

3. Financial instruments



Summary

This chapter covers:

- Ind AS 32, *Financial Instruments: Presentation*
- Ind AS 107, *Financial Instruments: Disclosures*
- Ind AS 109, *Financial Instruments*



Transactions in financial instruments are pervasive across many entities in India. Financial instruments include financial assets, financial liabilities, equity instruments, compound financial instruments, etc. Under the Ind AS framework, detailed guidance on recognition, classification, measurement, presentation and disclosure of financial instruments is available in three Ind AS (collectively referred to as the 'FI standards' in the chapter).





Key principles

- Financial instruments that give rise to a contractual obligation to deliver cash or another financial asset are classified as financial liabilities. Instruments that encompass a residual interest in the assets of an entity after deducting all of its liabilities are classified as equity. Instruments may also have a component of both - liability and equity, these components will be classified and presented separately.
- Puttable instruments are generally classified as financial liabilities, however, Ind AS 32 specifies the conditions under which these can be considered as 'equity'.
- Interest, dividends, losses and gains on financial instruments or their components are recorded either in the statement of profit and loss or in Other Comprehensive Income (OCI), depending upon the classification of the related instrument as financial liability or equity.
- Financial assets are classified on initial recognition and subsequently measured at amortised cost, Fair Value Through Profit or Loss (FVTPL) or Fair Value Through Other Comprehensive Income (FVOCI), depending upon the business model within which they are held and the contractual cash flows of the instrument (i.e. whether the contractual cash flows are solely in the nature of principal and interest on the principal amount outstanding).
- Financial assets measured at amortised cost and at FVOCI are assessed for impairment at each reporting date, using an Expected Credit Loss (ECL) model.
- A modification in the terms of financial instruments may result in their derecognition. The FI standards prescribe accounting for such modifications, and the conditions that would result in derecognition.
- Hybrid contracts may be treated as a single financial instrument measured at FVTPL, or under certain specified conditions, embedded derivatives may be separated from the host contract, and accounted for separately.
- All derivatives are generally classified as and measured at FVTPL, with mark-to-market gains and losses being recognised in the statement of profit and loss. However, those derivatives that qualify as hedging instruments and are designated in a hedging relationship, are treated in accordance with the hedge accounting principles prescribed by the FI standards.
- The hedge accounting principles permit excluding the time value of options, forward element of forward contracts, and foreign currency basis spread of currency swaps from the designated hedging instrument. These components may be separately recognised as a 'cost of hedging'.
- Financial assets and financial liabilities are required to be presented on a gross basis. However, an entity may offset these and present them as a net amount only if it has a legal right, and intends to settle both, the asset and liability simultaneously.
- Adequate disclosure of financial instruments and related risks are imperative to reflect an entity's financial position and performance, the nature and extent of risks that it is exposed to, and the manner in which it manages those risks. Accordingly, entities are required to provide quantitative and qualitative disclosures for exposure to financial instruments and financial risks, including liquidity risk, credit risk and market risk (which includes currency risk, interest rate risk and other price risks).

Significant differences from IFRS¹

Ind AS 32 compared with IAS 32, *Financial Instruments: Presentation*

- IFRS requires an equity conversion option that is embedded in a foreign currency convertible bond, to be recognised as a financial liability at inception as the conversion price is fixed in foreign currency and not in the entity's functional currency. Hence, it does not result in an exchange of a fixed amount of cash (in the entity's functional currency) for a fixed number of shares. Therefore, the conversion option would not be classified as equity under IFRS. However, Ind AS provides a specific exemption in the definition of a financial liability and states that an exchange of a fixed number of shares for a fixed amount of cash in any currency would result in a derivative financial instrument being classified as equity.

1. Indian Accounting Standards (Ind AS): An Overview (Revised 2019) issued by ICAI



Guidance from ITFG clarifications

Ind AS 32 defines a financial instrument as a contract that gives rise to a financial asset of one entity and a financial liability or an equity instrument of another entity. Generally, Ind AS 109 applies to all types of financial instruments, though, it has certain exceptions as well.

