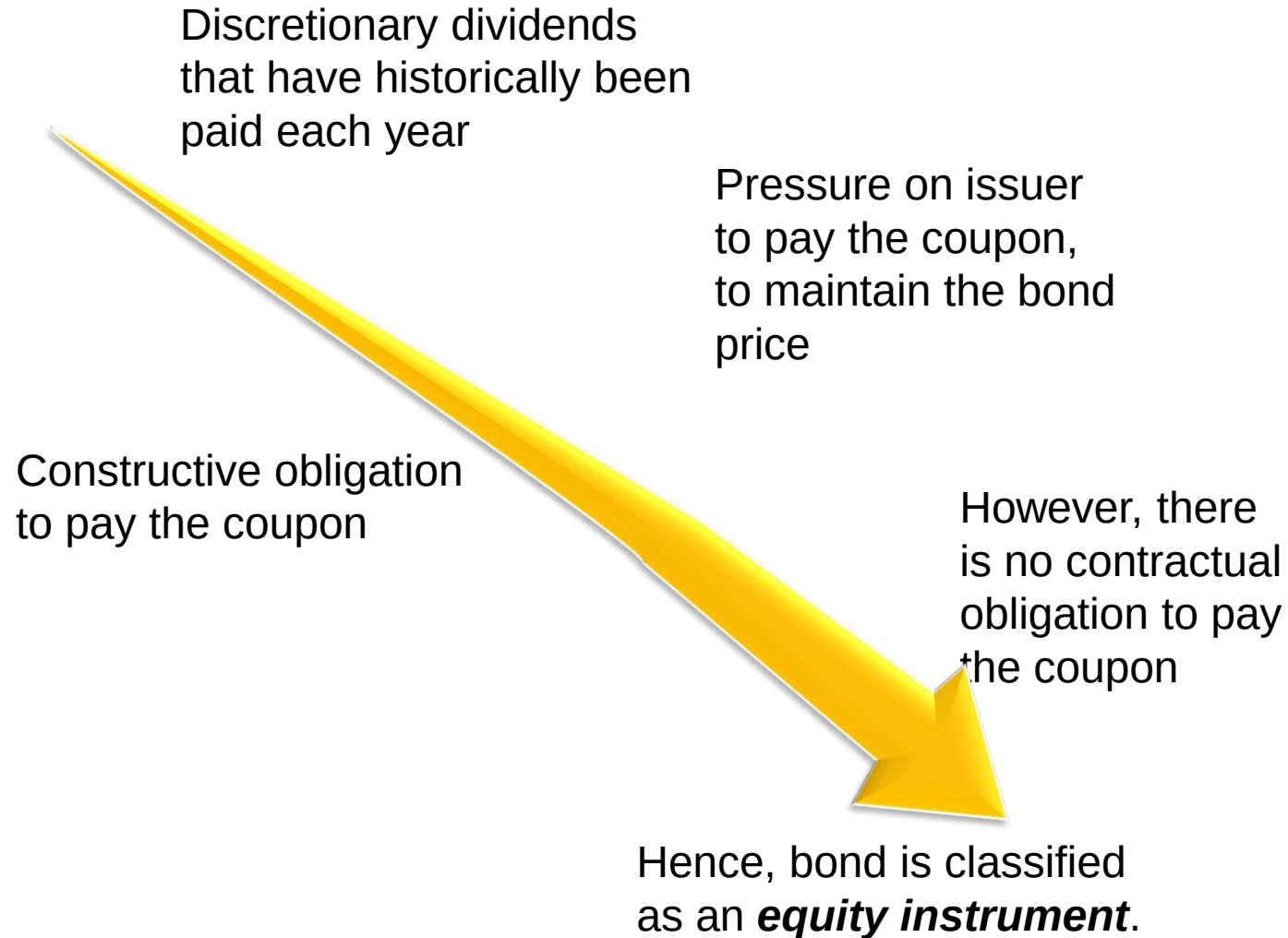
Case study

Company A issues a non-redeemable callable bond with a fixed 8% coupon.

- ☐ Coupon can be deferred in perpetuity at the A's option
- ☐ A has a history of paying the coupon each year and based on this trend current bond price is predictable on the holders expectation that the coupon will continue to be paid each year
- ☐ Stated policy of A says that the coupon will be paid each year, which is available in public domain

Whether the bond should be classified as liability or equity?

Case study : Solution



Liabilities vs. equity – preference shares

- ❑ Preference shares are issued with various permutations and combinations of rights and/or obligations with regards to redemption, dividend payouts, participation in distributable profits, cumulating of dividends, convertibility, etc.
- ❑ Classification of preference shares should be done on the basis of the contractual obligations arising from the instrument and not the legal form (same as for any other financial instrument under Ind AS 32)

Liabilities vs. equity – preference shares (cont'd.)

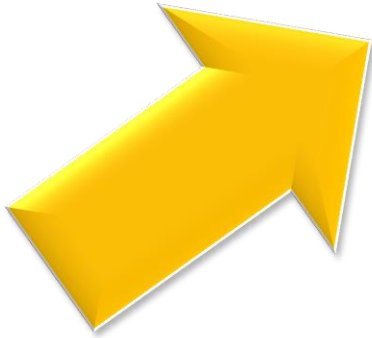
Mandatorily redeemable/ redeemable at the option of the Holder	Others - i.e. Non redeemable/ redeemable at the option of the Issuer
☐ Classified financial Liability	☐ Classified as Equity as there is no obligation for redemption
☐ If dividends are payable at the option of issuer, preference shares also contain as equity element and have to be treated as compound instrument and “split” accounted	☐ If there are contractual rights to dividends, preference shares also contain financial liability element and have to be treated as compound instrument and “split” accounted

Compound instruments

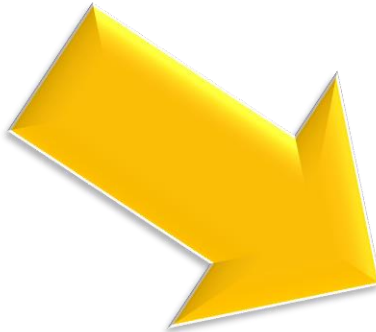
- ❑ The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity instrument.
- ❑ Such components shall be classified separately as financial liabilities, financial assets or equity instruments.

Example:

Instrument	Liability component	Equity component
Preference shares with discretionary dividends	Principal redemption liability	Discretionary dividend
Convertible bonds	Principal redemption and interest payment liability	Convertibility option to the holder



The liability component is determined by fair value of expected cash flows (for future interest payments and for principal payments)



The residual value is allocated to the equity component.

Case study

- ❑ Company J issues 2000 convertible bonds.
- ❑ The bonds have a 3 year term, and are issued at par with a face value of Rs.1,000 per bond, giving total proceeds of Rs. 2,000,000.
- ❑ Interest is payable annually in arrears at a nominal annual interest rate of 6% (i.e. Rs.120,000 per annum).
- ❑ Each bond is convertible at any time up to maturity into 250 ordinary shares. When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is 9% per annum.
- ❑ The entity incurs issue costs of Rs.100,000.

Accounting implications?

Case study: Solution

- ❑ The economic components of this instrument are:
 - ❑ a liability component - discounted fixed rate debt, and
 - ❑ an equity component - holder's right to convert at any time before maturity (a written call option)
- ❑ The liability component is measured at the NPV of the maximum potential cash payments and the difference between the proceeds of the bond issue and this calculated fair value of the liability is assigned to the equity component.
- ❑ The NPV of the liability component is calculated as Rs.1,848,122, using a discount rate of 9%.

Case study: Solution

- ❑ The issue cost Rs.100,000 would be allocated on a pro-rata basis i.e. $\text{Rs.}92,406 \left(100,000 \times \frac{1,848,122}{2,000,000} \right)$ towards debt and balance Rs.7,594 towards equity.
- ❑ The Rs.144,284 (151,878 minus 7,594) credited to equity is not subsequently re-measured.
- ❑ On the assumption that the liability is not classified as at fair value through profit or loss, Rs.1,755,716 (1,848,122 minus 92,406) liability component would be accounted for under the effective interest rate method i.e. 10.998%



Solution

Separation – Subsequent measurement

- ❑ The liability component is subsequently measured as per Ind AS 109- either at amortised cost or at fair value.
- ❑ The equity component is carried at the amount initially measured. It is not subsequently re-measured.
- ❑ Any premium or discount on redemption of compound instrument is factored in working out the liability component on initial recognition.
- ❑ In subsequent measurement, effective interest rates worked out considering premium or discount on redemption.

Conversion

- ❑ On conversion of a compound instrument at maturity, the entity should de-recognize the liability component and recognize it as equity.
- ❑ Equity issued on conversion is measured at the carrying amount of the liability component at the date of conversion.
- ❑ There is no gain or loss on conversion at maturity.
- ❑ The equity component of the instrument recognised initially is transferred to share capital. Other components of equity (like share premium) are recognised depending on the legal requirements.

IND AS 109

Classification and Measurement

Agenda

Classification of financial assets

- Business model test
- Contractual cash flow characteristics' test

Classification of financial liabilities

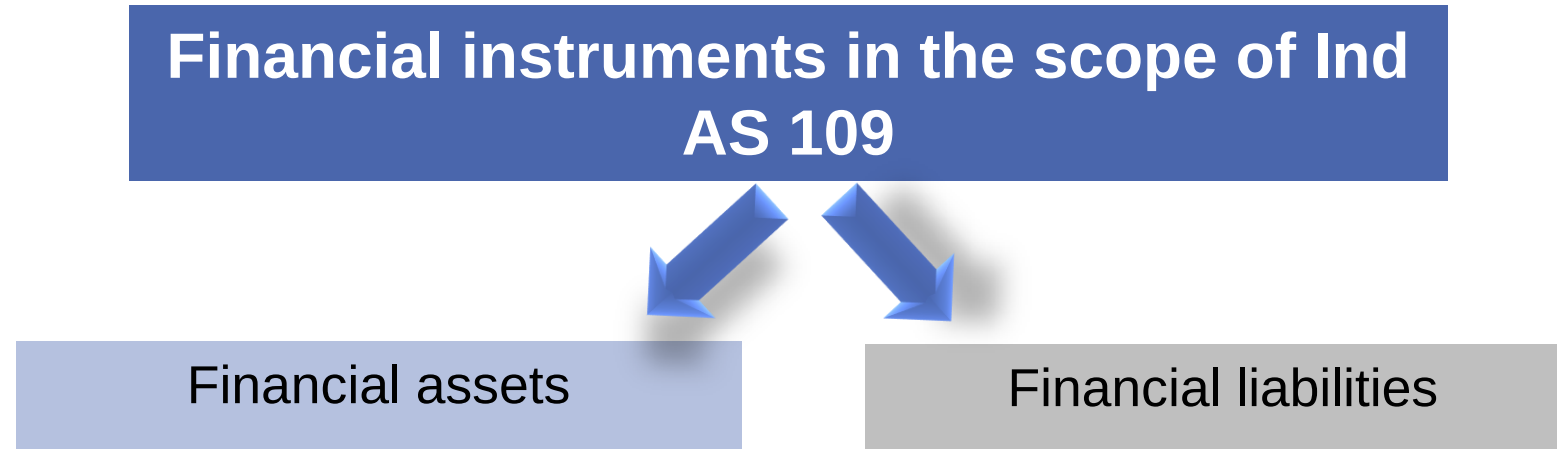
Reclassification

Initial measurement

Subsequent measurement

Classification of financial assets

Ind AS 109 classification and measurement model

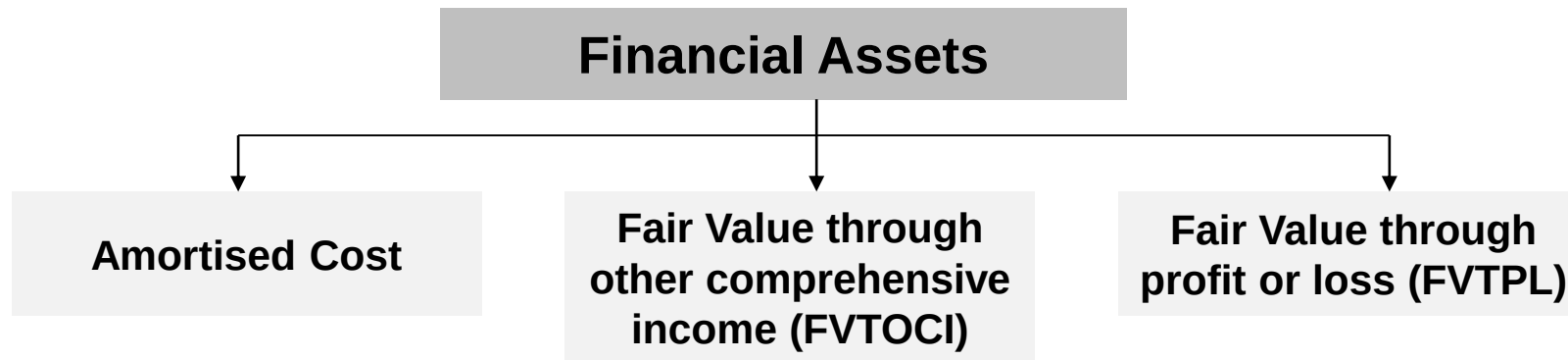


Categories of financial assets – based on subsequent measurement



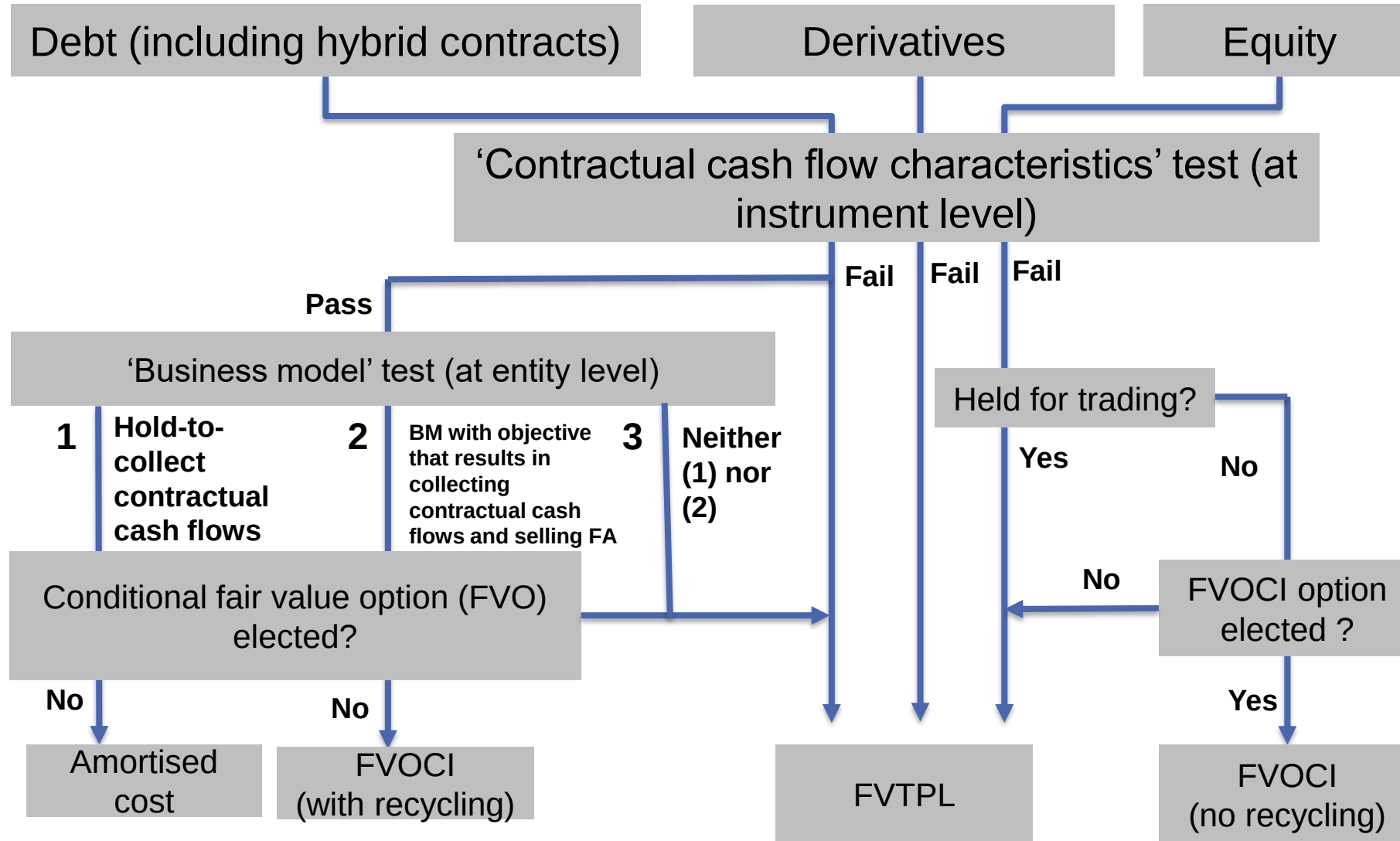
Classification of financial assets – an overview

- ❑ Financial assets has been classified into three categories as per Ind AS 109:

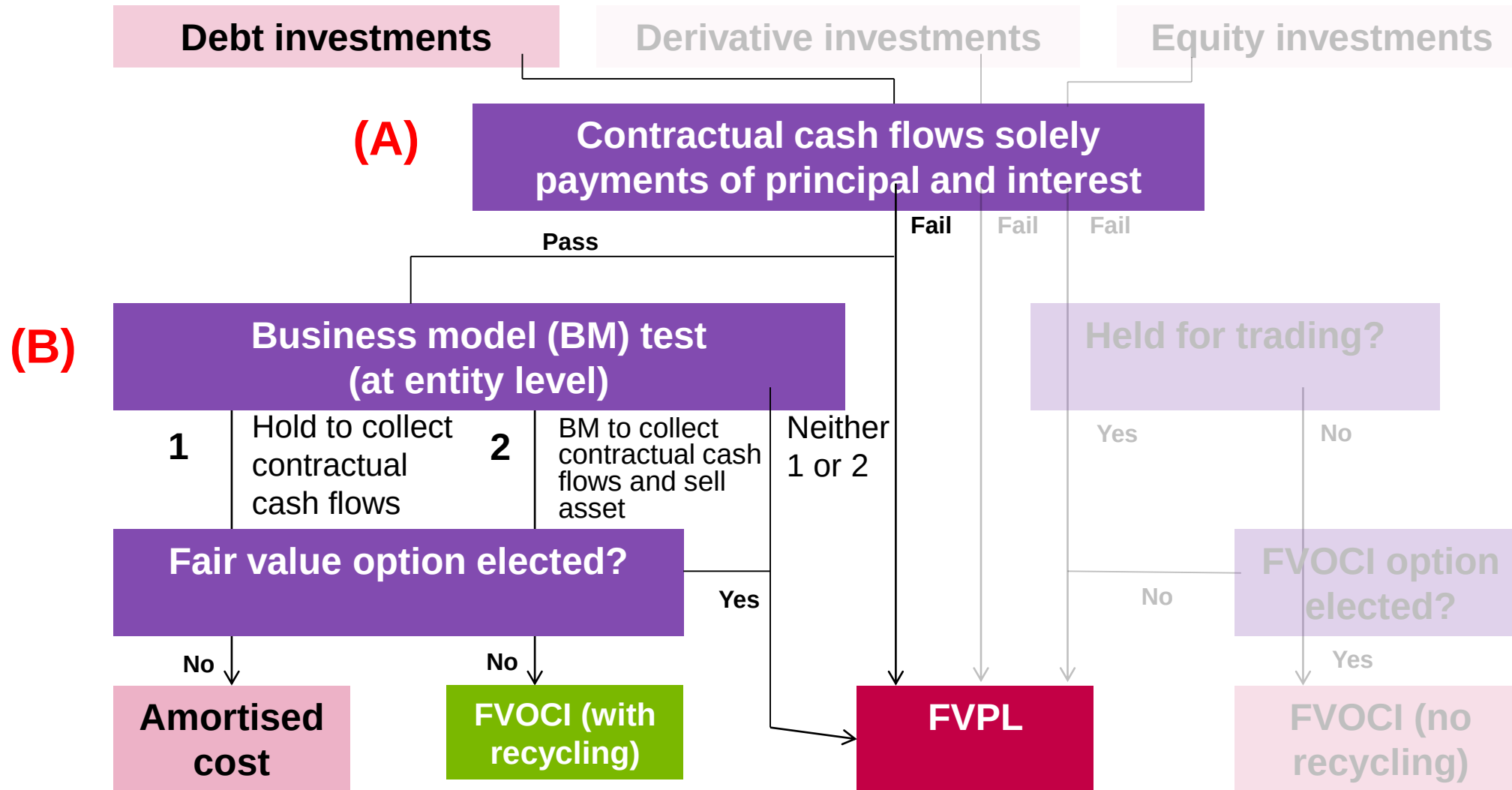


- ❑ Financial assets shall be classified on the basis of both:
 - a) the entity's **business model** for managing the financial assets and
 - b) the **contractual cash flow** characteristics of the financial assets.

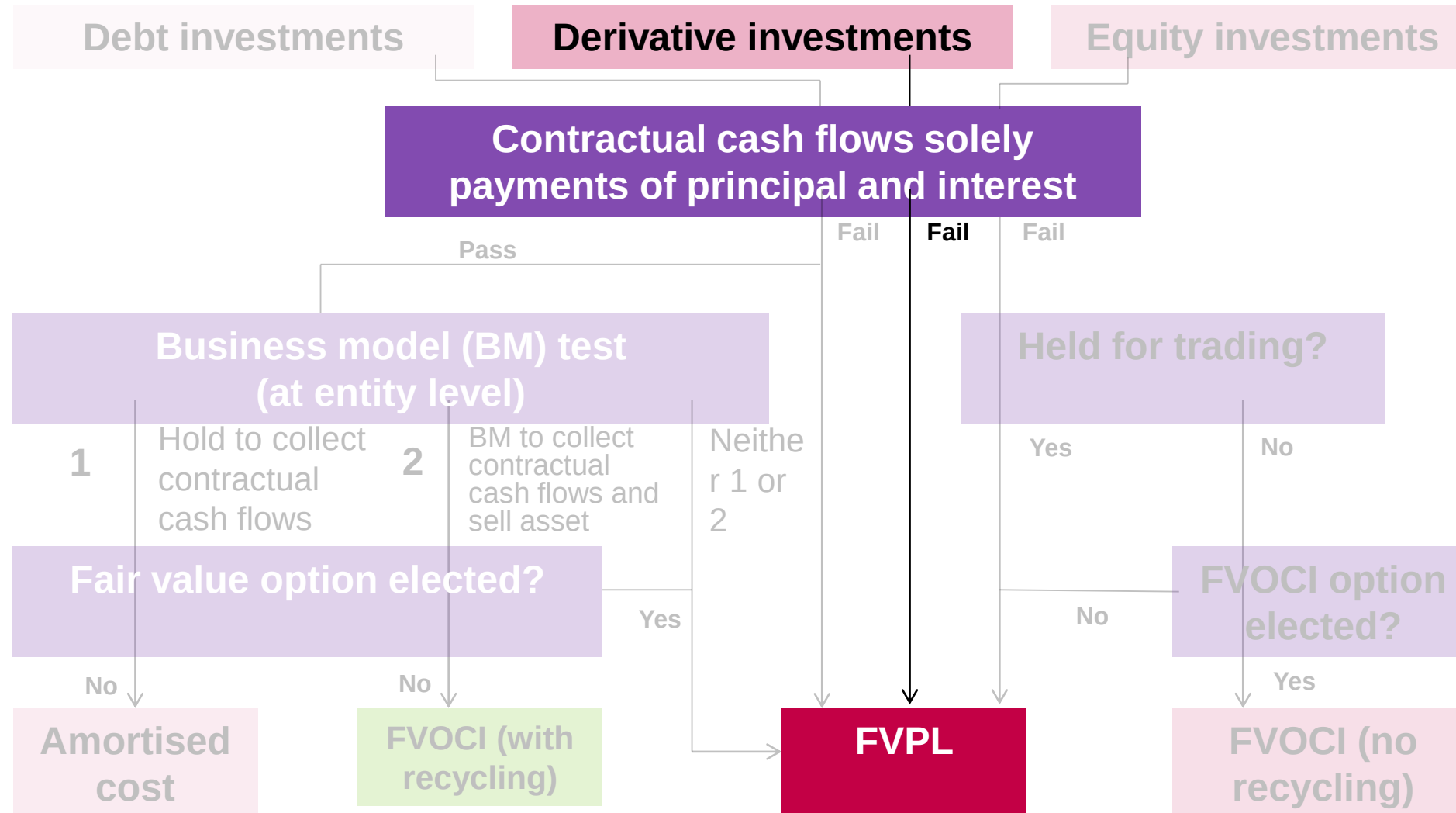
Classification and measurement model of financial assets



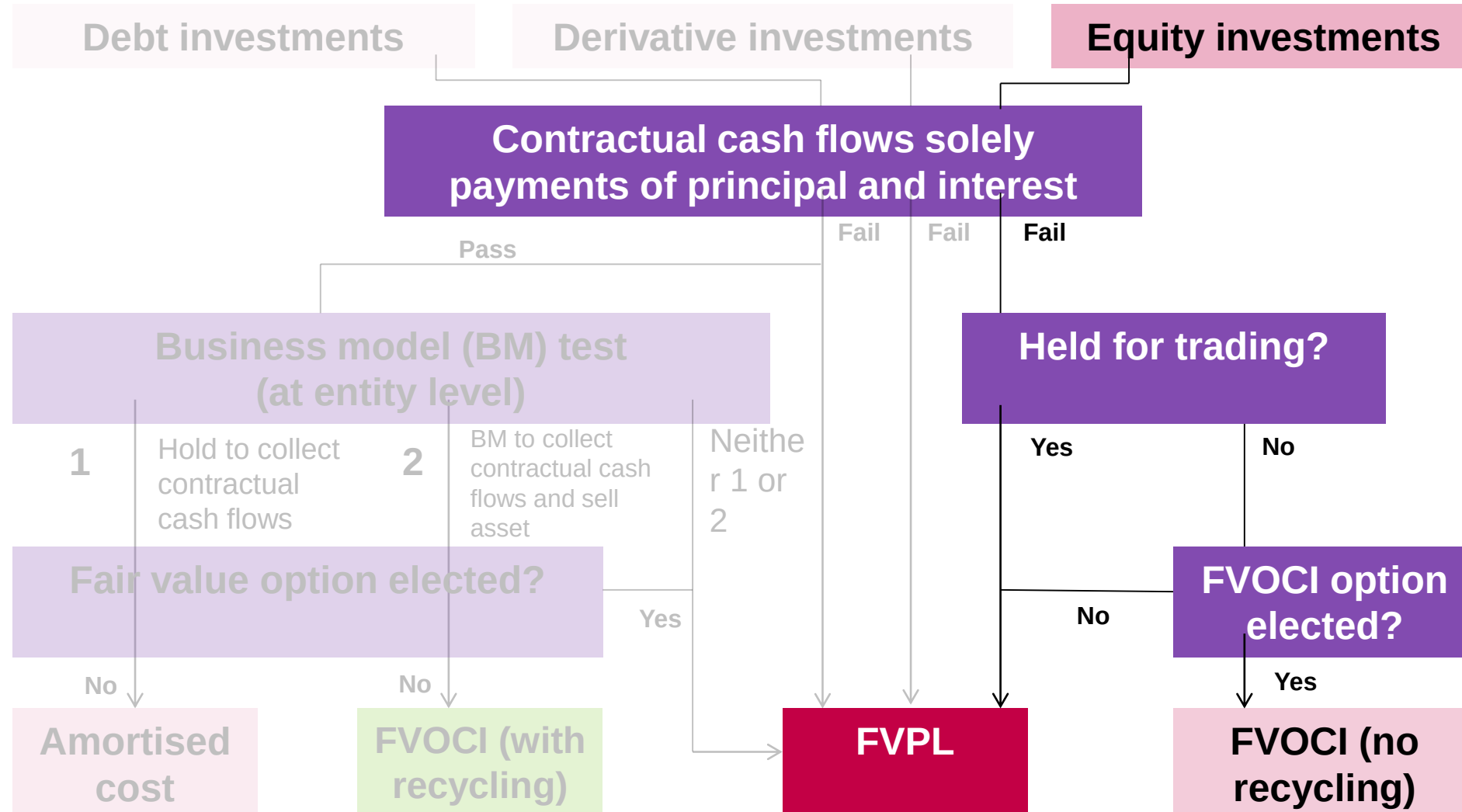
Application to investments in debt securities



Application to derivatives



Application to equity investments



Business model

Business model

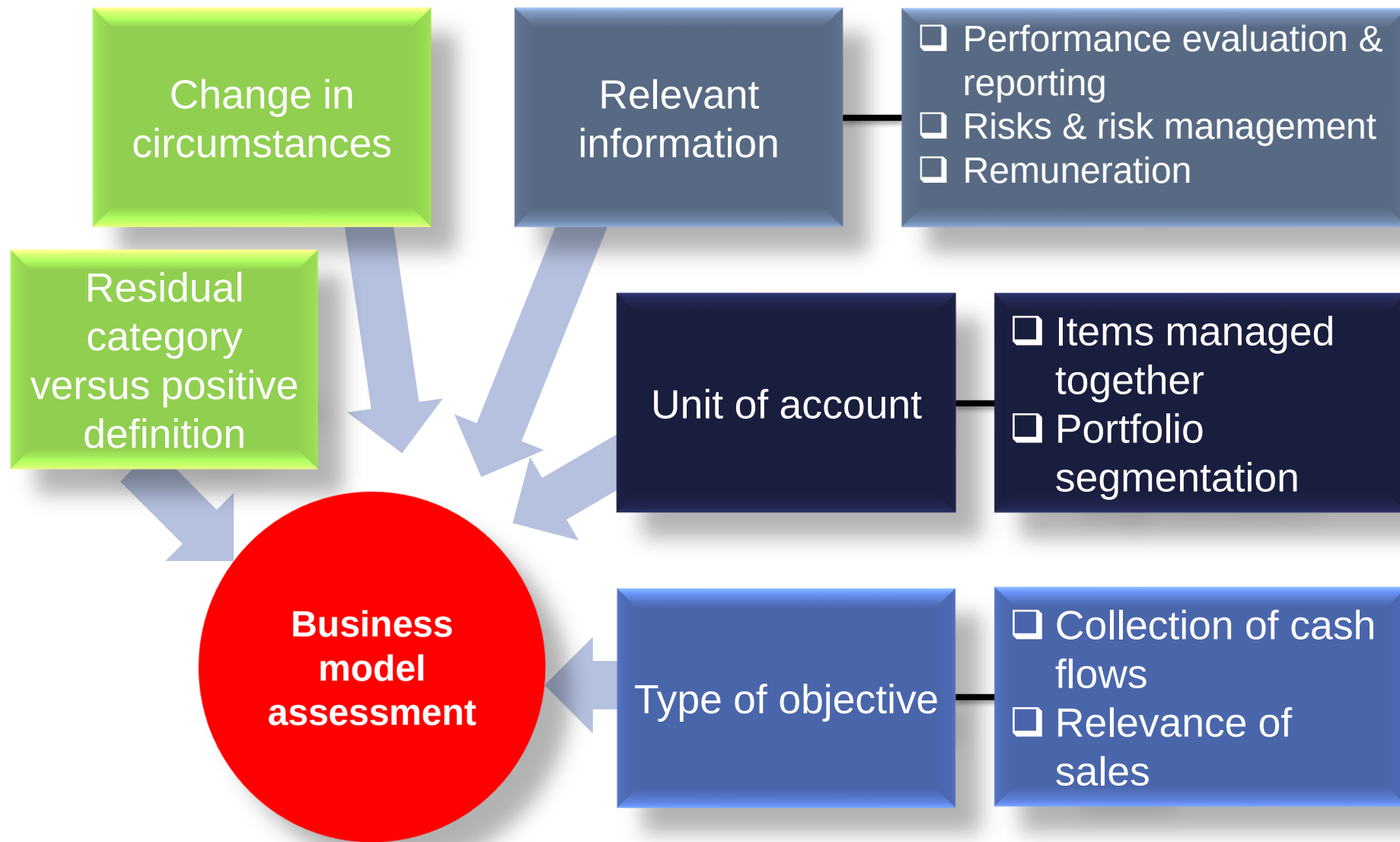
What it is...

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

What it is not...

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

How to assess the business model ?



Amortised cost business model (hold to collect)

- ❑ Examples of sales that would be consistent with a hold to collect business model:
 - ❑ Sales due to deterioration in credit quality in line with a documented investment policy
 - ❑ Infrequent sales (e.g., unanticipated stress scenarios), even if significant
 - ❑ Insignificant sales, both individually and in aggregate, even if frequent
 - ❑ Sales made close to the maturity and the proceeds approximate the collection of the remaining cash flows

- ❑ The fact that the requirement to sell the financial asset is imposed by a third party (e.g., a regulator) is not relevant for assessment of business model.

FVOCI business model (hold to collect and sell)

- ❑ FVOCI measurement applies under a business model whose objective results in both:
 1. Hold-to-collect contractual cash flows
 2. Sell financial assets
- ❑ Only financial assets with contractual cash flows that are solely P&I would qualify for FVOCI
- ❑ The category is neither a free choice nor a residual category

FVTPL business model

- ❑ FVTPL is the residual measurement category applicable to all instruments failing either the contractual cash flow or the business model test (this includes instruments held for trading, derivatives and equity instruments)
- ❑ FVO also applicable for financial instruments under a FVOCI business model if accounting mismatch is present

Contractual cash flow characteristics' test

Contractual cash flow characteristics' test

- ❑ Contractual terms of the financial asset give rise, on specified dates, to cash flows that solely represent principal and interest payments
- ❑ 'Interest' is consideration for the time value of money and the credit risk associated with the principal amount outstanding during a particular period of time
- ❑ Meaning of interest
 - ❑ De minimis and non-genuine features to be disregarded
 - ❑ Conceptual basis for P&I is a basic lending-type relationship
 - ❑ Time value of money and credit risk as the most significant, but not the only, components of a basic lending-type return
 - ❑ Liquidity risk and profit margin as other possible components

Contractual cash flow characteristics' test

- ❑ Contractual cash flow characteristic that introduces leverage do not have the characteristics of interest e.g. option, forward and swap contracts
- ❑ An instrument that is subordinated to other instruments (e.g. to general creditors) may still have contractual cash flows that are principal and interest.

Contractual cash flow characteristics' test

Prepayment, extension options and other provisions

May be recorded at amortised cost only if several conditions are met:

Prepayment options

- ☐ the prepayment amount substantially represents unpaid principal and interest (may include early termination compensation)

Extension options

- ☐ the terms can only result in payments of principal and interest during the extension period

Other contractual provisions:

- ☐ All other contractual provisions that could change the timing or amount of payments do not result in contractual cash flows that are solely principal and interest unless a variable rate represents consideration for the time value of money and the credit risk associated with the principal amount outstanding

Contractual cash flow characteristics' test

Examples

Instruments that will qualify	Instruments that will NOT qualify
A bond with a stated maturity date. Principal and interest are linked to an inflation index that is not leveraged.	A convertible bond that is convertible into equity instruments of the issuer.
A variable interest rate loan with a stated maturity date that permits the borrower to change the period of the market interest rate at each interest reset date on an ongoing basis.	A loan that pays an inverse floating rate, i.e. the interest rate has an inverse relationship to the market interest rates.
A bond with a stated maturity date and pays a variable market interest rate which is capped.	A constant maturity bond with a five-year term that pays a variable rate that is reset periodically but always reflects a five-year maturity.
A full recourse loan secured by collateral.	

Classification of Financial Liabilities

Classification of financial liabilities

Financial liabilities has been classified into two categories:

Category	Main use
Fair value through profit or loss	☐ Financial liabilities that are held for trading (including derivatives) ☐ Financial liabilities that are designated as FVTPL on initial recognition ☐ Contingent consideration recognised by an acquirer in a business combination
Amortised Cost	☐ All liabilities not in the above category

Reclassification of Financial assets and Liabilities

Reclassification of Financial assets and Liabilities

Financial Assets:

- ☐ When and only when entity changes its business model for managing financial assets, reclassification of financial assets is required. Such changes expected to be very rare.
- ☐ If financial asset is reclassified from amortised cost to FVTPL, its fair value is determined at reclassification date and gains or losses recognised in profit or loss.
- ☐ If financial asset reclassified from FVTPL to amortised cost, its fair value at reclassification date becomes new carrying amount.

Financial Liabilities:

- ☐ Reclassification of financial liabilities is not allowed.