Accounting of shares held by a broking entity for trading on its own account

Investments in shares of other entities¹ meet the definition of financial instruments. Accordingly, these would be recognised and measured in accordance with Ind AS 109, presented as per the requirements of Ind AS 32 and disclosed as per the principles enunciated in Ind AS 107.

The ITFG clarified that shares held by a broking entity for trading on its own account (as stock-in-trade) are financial instruments and are specifically excluded from the scope of Ind AS 2, *Inventories*. Accordingly, these shares would be accounted for and disclosed in accordance with the requirements of Ind AS 32, Ind AS 109 and Ind AS 107. (*ITFG 14, Issue 5*)

Incentives receivable from the government considered as financial instruments

Ind AS 32 defines a financial asset as a contractual right to receive cash or another financial asset from another entity. It further defines 'contract' and 'contractual'² as an agreement between two or more parties that have clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. It also clarifies that contracts, and thus financial instruments can take a variety of forms and need not be in writing.

Ind AS 109 provides that an entity should recognise a financial asset or a financial liability in its balance sheet when the entity becomes a party to the contractual provision of the instrument.

It has been clarified that when the government provides incentives (for example, taxation benefits, etc. to promote an industry or for some other reasons) it may not enter into a one to one agreement with each entity availing those benefits with regard to the rights and obligations of the scheme. Instead there is

an understanding between the government and the potential applicant/entity that on complying with the stipulated conditions attached to the scheme, the entity would be granted benefits of the scheme. Once the entity has complied with the conditions attached to the scheme then it rightfully becomes entitled to the incentives attached to the scheme. Thus, such an incentive receivable would fall within the definition of financial instrument and accounted for as a financial asset in accordance with Ind AS 109. (*ITFG 15, Issue 3*)

In practice, evaluation may require the exercise of significant judgement by entities that are entitled to receive incentives from the government, in order to determine whether a 'contractual' right exists resulting in the recognition of a financial asset. This interpretation may affect accounting of various types of government grants.

Accounting for amounts outstanding towards retired partners' capital balances

Ind AS 32 defines a financial liability as a contractual obligation to deliver cash or another financial asset to another entity, or a contractual obligation to exchange financial instruments with another entity under conditions that are potentially unfavourable. It also includes certain derivatives and non-derivative contracts that may be settled in the entity's own equity instruments. Careful analysis of the terms and conditions of the financial instruments is required to determine whether such an instrument would be classified as a financial liability.

In a scenario, where a partnership firm was required to prepare Ind AS financial statements for the purpose of consolidation³ (in accordance with Ind AS 110), ITFG has provided a clarification on the accounting for amounts outstanding towards retired partners' capital balances.

3. Ind AS is not applicable to partnership firms, however, partnership firms which are 'controlled' by entities to whom Ind AS is applicable, are required to prepare Ind AS financial statements for the purpose of consolidation.

2. The definition of a contract in Ind AS 115, Revenue from Contracts with Customers, focusses on legal enforceability. However, the definition of a contract was not amended in Ind AS 32. As a result, there are two definitions of contract in Ind AS - one in Ind AS 115 and another in Ind AS 32.





In this case, capital balances could be demanded by the retired partners anytime and the firm is contractually obliged to deliver cash or another financial asset. Hence such balances meet the definition of a financial liability. Accordingly, as per Ind AS 109, these amounts should be measured at fair value, computed as per the principles of Ind AS 113, *Fair Value Measurement*.

Guidance under Ind AS 113 provides that the fair value of a financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

Accordingly, retired partners' capital balances would not be required to be discounted on initial recognition and subsequent measurement. (*ITFG 15, Issue 9*)

Similarly, fair value of an interest-free loan liability or a low-interest bearing liability which the lender can demand immediate repayment is not discounted on initial recognition. The impact of this requirement is that interest expense would be recognised at the coupon rate for a low-interest financial liability with an immediate demand feature.