Reclassification- Examples

Reclassification required	Reclassification prohibited
An entity has a portfolio of commercial loans that it held to sell in the short term. However, the entity acquires a company that manages commercial loans and has a business model that holds the loans to collect the contractual cash flows.	A change in intention related to specific financial assets (even in circumstances of significant changes in market conditions)
A financial services firm decides to shut down its retail mortgage business, and is no longer accepting new business. The firm actively market its mortgage loan portfolio for sale.	A temporary disappearance of a particular market for financial assets
	A transfer of financial assets between existing business models

Initial Measurement

Initial Measurement

“The fair value of a financial instrument on initial recognition is normally the transaction price.”

However, if fair value differs from transaction price, an entity shall account for that instrument as follows (Application Guidance):

- a) If fair value is evidenced by quoted price in an active market (i.e. Level 1 input) or based on valuation technique that uses only data from observable markets, entity shall recognise difference between fair value at initial recognition and transaction price as gain or loss (Day 1 gain or loss).
- b) In all other cases, difference is deferred. After initial recognition, entity shall recognise deferred difference as gain or loss only to extent that it arises from change in factor (including time) that market participants would take into account when pricing asset or liability.

Initial Measurement

Please advice on initial measurement of following transactions:

- a) A Ltd lends to B Ltd loan of 10 million for 5 years and classify as asset under loans and receivable. The Loan carries no interest. Market rate of interest is 10%.
- b) A ltd grants interest free loan of 10 Lac to a employees for a period of two years. Market rate of interest is 10%

Eliminated: IAS 39 exception to measure unquoted equity instruments whose fair value cannot be determined reliably

Interest-free lease deposit – Example

Company A leases a tower site from Company B. A gives a lease deposit of INR 1000,000 to Company B for five years and classifies the resulting asset within loans and receivables. The deposit carries no interest. On initial recognition, the market rate of interest for a five year loan with payment of interest at maturity is 10% per year.

How will the deposit be recorded in the financial statements of entity A?

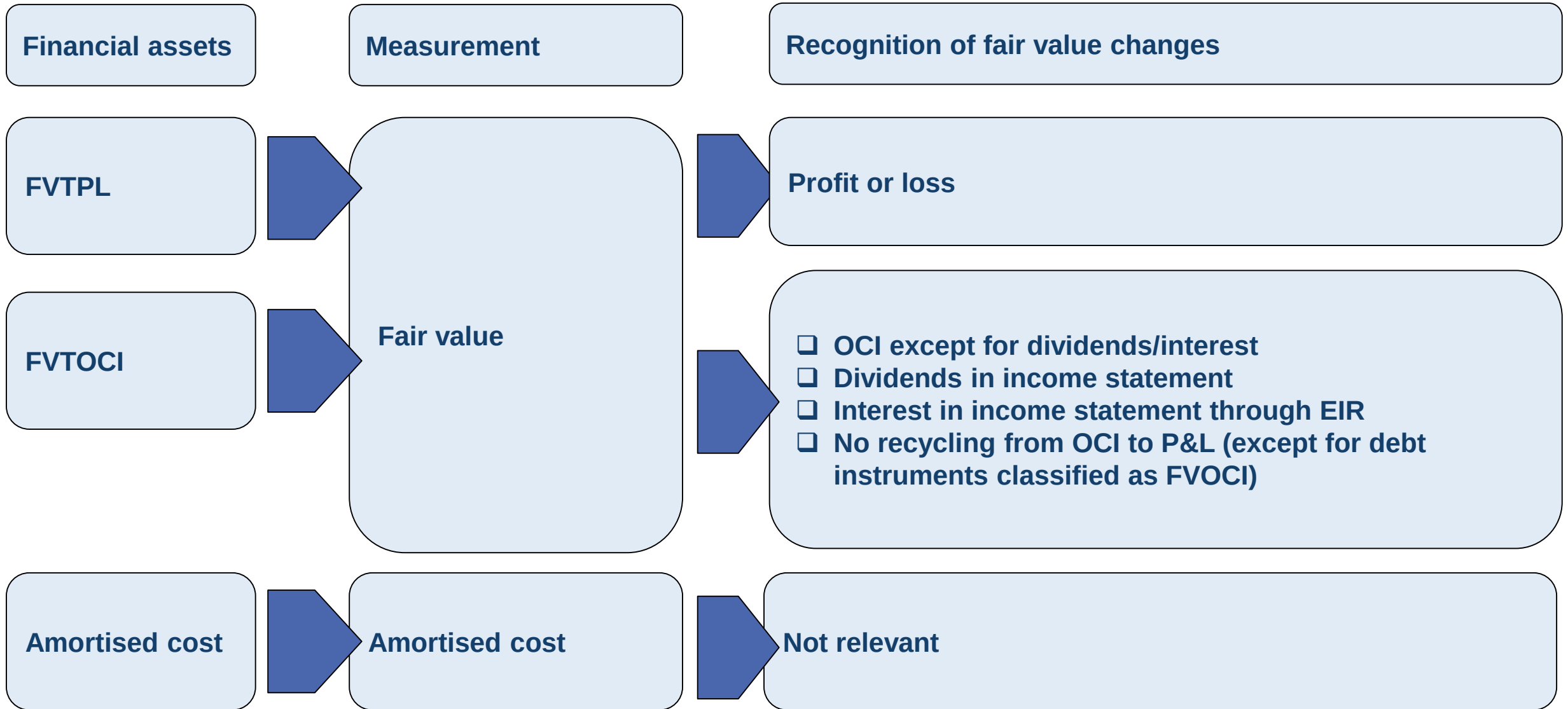
Solution:

The initial fair value of the deposit is the present value of the future payment of INR 1000,000, discounted using the market rate of interest for a similar loan of 10% for five years. This equates to INR 621,000.

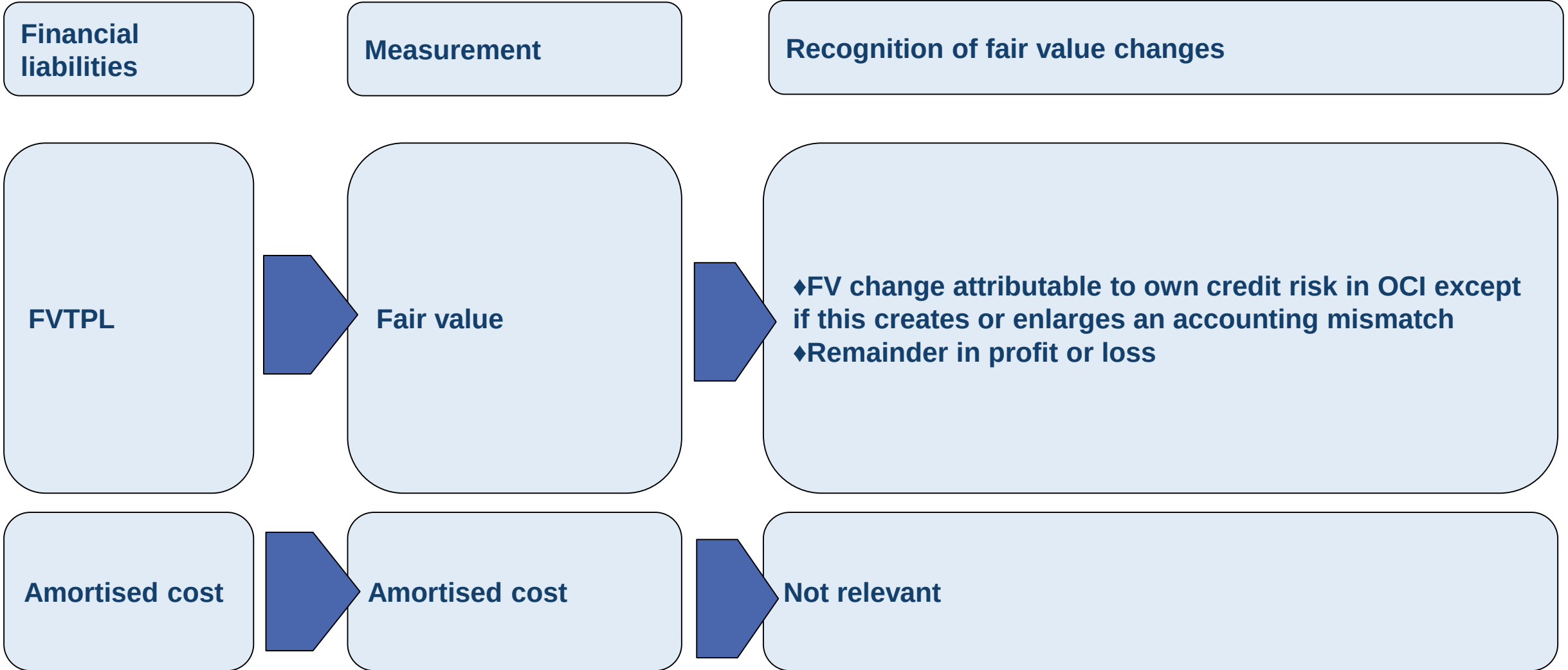
Rationally, A would also expect to obtain other future economic benefits that have a fair value of INR 379,000 (the difference between the total consideration given of INR 1000,000 and the loan's initial fair value of INR 621,000). The difference is not a financial asset, since it is paid to obtain expected future economic benefits, which here relate to the underlying lease. A recognises that amount as a pre-payment on the lease and amortises the resulting asset on a straight-line basis over the period of the lease.

Subsequent Measurement

Subsequent measurement: Financial assets



Subsequent measurement: Financial liabilities



Derivatives and Hedge Accounting

Agenda

Derivatives

- ☐ Meaning
- ☐ Types of derivatives
- ☐ Embedded derivatives
- ☐ Separation and accounting of embedded derivatives

Hedge accounting

- ☐ Qualifying hedge instruments
- ☐ Qualifying hedge items
- ☐ Hedged risks
- ☐ Hedge accounting models

Definition of a derivative

'underlying

- value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable
- exception for a non-financial variable that the variable is not specific to a party to the contract

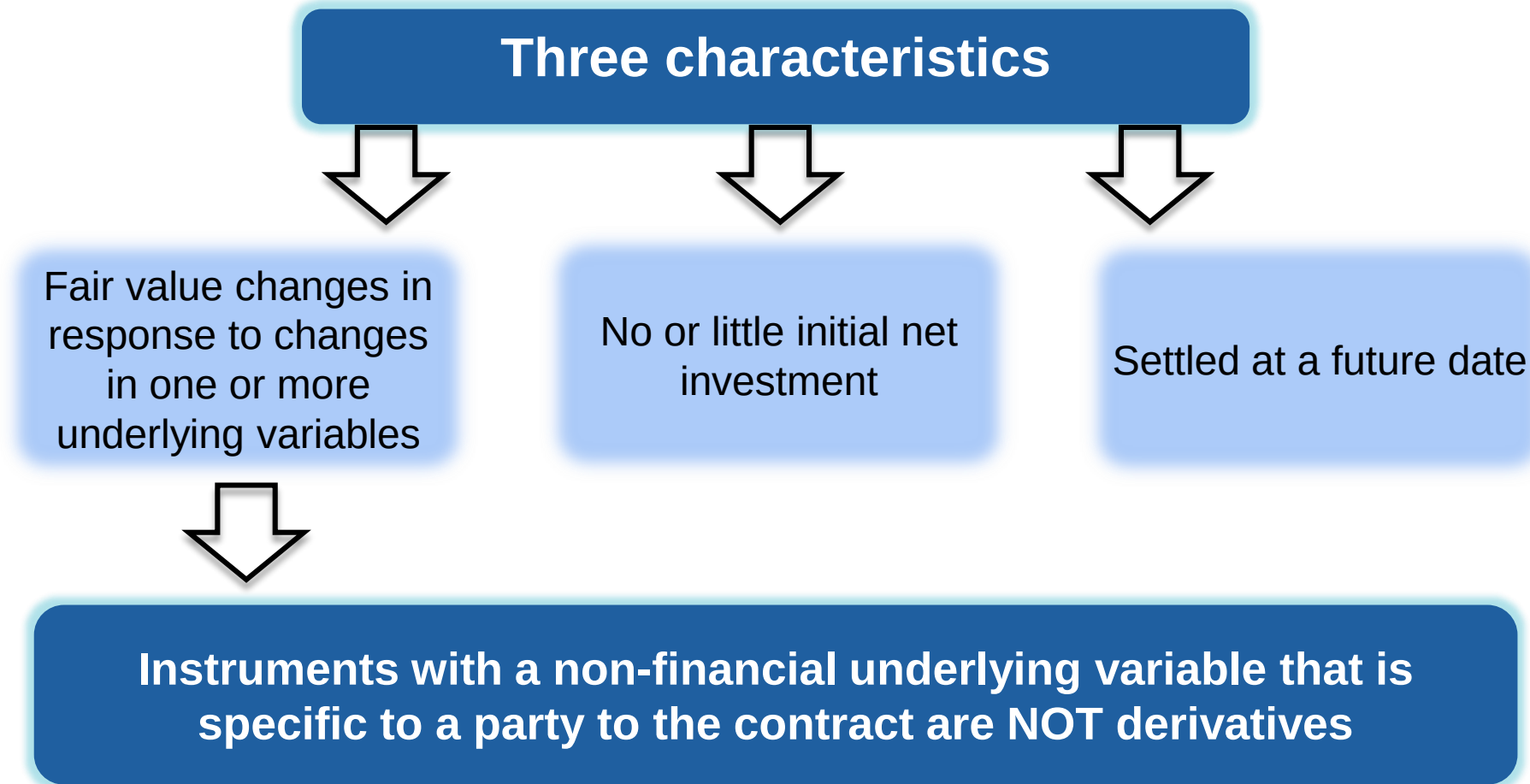
initial net investment

- requires:
 - no initial net investment; or
 - initial net investment smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors

future Settlement

- settled at a future date

Derivative definition



Example-non financial underlying variable

Non-financial variables that are not specific to one party to the contract may include an index of earthquake losses in a particular region or an index of temperatures in a particular city.

Non-financial variables that are specific to one party to the contract- Linked to credit rating of the party to the contract

Examples of derivatives and underlying

Type of contract

Main variable

Interest rate swap

Interest rate

FX forward

Foreign exchange rate

Commodity option

Commodity price

Credit default swap

Credit risk

**Purchased or written stock call
or put option**

Equity price

Why do entities use derivatives?

1. To manage risks

- ☐ Of price changes – e.g., fluctuating:
 - ☐ Exchange rates
 - ☐ Interest rates
 - ☐ Prices (shares, bonds, commodities, etc.)
- ☐ Of other causes – e.g.:
 - ☐ Default
 - ☐ Bad weather and other reasons

2. To speculate

Scope: Non-financial item contracts

Forward contracts to buy or sell a non-financial item (e.g. commodity contracts)



Establish practice of net settling similar contracts or taking delivery of the underlying and selling it within a short period after delivery

Continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale and usage requirements



New classification criteria

New classification criteria

Note-Such contracts may be irrevocably designated at FVTPL. This designation is available only at inception of contract and only if it eliminates or significantly reduces 'accounting mismatch'

Example – normal purchase/ sale exemption

- ❑ Company XYZ enters into a fixed-price forward contract to purchase 1,000 kg of copper in accordance with its expected usage requirements.
- ❑ The contract permits XYZ to take physical delivery of the copper at the end of twelve months, or to pay or receive a net settlement in cash, based on the change in fair value of copper.

Whether the contract is entitled to normal sale/ purchase exemption?

Response – example

- ❑ Contract has all characteristics of a derivative instrument
 - ❑ there is no initial net investment,
 - ❑ it is based on the price of copper, and
 - ❑ it is to be settled at a future date.
- ❑ However, it is entitled to normal sale/ purchase exemption if XYZ:
 - ❑ intends to settle the contract by taking delivery;
 - ❑ has no history for similar contracts of settling net in cash, or of taking delivery and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin.
- ❑ In such a case, contract would be accounted for as an executory contract rather than as a derivative.

Embedded Derivatives

Embedded derivatives

An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract

An embedded derivative causes some of the cash flows of the combined instrument to vary in a similar way to a stand-alone derivative

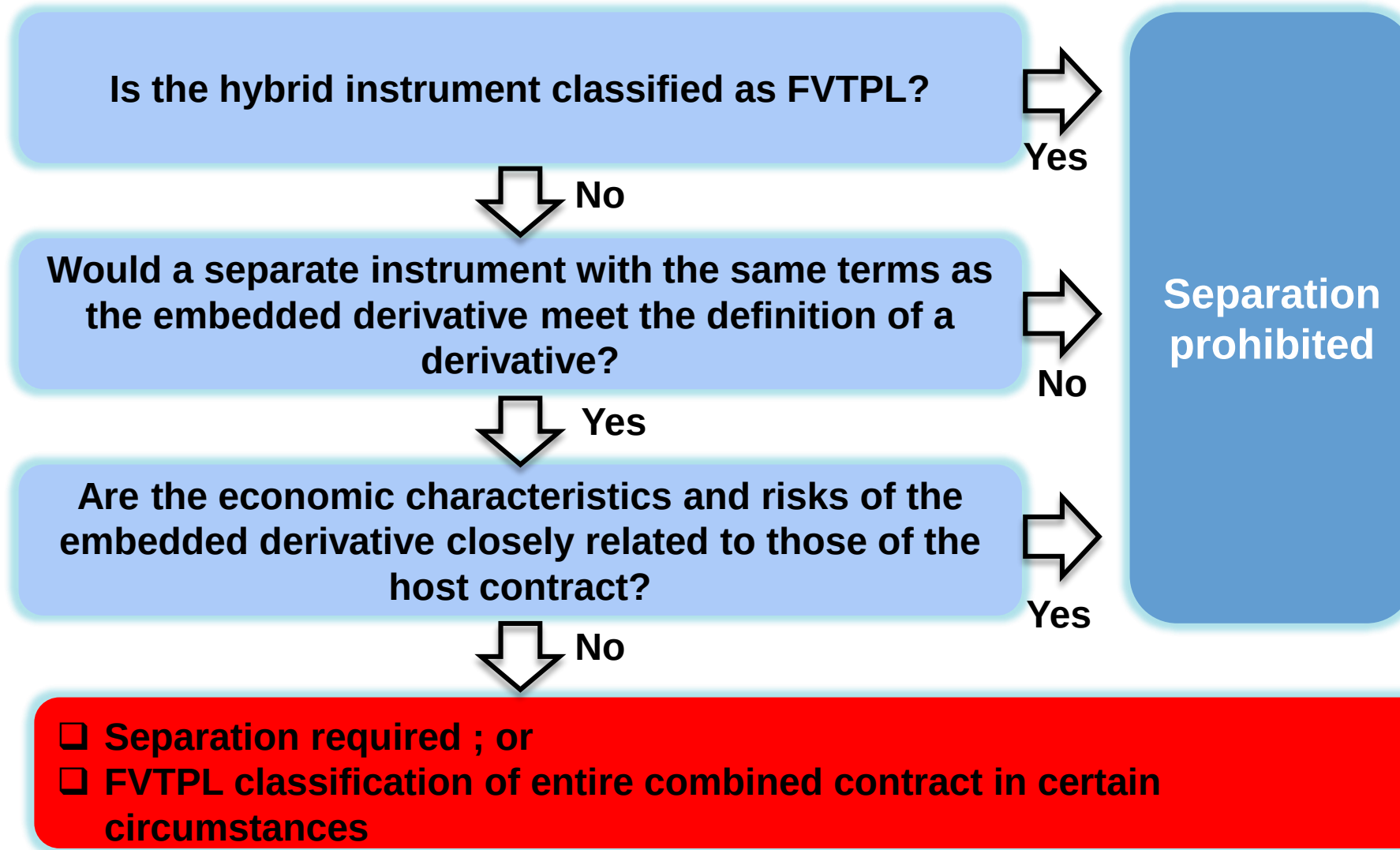
Requirements on separation of embedded derivatives retained from Ind AS 39 in relation to Financial Liability

An embedded derivative is attached to a financial instrument and is not contractually transferable independently of that instrument and has the same counterparty

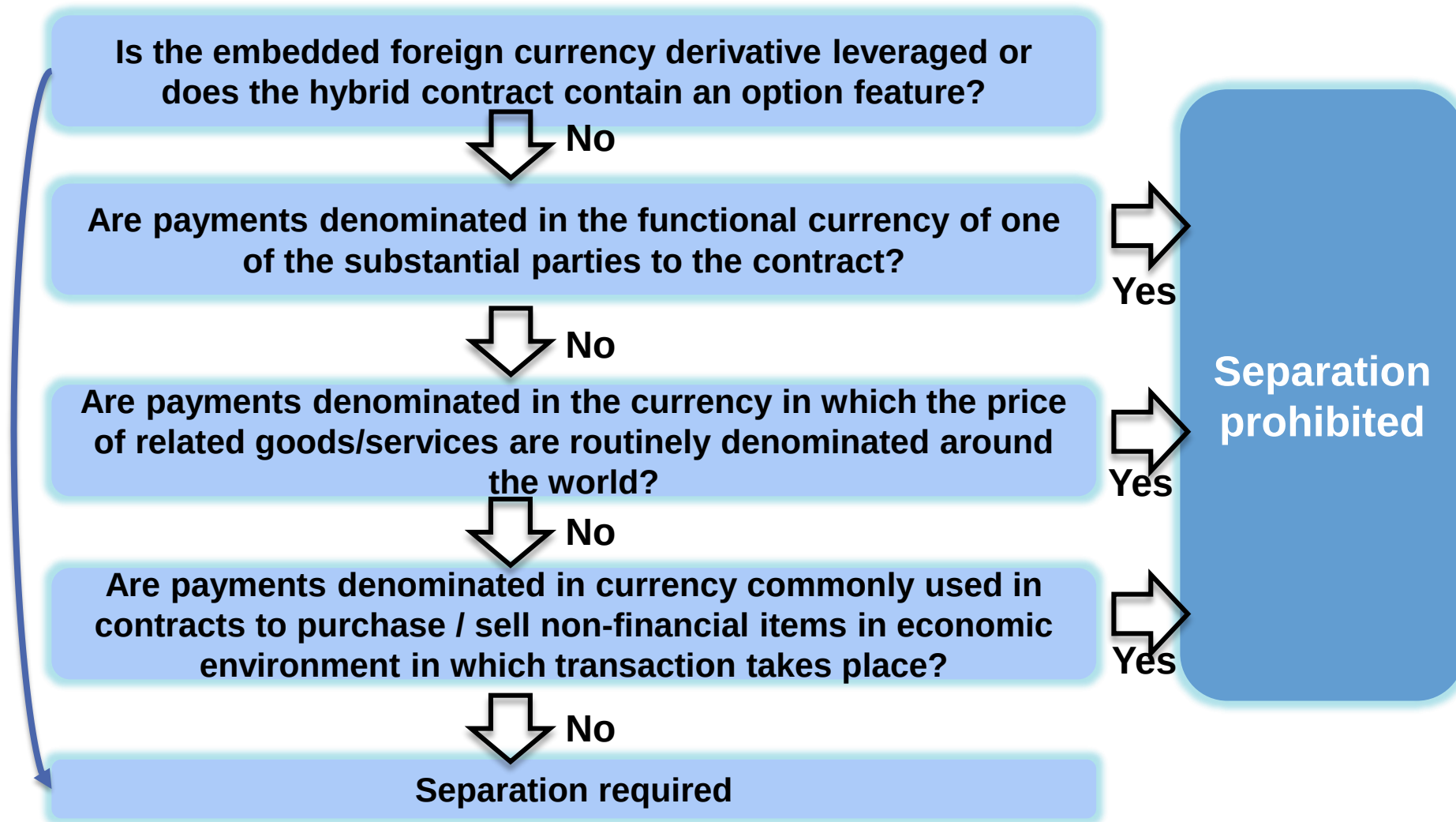
Examples of embedded derivatives

Type of contract		Embedded derivative
Interest rate swap	➡	Interest rate
FX forward	➡	Foreign exchange rate
Commodity option	➡	Commodity price
Credit default swap	➡	Credit risk

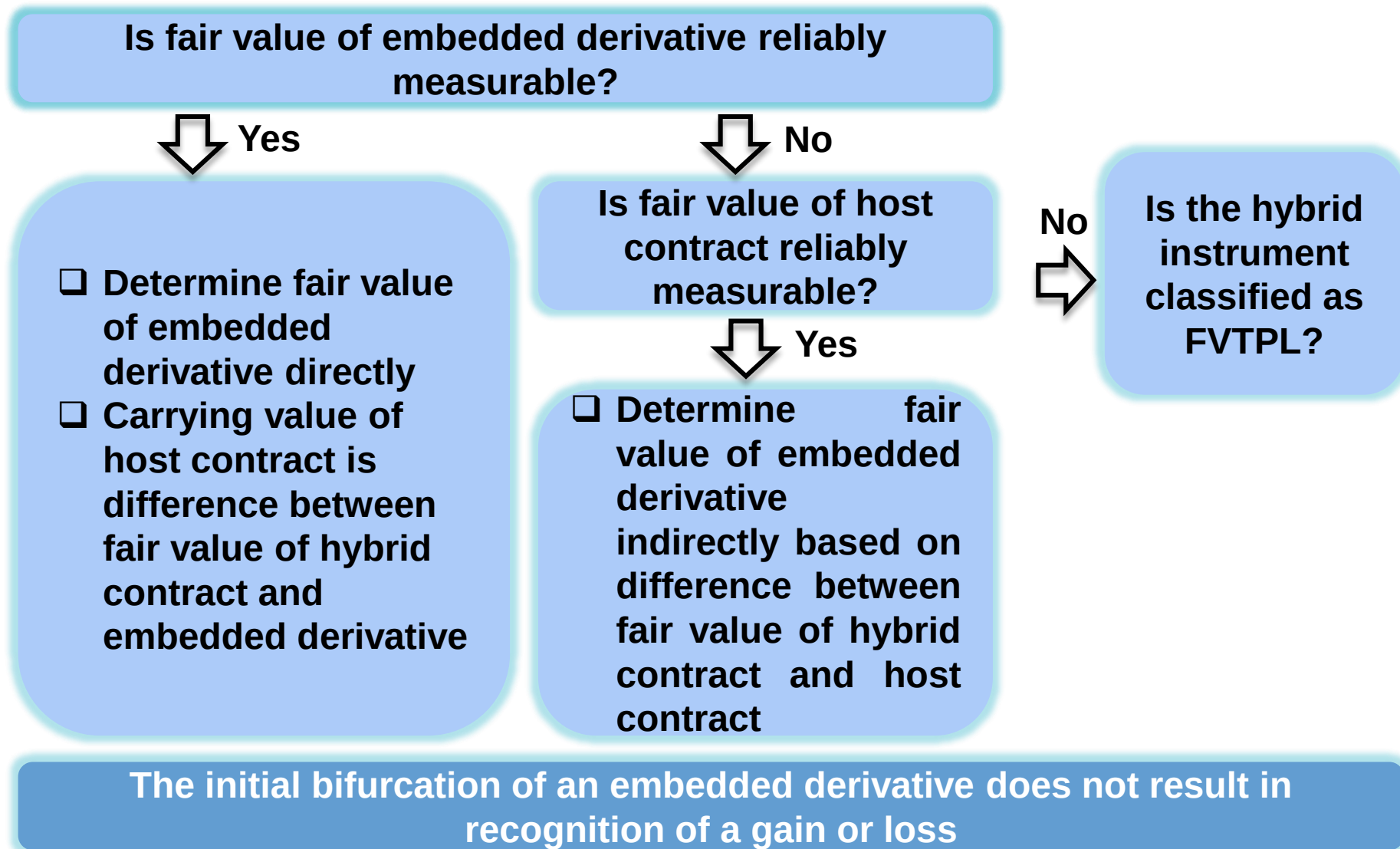
Separation of embedded derivatives



Separation of embedded derivatives



Accounting for separable embedded derivatives



Revenue Recognition: Embedded Derivatives Example

- Entity A (an INR functional currency entity) enters into a USD 1,000,000 sale contract on 1 January 2015 with Entity B (an INR functional currency entity) to sell equipment on 30 June 2015.

Spot rate on 1 January 2015: INR/USD	45
Spot rate on 31 March 2015: INR/USD	57
Three month forward rate on 31 March 2015: INR/USD	45
Six month forward rate on 1 January 2015: INR/USD	55
Spot rate on 30 June 2015: INR/USD	60

- The contract should be separated using the 6 month USD/INR forward exchange rate, as at the date of the contract (INR/USD = 55). The two components of the contract are therefore:
 - A sale contract for INR 55 Million
 - A six month currency forward to purchase USD 1 Million at 55.
- This gives rise to a gain or loss on the derivative, and a corresponding derivative asset or liability.

Revenue Recognition: Embedded Derivatives - Example

On delivery

1. Entity A records the sales at the amount of the host contract = INR 55 Million
2. The embedded derivative is considered to expire.
3. The derivative asset or liability (i.e. the cumulative gain or loss) is settled by becoming part of the financial liability on delivery.
4. In this case the carrying value of the currency forward at 30 June 2015 on maturity is = INR $(1,000,000 \times 60 - 55 \times 1,000,000) = \text{Rs } 5,000,000$ (profit/asset)

Date	Transaction	Sales	Debtors	Derivative Asset (Liability)	(Profit) Loss
		INR	INR	INR	INR
1-Jan-15	Embedded Derivative			Nil Value	
31-Mar-15	Change in Fair Value of Embedded Derivatives MTM $(55-45) \times 1 \text{ Million}$			(10,000,000)	10,000,000
30-Jun-15	Change in Fair Value of Embedded Derivatives $(60-45) \times 1 \text{ Million}$			15,000,000	(15,000,000)
30-Jun-15	Recording sales at forward rate	(55,000,000)	55,000,000		
30-Jun-15	Embedded derivative-settled against debtors		5,000,000	(5,000,000)	

Hedge Accounting

Objective of hedge accounting

Application of hedge accounting permits to:

- ☐ **Re measure both the items from which the risk exposure arises and the instruments used to manage the risk in profit or loss; or**
- ☐ **Defer recognition in profit or loss of certain gains and losses on derivatives by recognising them in OCI**



**Solves accounting mismatch in
profit or loss**

Qualifying hedging instruments (1)

Derivatives

Separable embedded
derivatives

**Non-derivatives designated as
hedging instruments for
hedging of any risk.**

**For example: Commodity price linked
investments can be used as hedging
instruments against purchase of
commodity**

Written options may be designated
only for hedging of purchased
options

Qualifying hedging instruments (2)

Derivatives should be designated as hedging instruments in their entirety except for:

- ◆ Intrinsic value of options
- ◆ Spot price element of forwards

Derivative may not be designated as hedging instruments for only a portion of its remaining period to maturity

Intra group hedge-instruments are not considered for consolidation purpose but may qualify for separate financial statements (except currency risk)

A proportion of a financial instrument may be designated as the hedging instrument

A question : Qualifying hedging instruments

Are the following items qualifying hedging instruments?

1. An issued loan denominated in CU1 (functional currency is CU2) with a variable coupon.
2. 50% of an interest rate swap entered into with a subsidiary.
3. The time value of an option.
4. The first 10 cash flows of an interest rate swap out of a total of 20 cash flows.

CU1 = Currency Unit 1

CU2 = Currency Unit 2

Response

Are the following items qualifying hedging instruments?

1. May be an eligible hedging instrument.
2. This is an eligible hedging instrument for hedge accounting in the separate financial statements.
However, if it is an intra-group hedging instrument, this is not an eligible hedging instrument for hedge accounting in the consolidated financial statements. The designation of proportions of financial instruments as hedging instruments is allowed.
3. Not an eligible hedging instrument.
4. This is not an eligible hedging instrument because hedging instruments are designated for the entire period for which they are outstanding.

Costs of hedging

Costs of hedging

- ☐ Time value of options
- ☐ Forward element of forward contracts
- ☐ Foreign currency basis spread

Accounting for the Cost of Hedging- Changes in fair value are first recognised in OCI. For subsequent treatment-

Transaction-related hedged items

- ☐ If hedged transaction subsequently results in recognition of non-financial item, amount becomes a 'basis adjustment' and else amount is reclassified to profit or loss in same period during which hedged cash flows affect profit or loss

Time period-related hedged items

Amount accumulated in OCI is amortised on systematic and rational basis to profit or loss

Note: Time value could be considered as premium for protection against risk (i.e. 'insurance premium')

Qualifying hedge items

A single (or a group of items if they share the same risk):

- ☐ Recognised asset or liability
- ☐ Unrecognised firm commitment
- ☐ Highly probable forecast transaction
- ☐ Net investment in a foreign operation
- ☐ Equity investments at FVOCI
- ☐ Net position hedging for fair value hedges and cash flow hedges of foreign exchange risk

Hedge items explained (1/2)

Equity investments at FVOCI

IAS 39

Only hedge of exposures that could affect profit or loss qualify for hedge accounting.

Ind AS 109

An entity, may, at initial recognition, make an irrevocable election to present subsequent changes in fair value of equity investments not held for trading in OCI.

Under Ind AS 109, an entity may hedge foreign exchange risk exposure or equity price risk exposure of equity investments at fair value through OCI (FVOCI)

- ☐ For such hedge, fair value change of hedging instrument is recognized in OCI
- ☐ Ineffectiveness is also recognized in OCI
- ☐ On sale of the investment, gains or losses accumulated in OCI are not reclassified to profit or loss

Hedge items explained (2/2)

Net position as hedged item

IAS 39

Net position hedging that may reflect risk management strategy is not allowed.

Ind AS 109

Net position hedging for fair value hedges and cash flow hedges of foreign exchange risk is allowed..

Ind AS 109 aligns hedge accounting with risk management strategy of hedging net position

Question : Qualifying hedged items

Are the following items qualifying hedged items?

1. A probable forecast transaction
2. An issued loan with a fixed coupon
3. CU1 100 of a net investment which amounts to CU1 150 in total (functional currency is CU2)
4. 50% of an interest rate swap
5. A net position of CU1 150 consisting of assets amounting to CU1 250 and liabilities amounting to CU1 100 (functional currency is CU2)

Response:

1. Not allowed, because only highly probable forecast transactions are eligible hedged items.
2. Allowed as a hedged item.
3. Allowed, as Ind AS 109 allows designating portions of net investments as hedged items.
4. Not allowed, Ind AS 109 generally precludes derivatives from being the hedged item and therefore it is not allowed.
5. Allowed, because hedge accounting is now allowed for hedges of net positions for foreign currency risk.

Hedged items: risk components designation criteria

IAS 39

Non-financial item
can only be
designated as
hedged item for its
foreign currency risk
or all its risks in their
entirety

Ind AS 109

Risk component of a
non-financial item can
be designated as
hedged item if it's:

Separately identifiable

+

Reliably measurable

Hedged items: risk components designation criteria

For Example:

- ❑ Price of natural gas contractually linked in part to a gas oil benchmark price and in part to a fuel oil benchmark price
- ❑ Price of wires contractually linked in part to a copper benchmark price and in part to a variable tolling charge reflecting energy costs
- ❑ Price of electricity contractually linked in part to a coal benchmark price and in part to transmission charges that include an inflation indexation

Hedged risk: Inflation

Inflation as a risk component:

IAS 39

- **Financial instruments:** Inflation cannot be designated as hedged risk, unless it is contractually specified.
- **Non-financial instruments:** Not allowed at all.

Ind AS 109

Non-financial instruments, inflation component can be designated as hedged risk, provided that it is separately identifiable and reliably measureable.

- ❑ For example, contractually specified inflation risk component would normally qualify as hedged item (e.g., sales contract to sell the inventory with price formula linked to consumer price index) under Ind AS 109, whereas it would not under IAS 39

Hedged risk: Aggregated exposures

Entities often purchase or sell items that expose them to more than one type of risk. When hedging those risk exposures, entities do not always hedge each risk for same time period.

For example:

- ❑ Entity manufacturing electrical wires is expecting to purchase copper in 12 months. Copper price is fluctuating and is denominated in USD, which is foreign currency for entity. Entity is exposed to two main risks, copper price risk and foreign exchange risk
- ❑ Entity first decides to hedge copper price fluctuation risk using copper futures contract. By doing so, entity now has fixed-price copper purchase denominated in foreign currency and is therefore still exposed to foreign exchange risk
- ❑ 3 months later, entity decides to hedge foreign exchange risk by entering into foreign exchange forward contract to buy fixed amount of USD in 9 months. By doing so, entity is hedging aggregated exposure

Hedged risk: Aggregated exposures

Example contd..

IAS 39

IAS 39 precludes derivatives from being designated as part of hedged item for accounting purposes. Entity would have to:



Discontinue first hedging relationship (i.e., copper price risk hedge) and re-designate new relationship with joint designation of copper futures contract and foreign exchange forward contract as hedging instrument.