Financial guarantee contracts

Ind AS 109 defines a financial guarantee contract as one that requires the issuer to make specified payments to reimburse the holder for a loss that it incurs because a specified debtor fails to make a payment when it is due in accordance with original or modified terms of a debt instrument.

Legal form

Financial guarantee contracts can have various legal forms. Such contracts may include a comfort letter, on the basis of which a credit holder receives a bank loan and the significant feature of the instrument is the contractual obligation to make specified payments in case of default by the credit holder. (*ITFG 12, Issue 3*)

Accounting

1. By the issuer

As per Ind AS 109, on initial recognition financial guarantee contracts are recognised as a liability (i.e. deferred income liability, such as 'unearned financial guarantee commission') at their fair value, with a corresponding debit given to an appropriate account. The fair value of a financial guarantee contract issued in a stand-alone arm's length transaction to an unrelated party is likely to equal the premium received. Where no up-front payment of premium is charged between unrelated parties, the fair value is likely to be zero.

The application of Ind AS 115 would result in the amount of unearned financial guarantee commission, recognised initially as liability being amortised over the period of the guarantee. Consequently, the balance of the unearned financial guarantee commission would decline progressively over the period of the guarantee. Additionally, at each reporting date, the issuer of the guarantee, would be required to compare the unamortised amount of the deferred income with the amount of loss allowance determined in respect of the guarantee in accordance with the requirements of section 5.5 of Ind AS 109. Accordingly, the guidance would be as below:

- *Amount of loss allowance is lower than the unamortised amount of deferred income:* Liability with respect to financial guarantee would be represented by the unamortised amount of the financial guarantee commission.
- *Amount of loss allowance is higher than the unamortised amount of deferred income:* A further liability equal to the excess of the amount of the loss allowance over the amount of the unamortised unearned financial guarantee commission would be recognised. (*ITFG 16, Issue 1*)



Initial measurement

Where an entity provides a financial guarantee against a loan taken by its related entity⁴, and receives a guarantee commission from that related entity, it should determine whether the commission is equivalent to the premium that its related entity would pay to obtain a similar guarantee in a stand-alone arm's length transaction. If so, then, on initial recognition, the fair value of the financial guarantee contract is likely to equal the commission received. (*ITFG 12, Issue 11*)

If on the other hand, an entity issues a financial guarantee against a loan taken by its related entity⁵, and no fee/commission is charged by the entity, then on initial recognition, it would recognise the financial guarantee contract at its fair value.

As there is no specific guidance in Ind AS 109 or any other standard with respect to determination of fair value of such financial guarantee, the following approaches have been suggested (by ITFG) for determining fair value based on the principles of Ind AS 113:

- Fair value of the financial guarantee (at initial recognition) could be the amount that an unrelated, independent third party would have charged for issuing the financial guarantee.
- Estimate the fair value of the financial guarantee as the present value of the amount by which the interest (or other similar) cash flows in respect of the loan are lower than what they would have been if the loan was an unguaranteed loan.
- Estimate the fair value of the financial guarantee as the present value of the probability-weighted cash flows that may arise under the guarantee (i.e. the expected value of the liability). (*ITFG 16, Issue 1*)

While a liability is created on initial recognition of a financial guarantee, the corresponding debit has to be given to an appropriate head. Where no commission is paid by a related entity (or where the payments are not equivalent to the fair value of the financial guarantee contract), the financial guarantee contract will be accounted for as below:

- **Guarantee provided by parent to its subsidiary/ associate:** The fair value of the guarantee would have been charged for issuing a similar guarantee for a loan taken by an unrelated third party. Therefore, a parent entity may consider that the guarantee has been provided in its capacity as a shareholder, consequently, the fair value of the guarantee (or the difference between the fair value and the payments received from the subsidiary/ associate) would be considered as a capital contribution to the subsidiary/associate.