Ind AS 109

Entity could designate foreign exchange forward contract in cash flow hedge for aggregated exposure without affecting first hedging relationship



It would no longer be necessary to discontinue and re-designate first hedging relationship

Types of Hedges

Main types of hedging relationships

Fair value hedge

Hedge of exposure to changes in fair value of a recognised asset or liability; an unrecognised firm commitment; or an identified portion of any of the above two, that is attributable to a particular risk

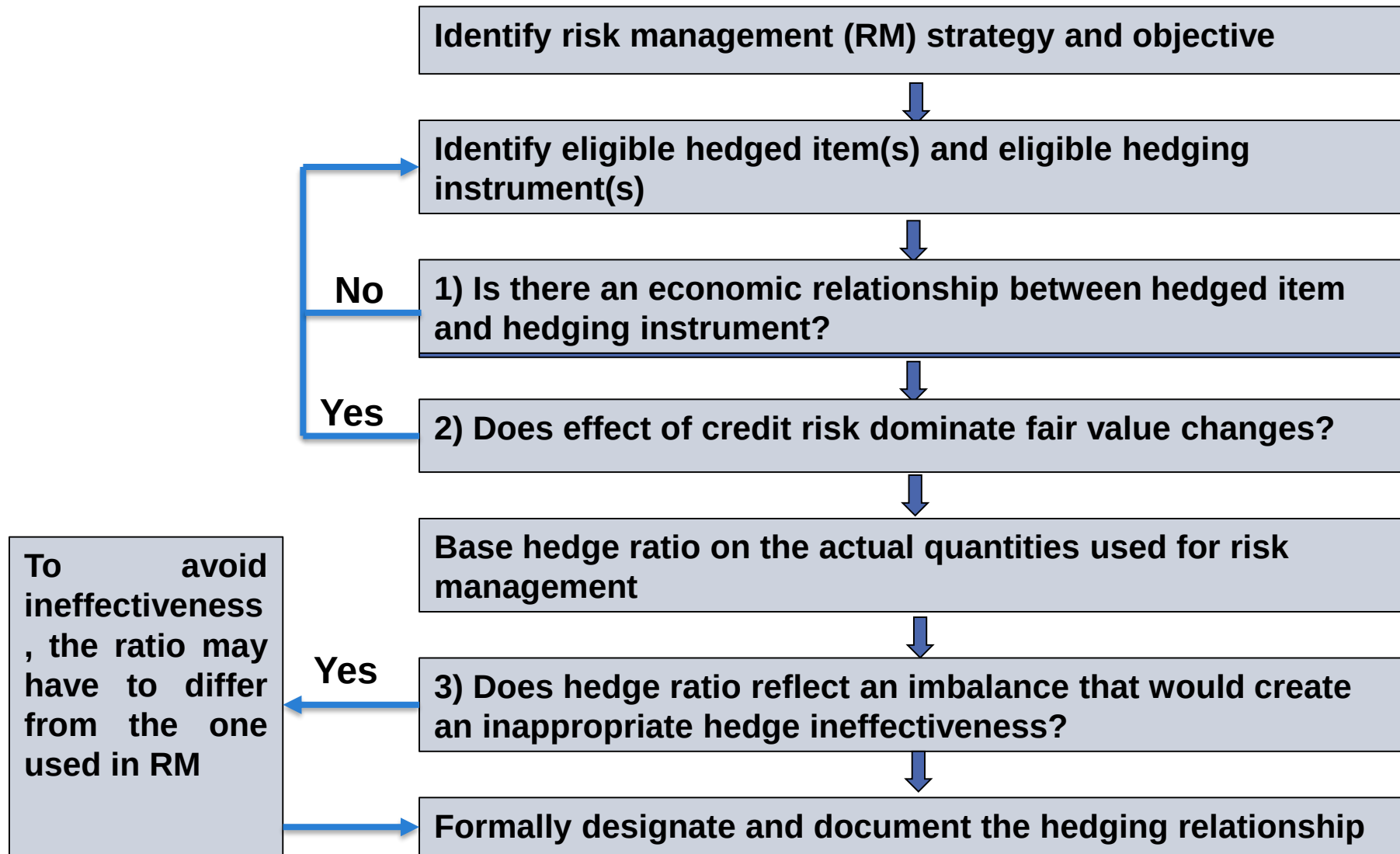
Cash flow hedge

Hedge of exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability or foreign currency risk of firm commitment (unrecognised) or a highly probable forecast transaction (also an inter-company one) and could affect profit or loss

Net investment hedge

Hedge of a net investment in a foreign operation (including a hedge of a monetary item that is accounted for as part of the net investment)

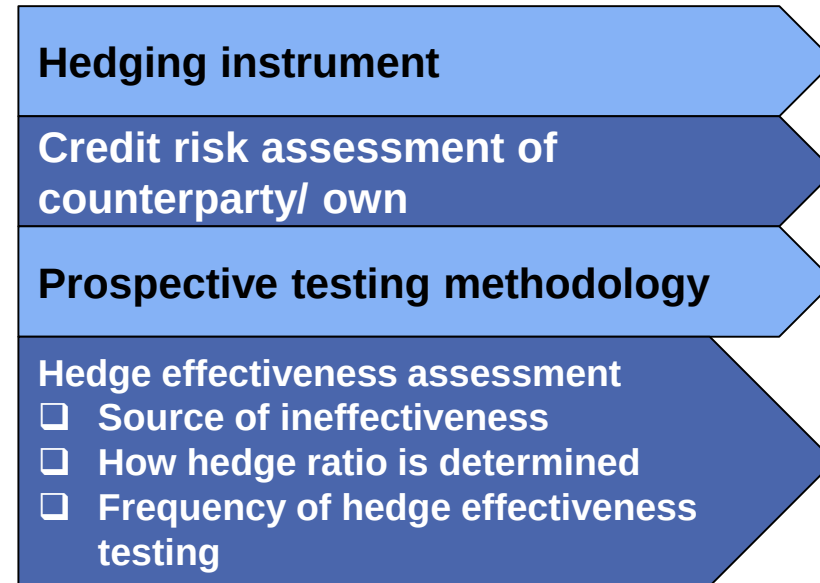
Designating a hedging relationship



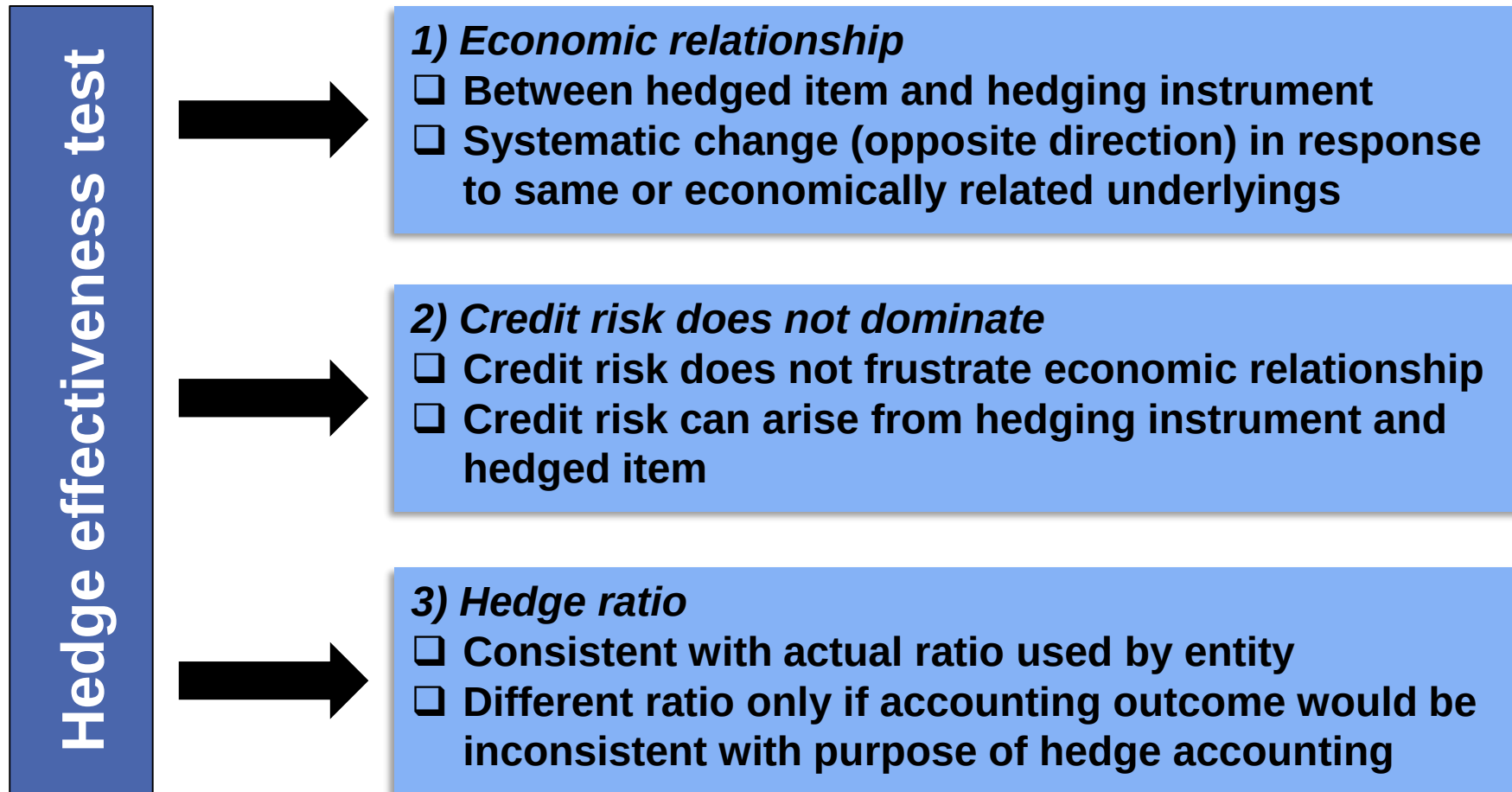
Examples of risk management strategy and risk management objective

Risk management strategy	Risk management objective
Maintain 40% of liabilities at floating interest rate	Designate an interest rate swap as a fair value hedge of a GBP 100m fixed rate liability
Assure long-term price stability of commodity purchases	Designate a coal forward contract to hedge the 100 tonnes of coal purchases in March 20XX
Hedge foreign currency risk of all forecast purchases in USD up to 12 months	Designate a foreign exchange forward contract to hedge the foreign exchange risk of the USD100 purchases in March 20XX

Key pointers to be considered in hedge documentation



Hedge effectiveness assessment: overview



Applying the effectiveness assessment in practice

1) Is there an economic relationship between hedged item and hedging instrument?

- ☐ The economic relationship requires causality, not only correlation
- ☐ Causality can usually be demonstrated with only a qualitative assessment
- ☐ However, the standard indicates that when the critical terms are not aligned closely, a quantitative analysis would have to support the conclusion that an economic relationship exists

2. Does the effect of credit risk dominate the fair value changes?

Credit risk in the hedging instrument

```
graph TD; A[Credit risk in the hedging instrument] --> B[Counterparty credit risk]; A --> C[Own credit risk];
```

Counterparty credit risk

Own credit risk

Credit risk in the hedged item

```
graph TD; D[Credit risk in the hedged item] --> E[Counterparty credit risk]; D --> F[Own credit risk];
```

Counterparty credit risk

Own credit risk

Applying the effectiveness assessment in practice (cont.)

- 3. Does the hedge ratio reflect an imbalance that would create hedge ineffectiveness resulting in an accounting outcome inconsistent with the purpose of hedge accounting?**

When does a hedge ratio result in an accounting outcome inconsistent with hedge accounting? For example:

- ☐ Deliberate under-hedging to avoid recognising hedge ineffectiveness in a cash flow hedge
- ☐ Deliberate under-hedging to achieve fair value accounting in a fair value hedge

Example:

For example, an entity hedges 100 units of forecast transaction with only 80 units of derivative, simply to avoid recognising hedge ineffectiveness under the 'lower of' test.

Case Study

A manufacturing company (AAA rated) in India, having INR as its functional currency, is expecting forecast sales in USD. The company assesses sales of USD 1mn for the next twelve months to be highly probable and wishes to hedge all of its forecasted sales by entering into a forward contract, with a well known bank having sound financial conditions, on the basis of its risk management policy. The company enters into a foreign exchange forward contract to hedge the forward rate risk of the highly probable USD sales and designates the forward contract as a hedging instrument.

Case Study (contd)

Risk Management Objective

Designate foreign exchange forward contract to hedge 100% of the foreign exchange risk on forecasted USD sales.

Type of hedge

Cash Flow Hedge

Hedge Documentation

- ☐ Risk management **strategy and objective**
- ☐ Hedged risk and hedging instrument
- ☐ Prospective effectiveness testing
- ☐ **Source of ineffectiveness**
- ☐ How **hedge ratio** is determined

Effectiveness Testing

Prospective Testing

- ☐ **Economic hedging:** Qualitative test – Critical terms matching (Currency, notional amount, start date and end date)
- ☐ **Credit Risk:** Credit risk of the company and counterparty is considered to be negligible
- ☐ **Hedge ratio:** The likely hedge ratio would be 1:1 to be in line with the risk management strategy of the company

Case Study

A company issued INR 100mn debt instrument recently. The entity, based on its policy, wishes to convert all of its fixed rate debt into debt with variable pay.

The treasurer enters into a INR 2mn receive fixed/pay variable IRS and designates the IRS in a hedge of INR 100mn of fixed rate liability. As a result, the entire INR 100mn of liability would be adjusted for changes in the hedged interest rate risk.

Case Study 2 (contd)

Risk Management Objective

Designate foreign exchange forward contract to hedge 100% of the foreign exchange risk on forecasted USD sales.

Type of hedge

Fair value hedge

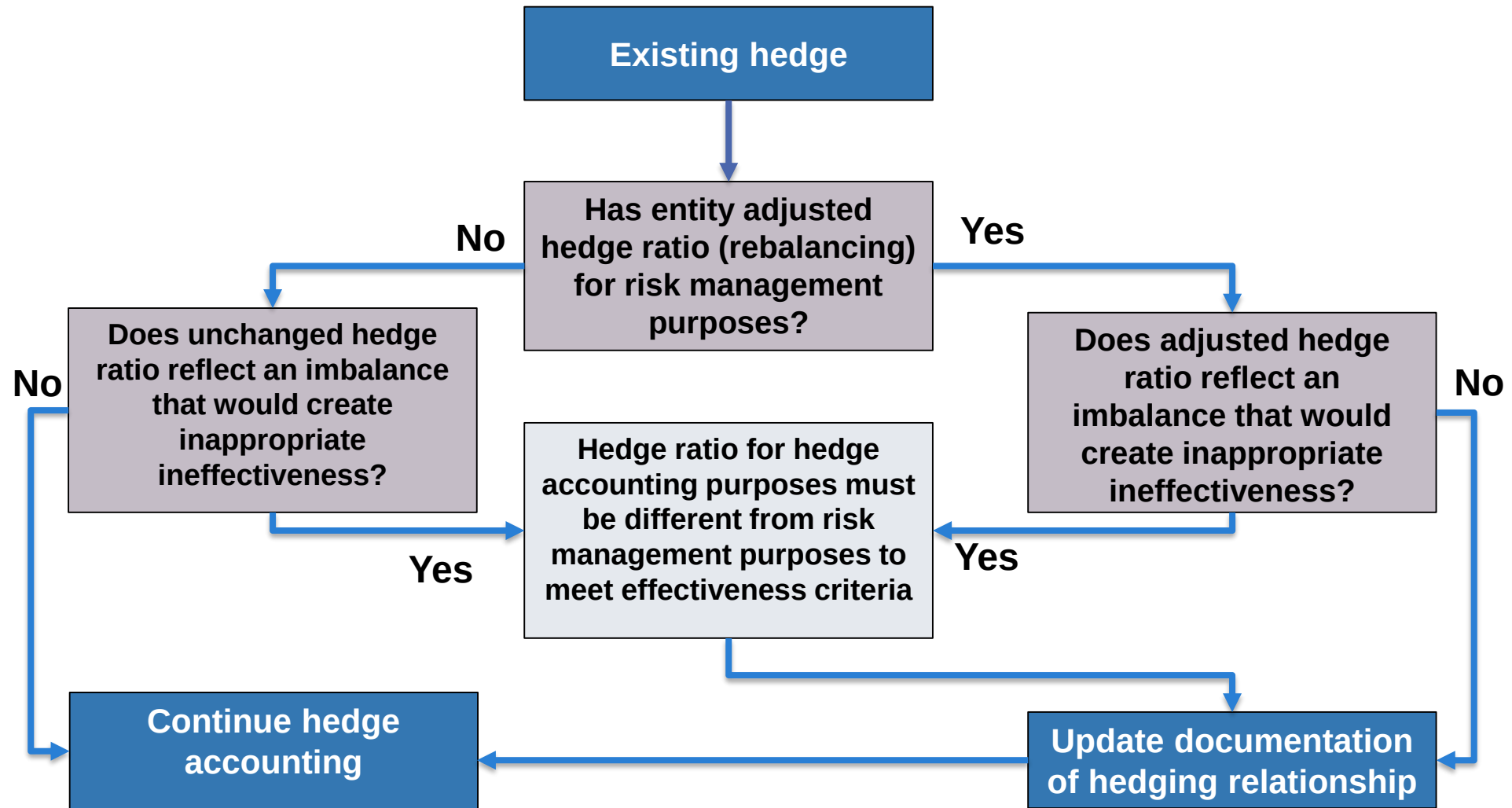
Is this a valid designation?

No, the designation is not valid.
The hedge ratio is unbalanced as the real purpose of the hedging relationship is to achieve fair value accounting (related to changes in interest rate risk) for INR 100mn of the liability

What should be the proper hedge ratio for the transaction to be a valid designation?

The hedge ratio used for hedge accounting purposes may be closer to 1:1

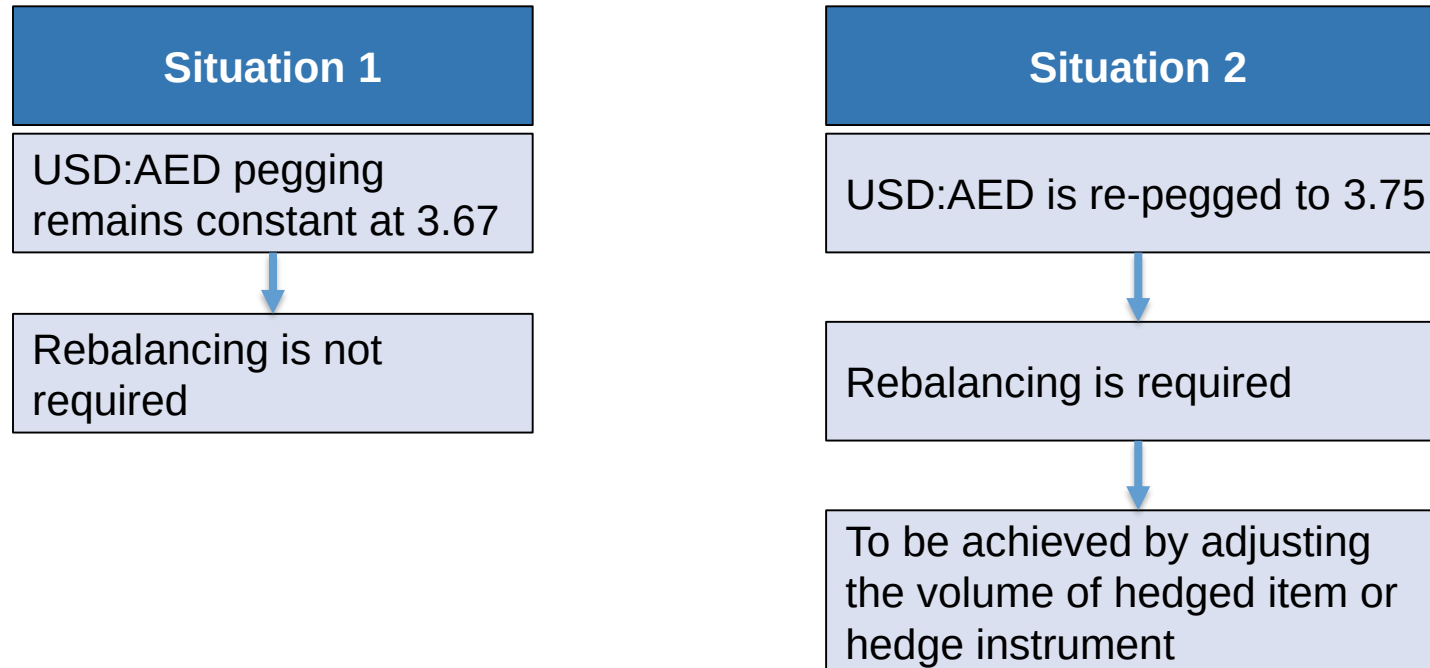
Rebalancing the hedge ratio - Overview



Rebalancing the hedge ratio: example

An entity with a INR functional currency has a forecast purchase in AED in six months' time amounting to AED 3.67 million. In order to hedge its future exposure, the entity wants to enter into foreign currency forward contract to effectively fix the purchase price in INR.

- ❑ The entity takes a USD:INR forward contract for USD 1 million as AED is pegged to the USD – USD 1 : AED 3.67



Discontinuing hedge accounting

- ☐ Is the hedged forecast transaction no longer highly probable?
- ☐ Is the hedging instrument expired, sold, terminated or exercised?
- ☐ Is the hedged item sold, settled or otherwise disposed of?
- ☐ Is the hedge no longer effective?



Discontinue hedge accounting prospectively and revert to accounting under usual principles



Fair value hedge:

- ☐ Cumulative FV adjustment is amortized to profit or loss by adjusting the effective interest rate of the hedged item measured at amortised cost



Cash flow hedge:

- ☐ **Forecast transaction still expected to occur** reclassify from OCI when transaction affects profit or loss i.e defer
- ☐ **Forecast transaction not expected to occur** reclassify from OCI to profit or loss immediately

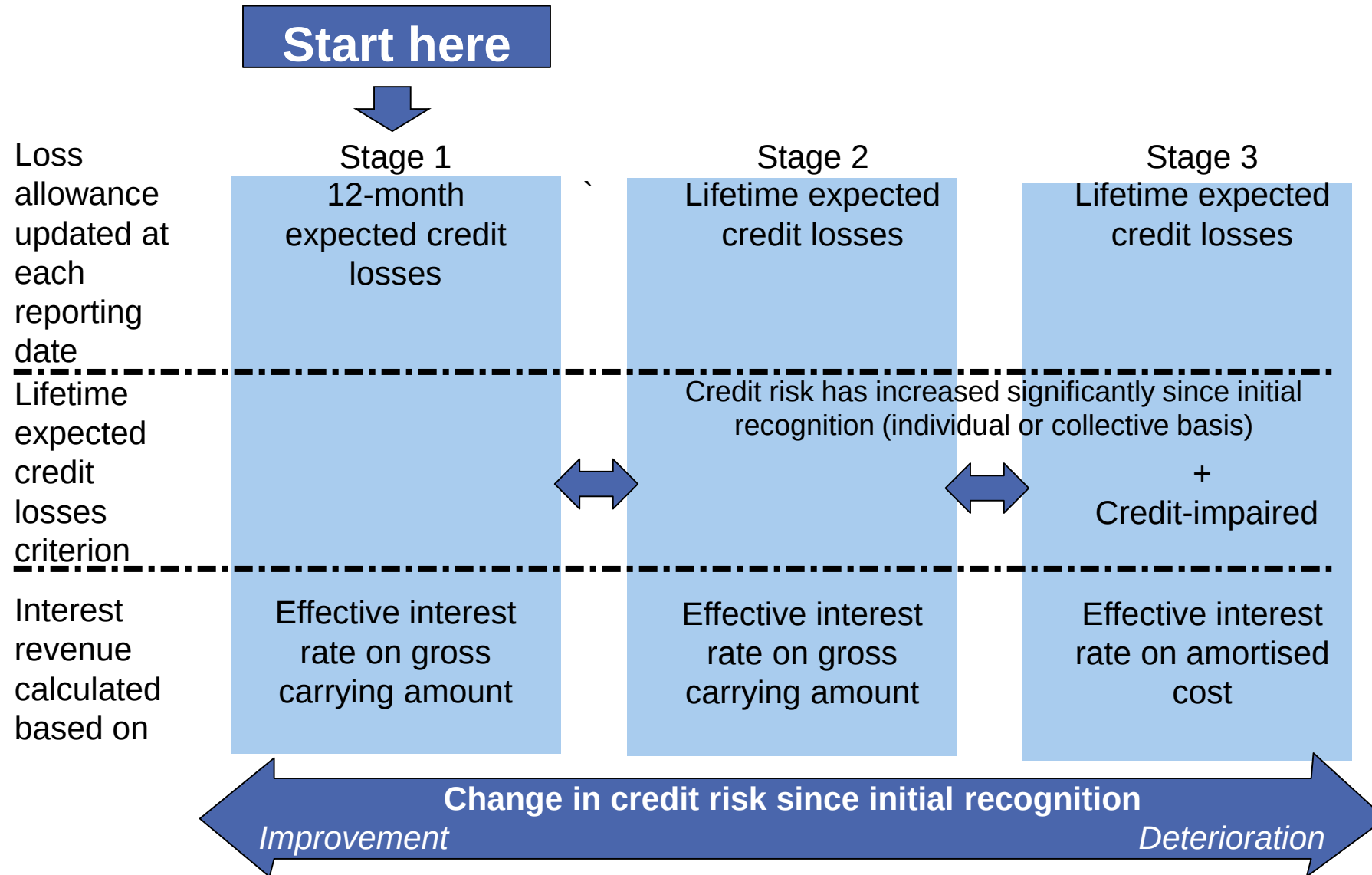
Impairment and Derecognition

Impairment- Financial instruments

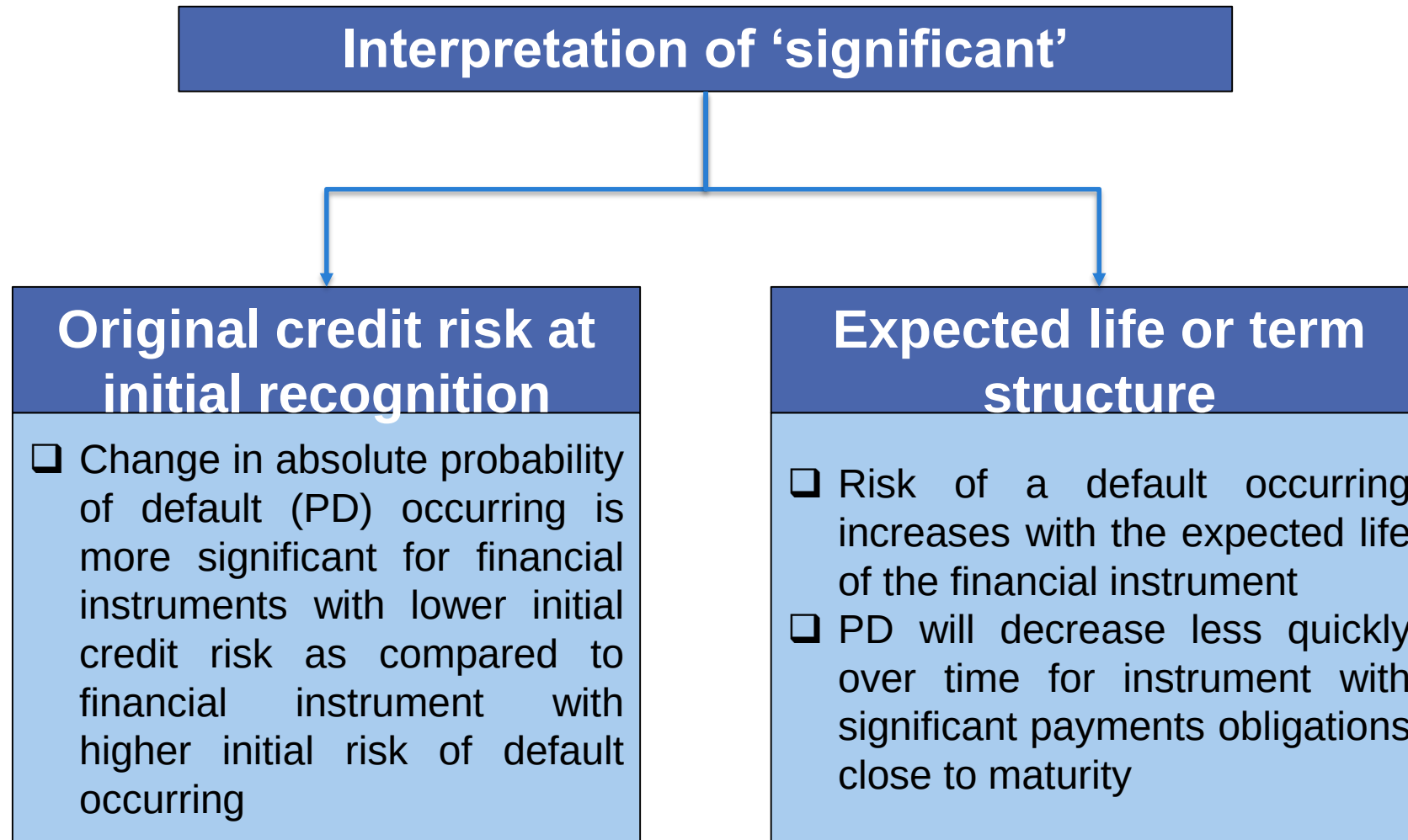
Scope

- ❑ The impairment requirements would apply to:
 - ❑ Debt instruments measured at amortised cost
 - ❑ Debt instruments measured at fair value through other comprehensive income
 - ❑ Loan commitments and financial guarantee contracts not measured at fair value through profit or loss
 - ❑ Trade receivables and contract assets
 - ❑ Lease receivables

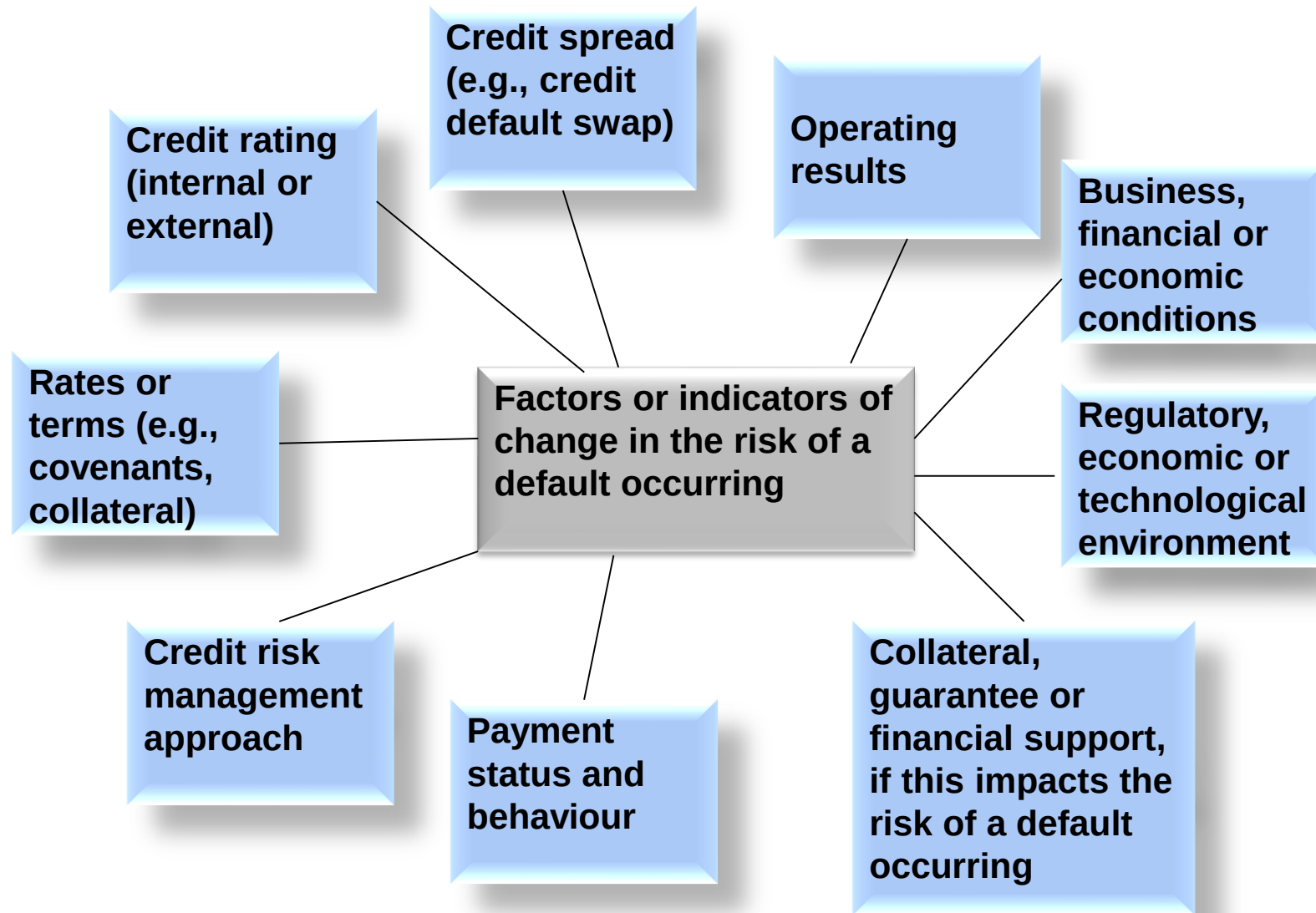
Expected credit loss model – general approach



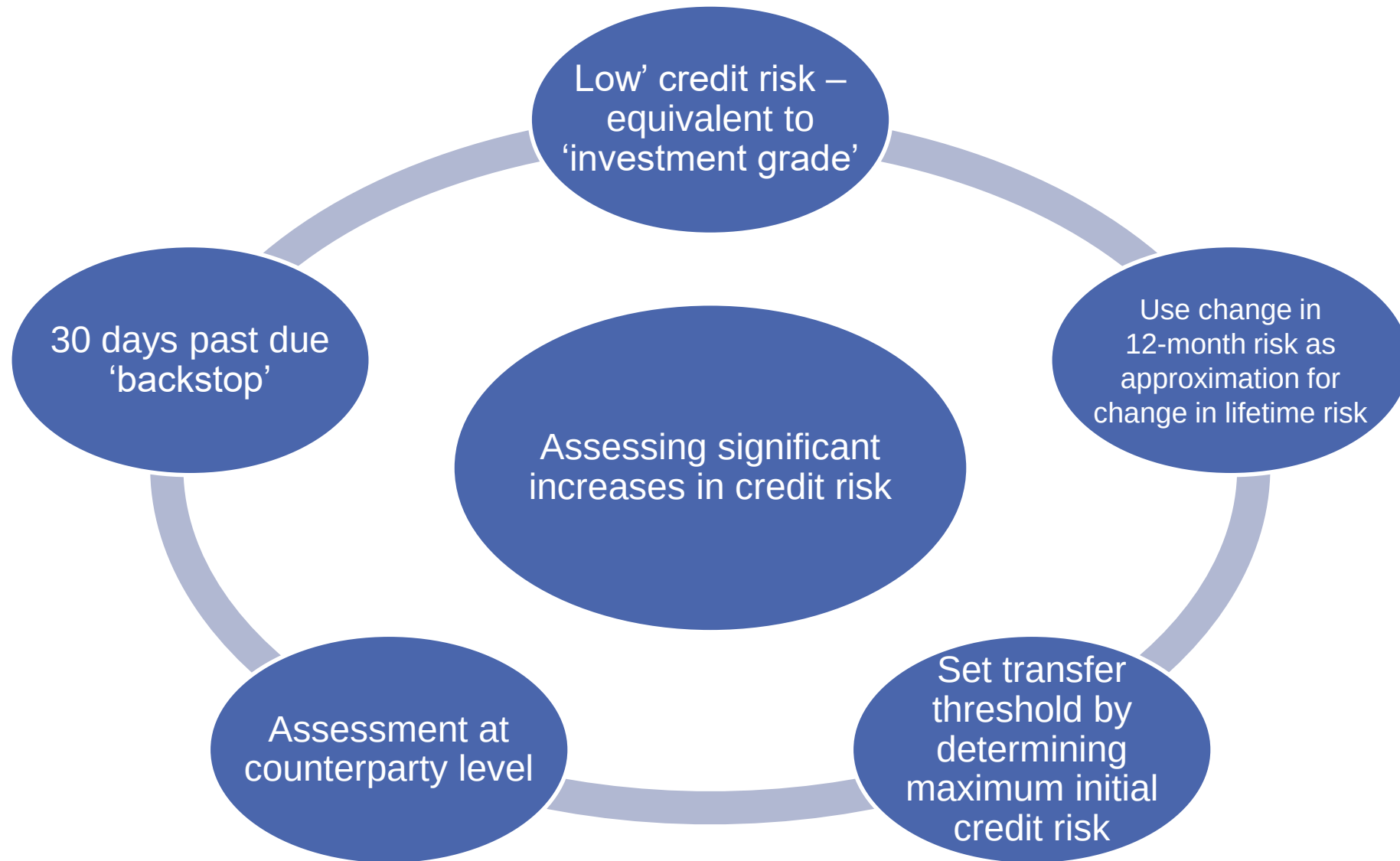
What is a 'significant' increase in credit risk?