- **Guarantee provided by subsidiary to its parent:** Similar to the assessment above, the economic substance of the arrangement in this case may be considered as a distribution made by the subsidiary to its parent. Accordingly, the debit should be made to an appropriate head under 'equity'. It would not be appropriate to debit fair value of the guarantee to profit or loss (as if it were a non-reciprocal distribution to a third party) as it would fail to properly reflect the existence of the parent-subsidiary relationship that would have caused the subsidiary not to charge the guarantee commission. (*ITFG 16, Issue 1*)

Subsequent measurement

Financial guarantee contracts should subsequently be measured in accordance with Ind AS 109. (*ITFG 12, Issue 11 and ITFG 16, Issue 1*)

2. By the beneficiary

Ind AS 109 does not specifically address the accounting for financial guarantees by the beneficiary. However, in an arm's length transaction between unrelated parties, the beneficiary of the financial guarantee would recognise the guarantee premium or fee paid as an expense in its statement of profit and loss.

Where a director of the beneficiary company has issued a financial guarantee in favour of a bank, which has provided a loan to the company, the beneficiary company would be required to assess the substance of the transaction, taking relevant facts and circumstances into consideration, to determine the accounting treatment as follows:

- **Guarantee fee:** If the company has paid a guarantee fee or a premium to the director for the guarantee provided, then it would account for such fee in accordance with Ind AS 109.
- **Other compensation:** Where a director is being compensated for providing the guarantee, an appropriate accounting treatment based on the principles of the relevant Ind AS would be followed to recognise such compensation.

4. ITFG clarification bulletin 12, Issue 11, dealt with a situation where a financial guarantee had been issued by a parent against a loan taken by its associate company.

5. ITFG clarification bulletin 16, Issue 1, clarified a situation in which a financial guarantee was issued by a subsidiary, against the loan taken by its parent.



Therefore, if no fee has been paid to the director (or other related party), and such party is not being compensated in any other manner, the company is not required to account for such a financial guarantee in its financial statements considering that the unit of account is the guaranteed loan. The loan is recognised at its fair value that is expected to be the face value of the loan proceeds received by the company. However, this transaction needs to be evaluated for disclosure under Ind AS 24, *Related Party Disclosures* which requires disclosure of any guarantees given to or received from related parties. (ITFG 13, Issue 2)

A similar scenario may involve a parent entity providing a financial guarantee to a bank relating to a loan advanced to its subsidiary. While Ind AS 109 requires the guarantor, the parent entity to recognise the guarantee liability at its fair value, there is no specific accounting guidance relating to a situation where a subsidiary does not pay any guarantee fee or premium to the parent entity. In this case, we consider that this is akin to a deemed capital contribution by the parent to its subsidiary and should be recognised as an additional investment in the subsidiary.

Additionally, ITFG has clarified the treatment for such a case as above.

Where a subsidiary had issued a financial guarantee against a loan taken by its parents, ITFG clarified that since the financial guarantee is an integral part of the loan taken, the parent should debit the fair value of the guarantee to the carrying amount of the loan (which would have the effect of such fair value being included in determination of Effective Interest Rate (EIR) on the loan) and credit the same in accordance with the requirements of Ind AS 27 (as it is deemed as distribution made by the subsidiary).

In accordance with requirements of Ind AS 27, investment in a subsidiary should be accounted for at cost or in accordance with Ind AS 109 in the SFS of the parent.

Accordingly, the accounting in SFS would be as follows:

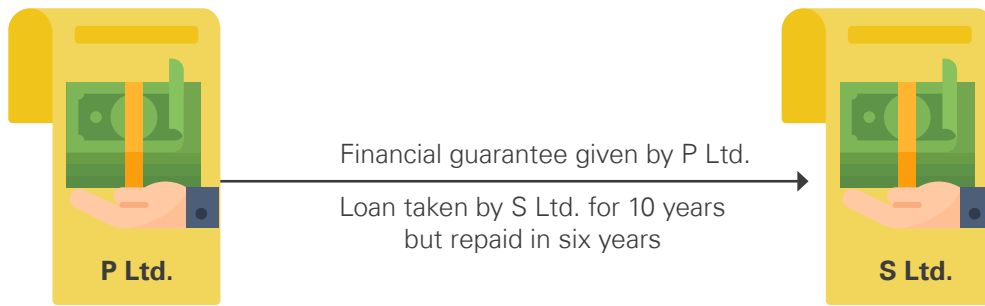
- **If the investment in a subsidiary has been accounted for at cost:** Credit the distribution received to the statement of profit and loss. Impairment loss, if any, would be separately considered.
- **If the investment in subsidiary has been accounted for in accordance with Ind AS 109 then accounting depends upon whether its FVOCI or FVTPL as below:**
 - **Measured at FVOCI:** Recognise distribution in the statement of profit and loss in accordance with guidance in Appendix B to Ind AS 109, unless the distribution clearly represents a recovery of part of the cost of the investment.
 - **Measured at FVTPL:** Credit the distribution received to the statement of profit and loss.

Further, in accordance with Ind AS 24, in this situation too, disclosures of related party transactions during the periods covered by the financial instruments, including details of any guarantees given or received by the entity are required to be made. Based on this, the parent would be required to make necessary disclosure of the financial guarantee provided by its subsidiary. (ITFG 16, Issue 1)

Financial guarantee by a parent for a loan taken by its subsidiary that is repaid earlier than the scheduled term

In a case where a financial guarantee was issued by a parent (P Ltd.) against a loan taken by its subsidiary (S Ltd.). The loan was initially scheduled to be repaid over a period of 10 years and therefore, a liability (of say INR1,000) was created by the parent which was to be amortised over a period of 10 years. When the loan was prepaid within six years, ITFG clarified that guidance provided in Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors* should be considered to account for the change in the estimate of expected life of the loan.





As per Ind AS 8, the effect of change in an accounting estimate, should be recognised prospectively by including it in profit or loss in the:

- **Period of the change:** If the change affects that period only or
- **Period of the change and future periods:** If the change affects both.

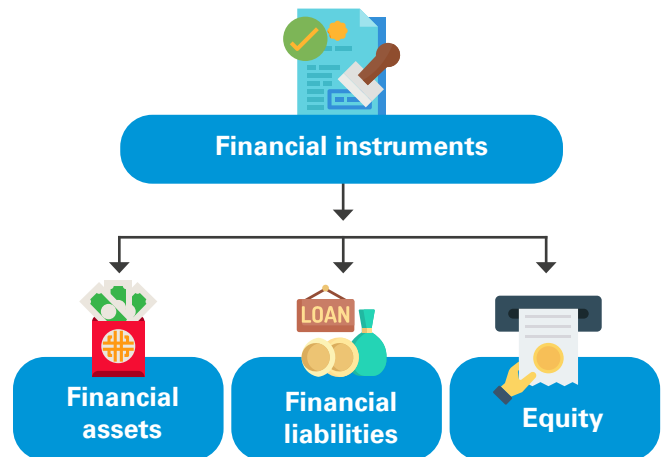
Further, if a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it should be recognised by adjusting the carrying amount of the related asset, liability or equity item in the period of the change.

The attribution debited to 'investment' upon providing guarantee is in substance the consideration that the parent would have collected for providing similar guarantee to an unrelated third party. Generally, in case of prepayment of loan by an unrelated third party, the parent would not have refunded the consideration and would have recognised the entire unrecognised commission in the statement of profit and loss. Similar approach should be followed for guarantee given to the subsidiary.

Accordingly, in the given case, amount of financial guarantee obligation initially recognised at INR1,000 would be amortised as income in each accounting period as per Ind AS 109. At the end of year six, P Ltd. would have INR400 as the carrying value of financial guarantee in its financial statements. Since S Ltd. has repaid the loan and no obligation exists for P Ltd., therefore, P Ltd. should reverse the balance outstanding as guarantee obligation with corresponding recognition of revenue of INR400 in the statement of profit and loss. (ITFG 16, Issue 7)

Debt-equity classification

As per Ind AS 32, financial instruments or their components are classified as a financial liability or equity in accordance with the substance of the contractual arrangement. Instruments are classified as a financial liability if they include a contractual obligation to deliver cash or other financial assets. Equity instruments on the other hand, evidence a residual interest in the assets of the entity after deducting all its liabilities.