Factors or indicators of change in the risk of a default occurring



General approach - simplifications and presumptions for assessing deterioration



Operational simplifications in assessing significant increases in credit risk

Low credit risk

For financial instruments that are equivalent to 'investment grade' quality, an entity would continue to recognise 12-month ECL

More than 30 days past due (DPD)

Rebuttable presumption that there is a significant increase in credit risk when contractual payments are more than 30 DPD

- ☐ An entity can assume that a financial instrument has not significantly increased in credit risk if it has low credit risk at the reporting date
- ☐ Low credit risk notion is *not* a bright-line trigger and financial instruments are *not* required to be externally rated

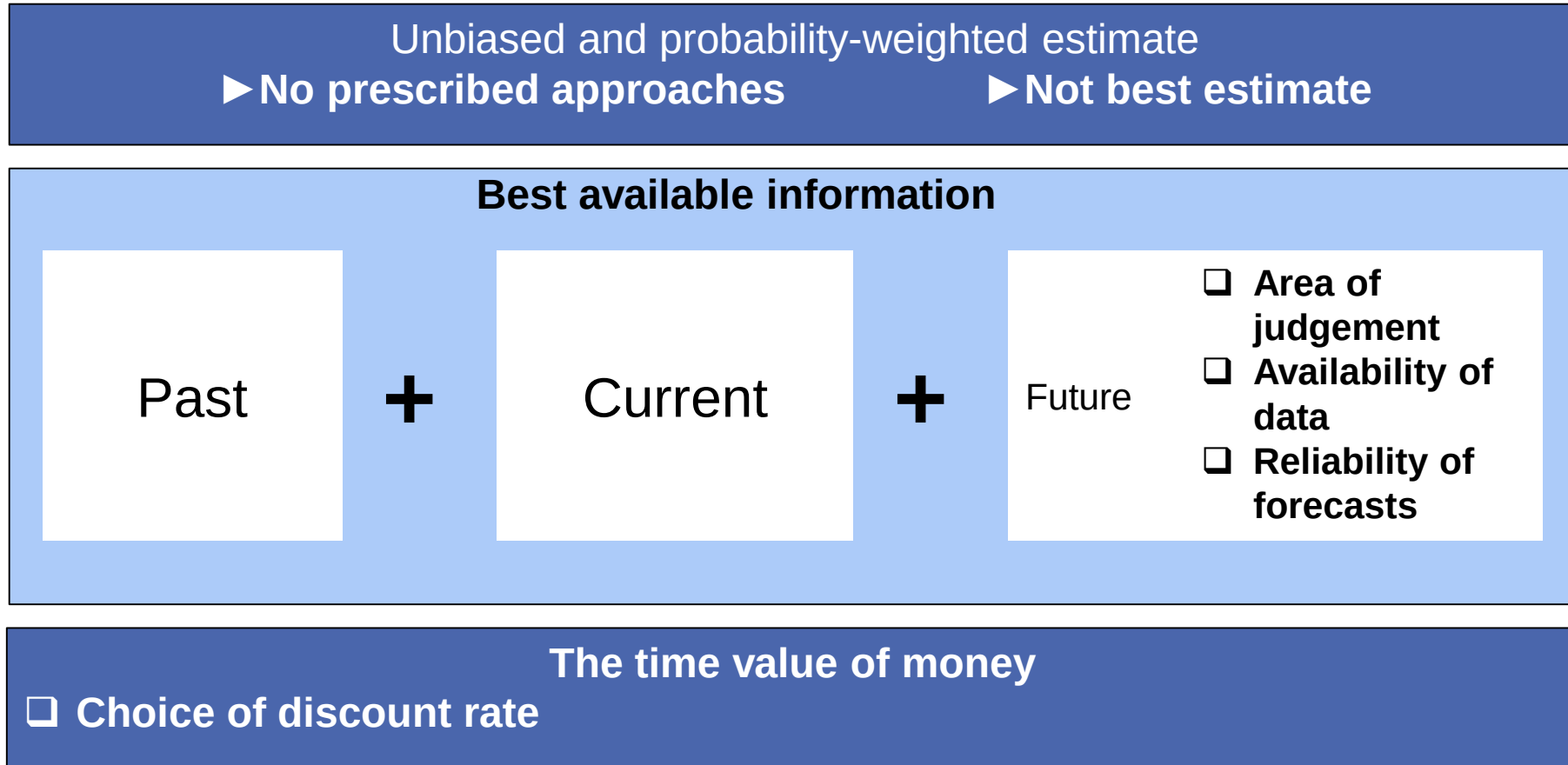
More than 30 DPD rebuttable presumption is intended to serve as a backstop and should identify significant increases in credit risk before default or objective evidence of impairment.

Simplified approach: Provision matrix

- ❑ According to the simplified approach, for trade receivables and contract assets that do not contain a significant financing component, an entity shall always measure loss allowance at an amount equal to lifetime expected credit losses.
- ❑ A provision matrix could be used to estimate ECL for these financial instruments.
- ❑ For example, an entity may set up the following provision matrix based on its historical observed default rates, which is adjusted for forward-looking estimates: Example-
 - ❑ non-past due: 0.3% of carrying value
 - ❑ 30 days past due: 1.6% of carrying value
 - ❑ 31-60 days past due: 3.6% of carrying value
 - ❑ 61-90 days past due: 6.6% of carrying value
 - ❑ more than 90 days past due: 10.6% of carrying value

Measuring expected credit losses: implementation challenges

- ☐ Defining default
- ☐ Determining 12-month and lifetime ECL



Example: Estimating expected credit losses – FVOCI (1/2)

On December 31, 2015, an entity 'Q' purchases a debt instrument with fair value of CU1,000 and classifies it as measured at FVOCI. The instrument is not credit-impaired. Q estimates 12 month expected credit losses for the instrument of CU 10. On initial recognition of the instrument, Q makes the following entries:

	Debit	Credit
Statement of Financial Position – debt securities	1000	
Statement of Financial Position – cash		1000
Profit or loss – impairment loss	10	
OCI		10

At the end of the next reporting period, the fair value of the debt instrument decreases to 950. Q concludes that there has not been a significant increase in credit risk since initial recognition and that the 12 month expected credit losses on December 31, 2016 are CU 30

Example: Estimating expected credit losses – FVOCI (2/2)

Accordingly, Q makes the following entries at that date:

	Debit	Credit
Statement of Financial Position – debt securities		50 (a)
Profit or loss – impairment loss	20 (b)	
OCI	30 (c)	

Notes:

- a) Calculated as 1000-950, being the amount needed to state the debt security at fair value as at reporting date.
- b) Calculated as 30-10, being the change in expected credit losses since initial recognition.
- c) Balancing amount.

Q also provides disclosures about accumulated impairment of 30

Derecognition of Financial Asset (1/2)

Determine whether the derecognition principles below are applied to a part or all of an asset (or group of similar assets)

Have the rights to the cash flows from the asset expired?

Derecognise the asset

Has the entity transferred its contractual rights to receive the cash flows from the asset?

Continue to recognise the asset

Has the entity assumed an obligation to pay the cash flows from the asset under pass-through arrangement?

Has the entity transferred substantially all risks and rewards?

Derecognise the asset

Has the entity retained substantially all risks and rewards?

Continue to recognise the asset

Has the entity retained control of the asset?

Derecognise the asset

Continue to recognise the asset to the extent of the entity's continuing involvement

Derecognition of Financial Asset (2/2)

When the entity's continuing involvement takes form of guaranteeing the transferred financial asset, Ind AS 39 states the extent of the entity's continuing involvement is lower of:

- ❑ Amount of the asset; and
- ❑ Maximum amount of the consideration received that the entity could be required to repay ("**guarantee amount**")

Additionally, when an entity continues to recognize an asset to extent of its continuing involvement, Ind AS 39 also requires entity to recognize an associated liability initially measured at guaranteed amount plus the fair value of the guarantee (which is normally consideration received for guarantee)

For example, Entity has loan portfolio carried at \$10 million with fair value of \$10.5 million. The entity sells the rights to 100% of cash flows to a third party for a payment of \$10.55 million, which includes a payment of \$50K in return for the transferor agreeing to absorb first \$1 million of default losses on portfolio.

 Treatment under Ind AS	Cash	10.55	
	Continuing involvement in assets	1.00	
	Loans transferred		10.00
	Liability (\$1M max + \$50K guarantee)		1.05
	Gain		0.50

Derecognition of financial liabilities

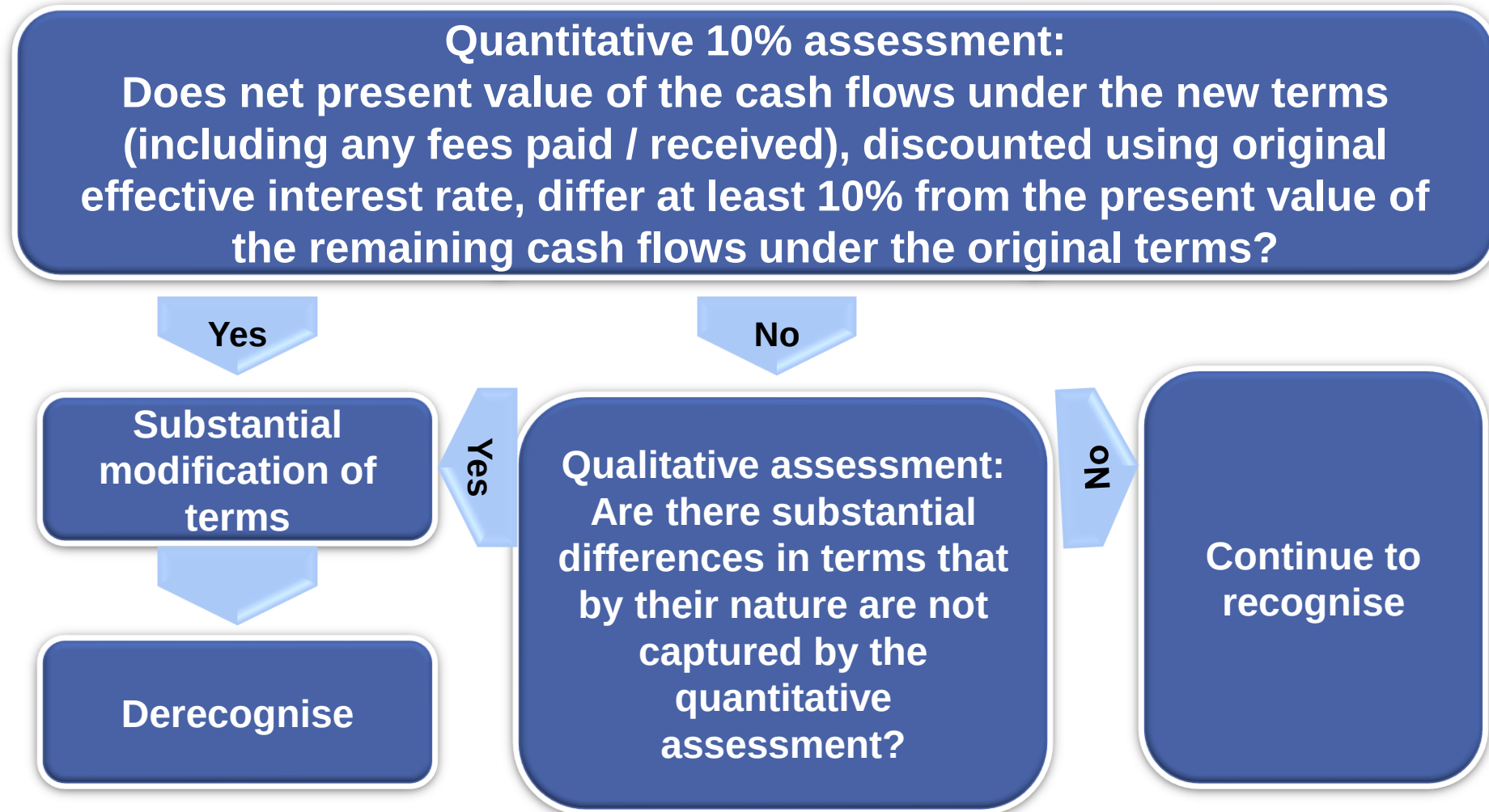
Is the obligation in the contract discharged,
cancelled or expired?

```
graph TD; A[Is the obligation in the contract discharged, cancelled or expired?] --> B[Financial liability is extinguished]; B --> C[Derecognise];
```

Financial liability is extinguished

Derecognise

Modification of terms



Accounting for an extinguishment

A gain or loss is recognised based on the difference between the carrying amount of the financial liability extinguished and the consideration paid

The consideration paid includes non-financial assets transferred and the assumption of liabilities, including the new modified financial liability

Any new financial liability recognised is measured initially at fair value

Any costs or fees incurred are recognised as part of the gain or loss on extinguishment

Accounting for a modification of terms that is not substantial

No gain or loss is recognised

Carrying amount of liability is adjusted for fees and transaction costs

Fees, transaction costs and difference in present value due to modification amortised over remaining new life of the liability

Any difference in present value arising as a result of the modification is recognised as an adjustment to effective interest rate

Classes of financial instruments

- ❑ Entity shall group financial instruments into classes that:
 - ❑ Are appropriate to the nature of the information disclosed; and
 - ❑ Take into account the characteristics of those financial instruments
- ❑ Entity shall provide sufficient information to permit reconciliation to the line items presented in the balance sheet
- ❑ May be distinct from the categories specified in Ind AS 109
- ❑ In determining classes, at a minimum:
 - ❑ Distinguish instruments measured at amortised cost from those measured at fair value
 - ❑ Treat financial instruments outside the scope of ind AS 107 as a separate class or classes
- ❑ Strike a balance between:
 - ❑ Overburdening Financial Statements With Excessive Details; And
 - ❑ Obscuring important information as a result of too much aggregation

Balance sheet disclosures

Categories of financial assets and financial liabilities

- ☐ Disclose carrying amounts of the following categories either in the balance sheet or in the notes:
 - ☐ Financial assets at fair value through profit or loss (FVTPL), showing separately:
 - ☐ Designated as such upon initial recognition; and
 - ☐ Classified as held-for-trading
 - ☐ Financial assets at amortized cost
 - ☐ Financial assets at fair value through other comprehensive income (FVOCI)
 - ☐ Financial Liabilities carried at amortised cost
 - ☐ Financial liabilities at fair value through profit or loss (FVTPL), showing separately:
 - ☐ Designated as such upon initial recognition; and
 - ☐ Classified as held-for-trading
- ☐ Carrying amounts of financial instruments classified as held for trading and those designated at fair value through profit or loss are shown separately because designation is at the discretion of the entity

Balance sheet disclosures (cont'd.)

Financial assets or financial liabilities at FVTPL

- ☐ Disclosure: If loans and receivables has been designated at FVTPL
 - ☐ Maximum exposure to credit risk
 - ☐ Amount by which any credit derivative or similar instrument mitigate that maximum exposure to credit risk
 - ☐ Change in fair value of loans and receivables that is attributable to changes in credit risk
 - ☐ Amount of the change in fair value of any related credit derivatives or other similar instruments

- ☐ Disclosures: If financial liabilities is designated at FVTPL
 - ☐ Change in fair value of financial liability due to credit risk
 - ☐ Difference between carrying amount and contractual amount

Balance sheet disclosures (cont'd.)

Other disclosures

Reclassification:

- ☐ Reclassification of financial assets from at cost/ amortised cost measurement to fair value measurement and vice versa:
 - ☐ The amount reclassified into and out of each category and
 - ☐ The reason for that reclassification
- ☐ Reclassification of financial assets out of FVTPL or FVOCI category:
 - ☐ The amount reclassified into and out of each category
 - ☐ Carrying Amounts and fair values of all financial assets previously reclassified
 - ☐ Fair value gain or loss on financial asset on reclassification recognized in profit or loss or other comprehensive income
 - ☐ For each reporting period following reclassification, fair value gain or loss that would have been recognized in profit or loss or other comprehensive income is the asset had not been reclassified, and gain, loss, income and expense recognized in profit and loss
 - ☐ Effective interest rate and estimated amounts of cash flows that entity expects to recover, as at the date of reclassification

Balance sheet disclosures (cont'd.)

Other disclosures

De-recognition:

- ☐ Entity may have transferred financial asset in such a way that part or all of the financial assets do not qualify for de-recognition. Entity shall disclose for each class of such financial assets:
 - ☐ Nature of the asset
 - ☐ Nature of the risks and rewards of ownership to which entity remains exposed
 - ☐ When the entity continues to recognise all the assets, the carrying amounts of the assets and of the associated liabilities
 - ☐ When the entity continues to recognise the assets to the extent of its continuing involvement, the total carrying amount of the original assets, the amount of the assets that the entity continues to recognise, and the carrying amount of the associated liabilities.

Balance sheet disclosures (cont'd.)

Other disclosures

Collateral:

- ☐ Collateral given:
 - ☐ Carrying amounts of financial assets pledged as collateral for liabilities or contingent liabilities
 - ☐ Terms and conditions relating to its pledge
- ☐ Collateral received:
 - ☐ Fair value of collateral held
 - ☐ the fair value of any such collateral sold or re-pledged, and whether the entity has an obligation to return it;
 - ☐ Terms and conditions associated with its use of collateral
- ☐ Allowances for credit losses: reconciliation for each class of financial asset
- ☐ Compound financial instruments: multiple embedded derivatives whose values are independent
- ☐ Defaults and breaches: carrying amount and details of defaults for loans payable

Profit and loss statement disclosures

Entity shall disclose following items either in statement of profit and loss or in the notes:

- ☐ Net gains / losses on:
 - ☐ Financial assets or liabilities at FVTPL and those that are classified as held for trading
 - ☐ Financial assets at FVOCI
 - ☐ Financial assets at amortized cost
 - ☐ Financial liabilities measured at amortized cost
- ☐ Total interest income and total interest expense (other than FVTPL)
- ☐ Fee income and expense for financial instruments (other than FVTPL)
- ☐ Interest income accrued on impaired financial assets
- ☐ Impairment losses for each class of financial assets

Other disclosures

- ❑ Accounting policy disclosures (in accordance with Ind AS 1):
 - ❑ The measurement basis (or bases) used in preparing the financial statements
 - ❑ The other accounting policies used that are relevant to an understanding of the financial statements
- ❑ Examples of accounting policies:
 - ❑ FVTPL (nature, criteria and conditions met for designation)
 - ❑ Criteria for designation as FVOCI
 - ❑ Whether trade date or settlement date is used for regular way purchases and sales
 - ❑ Allowance for credit losses, including criteria for write-offs
 - ❑ Determination of net gains or net losses for each category
 - ❑ Criteria to determine objective evidence of impairment

Hedge accounting disclosures – overview

Disclosure	Fair value hedges	Cash flow hedges	Net investment hedge
Description of each type of hedge, financial instrument designated as hedging instrument along with fair value at the end of reporting period, nature of risk being hedged	✓	✓	✓
When hedged cash flows are expected to occur and expected to affect P&L		✓	
Forecast transactions no longer expected to occur		✓	
Amount recognised in other comprehensive income during the period		✓	
Gain or loss recognized in equity and reclassifications to P&L		✓	
Gain or loss from hedging instrument and on hedged item	✓		
Ineffectiveness recognized in P&L		✓	✓
Amount removed from equity and included in initial cost or other carrying amount of non-financial asset or liability whose acquisition or incurrence was a hedged highly probable forecast transaction		✓	

Fair value disclosures

- ❑ Fair value for each class of financial assets and liabilities in a way that permits it to be compared with its carrying amount
- ❑ Methods and significant assumptions applied in determining fair value for each class of financial assets and liabilities
- ❑ Change in valuation technique and reason for making the change.
- ❑ Financial instruments whose carrying value approximates fair value exempt from required disclosures e.g. short term receivables and payables.

Fair value disclosures (cont'd.)

- ❑ Fair value measurements to be disclosed following fair value hierarchy that reflects the significance of inputs used in making the measurements:
 - ❑ Quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1)
 - ❑ Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly (as prices) or indirectly (derived from prices) (Level 2)
 - ❑ Inputs for the asset or liability that are not based on observable market data (unobservable inputs) (Level 3)
- ❑ Level of fair value hierarchy within which the fair value measurement is categorized in its entirety shall be determined on the basis of the lowest level input that is significant to the fair value measurement in its entirety.
- ❑ Assessing the significance of a particular input to the fair value measurement in its entirety requires judgement, considering factors specific to the asset or liability

Fair value disclosures (cont'd.)

- ❑ The three-level hierarchy disclosures required only for financial instruments recorded at fair value
- ❑ For Level 3 fair value measurements,
 - ❑ Reconciliation is required between the beginning and ending balances, including:
 - ❑ Total gains or losses for the period split between those recognised in P&L and those recognised in OCI
 - ❑ Purchases, sales, issues and settlements
 - ❑ Transfers into and out of Level 3, with 'significant' transfers into the category disclosed separately from transfers out, along with the reasons for those transfers
- ❑ Details of any 'significant' transfers between Level 1 and Level 2 and the reasons for the transfers

Examples: financial instruments and their levels in the fair value hierarchy

Instrument characteristics	Considerations	Conclusion
An instrument traded in an active market for which one or more market participants provide a binding price quotation on the balance sheet date.	A binding quote is a bid price and is evidence of the amount for which an asset could be exchanged, between knowledgeable, willing parties, in an arm's length transaction.	Level 1
An instrument for which there is currently no active market. An observable, recent transaction took place in this particular instrument. This was sufficiently close to the balance sheet date that no adjustments were deemed necessary to calculate the fair value	Whether a transaction was sufficiently 'recent' will depend on market conditions. Even if there is very little market volatility, in our view, they should generally not be older than 14 days . It is important that no events have happened to the issuer, the instrument or the environment since it was traded, that would indicate a possible, subsequent change in fair value	Level 2
An equity instrument for which there is currently no active market. The entity uses a valuation model which is accepted in the market/industry based on a price/earnings ratio for similar entities. No statistical technique is used to corroborate.	Although the calculation of a price/earnings ratio is usually based on market transactions, the application of the ratio is not evidence of market transactions in the same instrument	Level 3

Nature & extent of risks

- ☐ Disclosures on risks that arise from financial instruments and how they have been managed.
- ☐ Qualitative disclosures: for each type of risk arising from financial instruments, an entity shall disclose:
 - ☐ The exposures to risks and how they arise
 - ☐ Its objectives, policies and processes for managing the risk and the methods used to measure the risk
 - ☐ Any changes in above two from the previous period
- ☐ Quantitative disclosures: for each type of risk arising from financial instruments, an entity shall disclose:
 - ☐ Summary quantitative data about its exposure to that risk at the end of the reporting period.
 - ☐ This disclosure shall be based on the information provided internally to key management personnel of the entity
 - ☐ Disclosures regarding amounts of exposures to credit risk, liquidity risk, market risk
 - ☐ Concentration of risk if not apparent from the disclosures made as per above two points

Credit risk

- ❑ Maximum exposure to credit risk at the end of reporting period
- ❑ Description of collateral held as security and other credit enhancements and their financial effects
- ❑ Information about credit quality of financial assets that are neither past due nor impaired
- ❑ Ageing analysis for financial assets that are past due or impaired
- ❑ Disclosures regarding collateral and other credit enhancements obtained

Illustrative credit risk disclosure by Coca Cola Amatil, Australia: Quantitative disclosure

The financial assets that are exposed to credit risk are detailed in the table below –			
	Refer Note	2013 \$M	2012 \$M
Cash assets	6	1,425.9	1,178.0
Long term deposits		–	150.0
Trade and other receivables	7	965.9	963.1
Derivative assets	31	75.3	59.9
Other financial assets	9	–	24.4
Total CCA Group		2,467.1	2,375.4

Credit risk disclosure

Qualitative disclosure:

iv) Credit risk

Credit risk is the risk that a contracting entity will not fulfil its obligations under the terms of a financial instrument and will cause the Group to make a financial loss. The Group has exposure to credit risk on all financial assets included in the Group's statement of financial position. To help manage this risk, the Group –

- has a policy for establishing credit limits for the entities it deals with;
- may require collateral where appropriate; and
- manages exposures to individual entities it either transacts with or enters into derivative contracts with (through a system of credit limits).

The Group is exposed to credit risk on derivative financial instruments. For credit purposes, there is only a credit risk where the contracting entity is liable to pay the Group in the event of a closeout. The Group has policies that set limits as to the amount of credit exposure to each financial institution. New derivatives and cash transactions are limited to financial institutions that meet minimum credit rating criteria in accordance with the Group's policy requirements.

Customer credit risk is managed by each business unit subject to established policy, procedures and controls relating to customer risk management. Credit limits are set for each customer and these are regularly monitored. Outstanding receivables are regularly monitored and the requirement for impairment is analysed each reporting period.

The Group's credit risk is mainly concentrated across a number of customers and financial institutions. The Group does not have any significant credit risk exposure to a single or group of customer(s) or individual institution(s). Approximately 74.6% (2012: 68.1%) of the trade receivables balance as at balance date is reflected by the total of each operation's top five customers.

Liquidity risk

- ❑ Liquidity risk is the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset
- ❑ Entity shall disclose:
 - ❑ Maturity analysis for non-derivative financial liabilities
 - ❑ Maturity analysis for derivative financial liabilities
 - ❑ A description of how it manages the liquidity risk inherent in the above requirement

Example: Quantitative disclosure – Liquidity risk

As at 31 March 2014	Carrying value	Total contractual cash-outflow	Expected timing of contractual cash flows			
			Less than 1 year	1 year to 2 years	2 years to 5 years	Over 5 years
Financial Liabilities						
Trade and other payables	XX	XX	XX	-	-	-
Interest bearing liabilities	XX	XX	XX	XX	XX	XX
Derivative financial instruments	XX	XX	XX	-	-	-

Qualitative disclosure:

- ❑ The Group monitors its risk of shortage of funds using a liquidity planning tool.
- ❑ The Group's objective is to maintain a balance between continuity of funding and flexibility through the use of bank overdrafts, bank loans, debentures, preference shares, finance leases and hire purchase contracts. The Group's policy is that not more than 25% of borrowings should mature in the next 12 month period. Approximately 10% of the Group's debt will mature in less than one year at 31 December 2014 (2013:11%) based on the carrying value of borrowings reflected in the financial statements. The Group assessed the concentration of risk with respect to refinancing its debt and concluded it to be low. The Group has access to a sufficient variety of sources of funding and debt maturing within 12 months can be rolled over with existing lenders.

Example – market risk

☐ Market risks

Market risk is “the risk that the fair value or future cash flows of a financial instruments will fluctuate because of changes in market prices and includes interest rate risk, foreign currency risk and other price risk.”

☐ Disclosure

☐ Sensitivity analysis for each type of market risk

- ☐ Market risk sensitivity analysis includes the effect of ‘a reasonably possible change’ in risk variables in existence at balance sheet date if applied to all risks in existence at that date.

- ☐ Reasonable possible change is not remote or ‘worst-case’ scenarios or ‘stress tests

☐ Affect on profit or loss and equity

☐ Methods and assumption used in analysis

☐ Changes for previous period

☐ Reason for change

Example – market risk (Cont'd.)

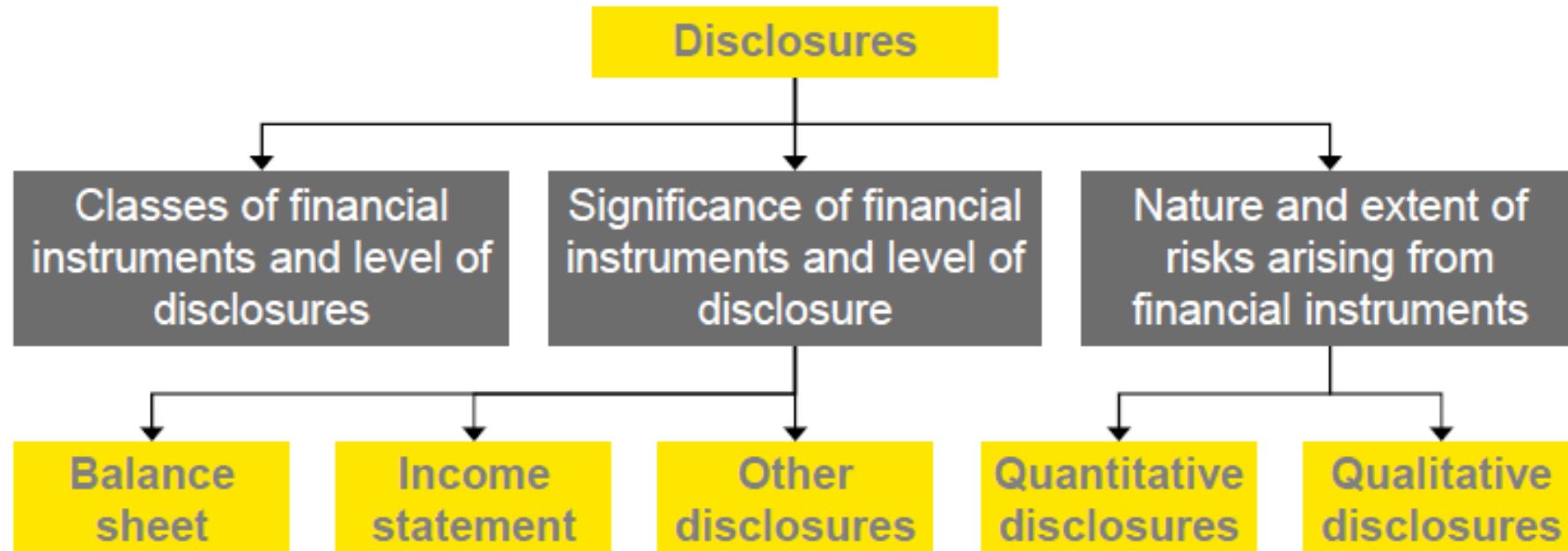
Interest rate sensitivity

The following table demonstrates the sensitivity to a reasonably possible change in interest rates on that portion of loans and borrowings affected, after the impact of hedge accounting. With all other variables held constant, the Group's profit before tax is affected through the impact on floating rate borrowings, as follows:

	Increase/decrease in basis points	Effect on profit before tax €000
2014		
Euro	+45	(48)
US dollar	+60	(13)
Euro	-45	33
US dollar	-60	12
2013		
Euro	+10	(19)
US dollar	+15	–
Euro	-10	12
US dollar	-15	–

The assumed movement in basis points for the interest rate sensitivity analysis is based on the currently observable market environment, showing a significantly higher volatility than in prior years.

IFRS 7 – disclosure summary



Summary

Classification of Liabilities and equity:

- Liabilities include a contractual obligation to pay cash or exchange financial instruments.
- Equity- no such obligation

Financial liabilities measured at either:

- Fair value through P/L A/c, or
- Amortised costs

Derivatives (assets and liabilities)

- Include options, swaps, forward contracts and future contracts.
- Categorised as fairvalue through P/L A/c unless used as hedge.
- Embedded derivatives are included in another non-derivative contracts- need to split from host contracts

Financial Assets:

- Initial recognition at fair value.
- Subsequent measurement depends on categorisation:
 - Fair value through P/L A/c is the default position.
 - Fair value through other comprehensive income – elect upon recognition of equity instruments only.
 - Amortised costs – elect upon initial recognition provided two tests pass:
 - Business model test
 - Cash flow characteristics test.

Impairment of Financial Assets:

- Need to review annually for evidence of impairment.
- If measured at Fair Value then impairment is accounted in P/L A/C other OCI as per categorisation
- If measured at amortised costs, impairment is accounted in P/L A/C

Disclosure Requirements:

- Significance of financial Instruments
- Nature and significance of risks
- Quantitative and Qualitative issues.

Ind AS 104 – Insurance Contracts

Scope

Ind-AS 104 applies to virtually all insurance contracts (including reinsurance contracts) that an entity issues, to reinsurance contracts that it holds and financial instruments that it issues with discretionary participation feature.

It does not apply to product warranties, employee benefit plans, contractual rights or contractual obligations that are contingent on the future use of, or right to use, lessee's residual value guarantee embedded in a finance lease, financial guarantee contracts unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts and contingent consideration payable or receivable in a business combination. It does not address accounting by policyholders.

Definition of insurance contract

An insurance contract is a "contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder."

Accounting policies

The Ind-AS 104 exempts an insurer temporarily from some requirements of other Ind-ASs, including the requirement to consider Ind-AS 8 Accounting Policies, Changes in Accounting Estimates and Errors in selecting accounting policies for insurance contracts. However, the standard: prohibits provisions for possible claims under contracts that are not in existence at the reporting date (such as catastrophe and equalisation provisions) requires a test for the adequacy of recognised insurance liabilities and an impairment test for reinsurance assets requires an insurer to keep insurance liabilities in its balance sheet until they are discharged or cancelled, or expire, and prohibits offsetting insurance liabilities against related reinsurance assets and income or expense from reinsurance contracts against the expense or income from the related insurance contract.

Changes in accounting policies

Ind-AS 104 permits an insurer to change its accounting policies for insurance contracts only if, as a result, its financial statements present information that is more relevant and no less reliable, or more reliable and no less relevant. In particular, an insurer cannot introduce any of the following practices, although it may continue using accounting policies that involve them:

- ✓ measuring insurance liabilities on an undiscounted basis
- ✓ measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current market-based fees for similar services
- ✓ using non-uniform accounting policies for the insurance liabilities of subsidiaries.

LIABILITY ADEQUACY TEST

An insurer is required to assess at the end of each reporting period whether its recognised insurance liabilities are adequate, using current estimates of future cash flows under its insurance contracts. If that assessment shows that the carrying amount of its insurance liabilities is not sufficient, the liability is increased and a corresponding expense is recognised in profit or loss.

Re-measuring insurance liabilities

Ind-AS 104 permits the introduction of an accounting policy that involves re-measuring designated insurance liabilities consistently in each period to reflect current market interest rates (and, if the insurer so elects, other current estimates and assumptions). Without this permission, an insurer would have been required to apply the change in accounting policies consistently to all similar liabilities.

An insurer need not change its accounting policies for insurance contracts to eliminate excessive prudence. However, if an insurer already measures its insurance contracts with sufficient prudence, it should not introduce additional prudence.

Future investment margins

There is a rebuttable presumption that an insurer's financial statements will become less relevant and reliable if it introduces an accounting policy that reflects future investment margins in the measurement of insurance contracts.

Ind-AS 104:

- clarifies that an insurer need not account for an embedded derivative separately at fair value if the embedded derivative meets the definition of an insurance contract
- requires an insurer to unbundle (that is, to account separately for) deposit components of some insurance contracts, to avoid the omission of assets and liabilities from its balance sheet
- clarifies the applicability of the practice sometimes known as 'shadow accounting'
- permits an expanded presentation for insurance contracts acquired in a business combination or portfolio transfer
- addresses limited aspects of discretionary participation features contained in insurance contracts or financial instruments.

Ind-AS 104 requires disclosure of:

❑ **information that helps users understand the amounts in the insurer's financial statements that arise from insurance contracts:**

- ❖ accounting policies for insurance contracts and related assets, liabilities, income, and expense
- ❖ the recognised assets, liabilities, income, expense, and cash flows arising from insurance contracts
- ❖ if the insurer is a cedant, certain additional disclosures are required
- ❖ information about the assumptions that have the greatest effect on the measurement of assets, liabilities, income, and expense including, if practicable, quantified disclosure of those assumptions
- ❖ the effect of changes in assumptions
- ❖ reconciliations of changes in insurance liabilities, reinsurance assets, and, if any, related deferred acquisition costs

Disclosures contd....

❑ Information that helps users to evaluate the nature and extent of risks arising from insurance contracts:

- ❖ risk management objectives and policies
- ❖ those terms and conditions of insurance contracts that have a material effect on the amount, timing, and uncertainty of the insurer's future cash flows
- ❖ information about insurance risk (both before and after risk mitigation by reinsurance), including information about:
 - the sensitivity to insurance risk
 - concentrations of insurance risk
 - actual claims compared with previous estimates
- ❖ the information about credit risk, liquidity risk and market risk that Ind-AS 107 would require if the insurance contracts were within the scope of Ind-AS 107
- ❖ information about exposures to market risk arising from embedded derivatives contained in a host insurance contract if the insurer is not required to, and does not, measure the embedded derivatives at fair value.

Documents referred in this Section:

The Ind-AS are available as hyperlink. Hyper links are underlined.

Sl.	Ind-AS	Topic
1	107	<u>Financial Instruments: Disclosures</u>
2	109	<u>Financial Instruments</u>
3	32	<u>Financial Instruments: Presentation</u>
4	104	<u>Insurance Contracts</u>
Additionally, the following Ind-AS provides guidance on fair value measurements. Discussions on Fair value measurement is in e-module Series 1: Ind-AS Framework		
5	113	<u>Fair Value Measurement</u>



Questions & Answers

THANK YOU

For further information please contact

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