Financial instruments or their components that are in the nature of derivatives that may be settled in the issuer's own equity instruments, would be classified as equity, only if the terms of the instrument require an exchange of a fixed amount of cash or other financial assets for a fixed number of the issuer's own equity instruments (known as the 'fixed for fixed' criterion).



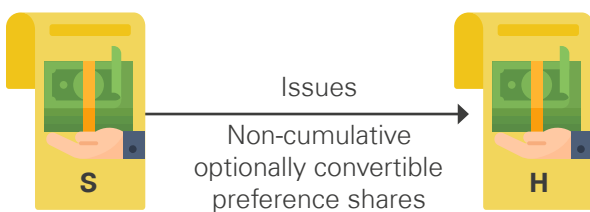
Classification as debt or equity

The primary factor determining the classification of a financial instrument either as a financial liability or equity, is whether the entity that has issued the instrument, has a contractual obligation to make payments (either principal, interest/dividend or both) or has a contractual right to avoid making such payment.

Discretionary dividends paid on a compound financial instrument, i.e. an instrument that is partly equity in nature may relate to the equity component of the instrument. In this scenario, an entity needs to assess whether discretionary dividend should be presented in equity. Depending upon the facts and circumstances in certain situations, discretionary dividends could be presented in profit or loss because dividend payments on an instrument wholly recognised as a liability are recognised as an expense.

In the context of debt-equity classification, the ITFG considered the accounting for the following instruments:

- **Non-cumulative, optionally convertible preference share issued by a entity (S) to its holding entity (H).**



As per the terms of issue, S has the option to convert or redeem the stated preference shares. Assuming that S has an option to convert the preference shares into a fixed number of its own shares, and dividend payment is discretionary, the accounting for the instrument will be as follows:

- **In the SFS of S:** While assessing the classification of the preference shares in its SFS, S assesses that:

- The terms of the instrument provide it with the ability to avoid making cash payment (of the dividend as well as of the principal), and convert the instrument into a fixed number of its own shares at any time,
- The conversion option is already considered in determining the classification of the entire instrument, and hence is not accounted for separately as an embedded derivative and
- Discretionary payment features (such as discretionary dividend) on equity instruments are considered as an integral component of the instrument. Considering these facts, the entire instrument would be classified as equity in the SFS of S.

- **In the SFS of H:** Ind AS 27 provides entities with an accounting policy choice to account for their investments in subsidiaries, joint ventures and associates in their SFS, either at cost or in accordance with Ind AS 109. Assuming that H has not chosen to account for its investment in accordance with Ind AS 109, it would account for it at cost.
- **In the CFS:** These transactions, being intra-group transactions, would be eliminated in accordance with Ind AS 110. (*ITFG 14, Issue 7*)

Foreign Currency Convertible Bonds (FCCB): In another situation, an entity (PQR) had issued FCCBs prior to transition to Ind AS at an interest rate of six per cent per annum, payable on a half yearly basis for a period of five years and one day. These FCCBs would mature post transition to Ind AS since PQR was required to comply with Ind AS from 1 April 2017. The holder of the instruments had an option to convert them into fixed number of shares of PQR.

A borrowing in the same currency, with a similar time period and credit status, but without the conversion option would have carried an interest rate of seven and a half per cent per annum.

From the perspective of the issuer, the FCCB had both a liability and an equity component. The liability component comprised a contractual obligation of PQR to deliver cash to the holder, and the equity component comprised the holder's equity conversion option embedded in the FCCB to acquire a fixed number of entity's own equity instruments. Although the FCCB was denominated in a foreign currency, the conversion option would meet the definition of an equity instrument based on the guidance in Ind AS 32.

PQR would be required to split the FCCB into the liability and the equity components on initial recognition and present these separately in the balance sheet. (ITFG 15, Issue 1)

- **Compulsorily Redeemable Non-Cumulative Preference Shares (RNCPS):** In case RNCPS issued by an entity (ABC) with a dividend of six per cent per annum, redeemable in cash after 10 years. The market rate of interest for similar instruments was four per cent per annum. It was clarified that in accordance with Ind AS 32, the RNCPS are compound financial instruments, since the payment of dividend to preference shareholders is at the discretion of the issuer, i.e. ABC. Additionally, it was clarified that any discretionary dividends would be recognised when they are actually declared and paid and since they relate to the equity component, they would be disclosed in the statement of changes in equity as a distribution of profit or loss. (ITFG 15 Issue 2)
- **Optionally convertible preference shares with discretionary dividend and an embedded call option:** An entity K issued 12 per cent, five year, optionally convertible preference shares with discretionary non-cumulative dividend, at par in its functional currency. As per the terms of issue:
 - a. The holder of the preference shares had an option to convert them into fixed number of equity shares at the end of five years
 - b. If the conversion option was not exercised, then the preference shares would be redeemed at par
 - c. Throughout the five year period, the holder had an option to put the preference shares back to entity K at its par amount⁶.

In accordance with Ind AS 32, the initial carrying amount of the compound financial instrument would be allocated to its equity and liability components. (ITFG 17, Issue 9)

For a discussion on the measurement of above compound financial instruments, please refer the section on 'Measurement of compound financial instrument'.

- **Issue of rights offer:** An entity X, with INR as its functional currency had two classes of non-puttable equity shares - Class A and Class B. Post the date of transition to Ind AS, entity X made a rights offer to all holders of Class B equity shares. The terms of the right offer were:

- a. For each equity share of Class B held, the shareholder is entitled to subscribe to 100 equity shares of Class A.
- b. The rights offer price was fixed at:
 - INR60 per Class A share for Indian shareholders, and
 - USD1 per Class A share for overseas shareholders.
- c. The rights offer was valid for six months.

Ind AS 32 lays down the principles for the classification of financial instruments as financial assets, financial liabilities or equity instruments from the issuer's perspective.

The definition of financial liabilities, inter alia, states that a financial liability is any liability that is a derivative that would or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments...'

Considering the above definition, ITFG evaluated the terms of the rights issue as below:

- The rights offer was for acquiring a fixed number of the entity's own equity instruments (i.e. for each equity share of Class B held, the shareholder was entitled to subscribe to 100 equity shares of Class A)
- The right exercise price was a fixed amount - i.e. INR60 per share for Indian shareholders and USD1 per share for overseas shareholders
- Entity X had made the rights offer to all the existing shareholders of Class B equity shares pro-rata to their holding of Class B equity shares.

On the basis of the above evaluation, since all the conditions for equity classification were met, ITFG concluded, that the rights offer to Class B shareholders to acquire Class A shares should be classified as an equity instrument. (ITFG 17, Issue 10)

6. For the purpose of this issue, it was assumed that issuance of preference shares on these terms was permissible in the relevant jurisdiction. Further, transaction costs were assumed to be negligible.

- **Preference shares issued in foreign currency:**
An entity Y, with INR as its functional currency, issued preference shares with three years term denominated in a foreign currency to an overseas investor. As per the terms of issue, at the end of three years, entity Y had an option to either redeem each preference share at USD10 or get it converted into three equity shares of entity Y.

As a general principle, a derivative is a financial liability if it 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. The term 'fixed amount of cash' referred to an amount of cash fixed in the functional currency of the reporting entity. Since an amount fixed in a foreign currency has the potential to vary in terms of functional currency of the reporting entity due to exchange rate fluctuations, it does not represent a 'fixed amount of cash'. However, as an exception, Ind AS 32 regards an equity conversion option embedded in a convertible bond denominated in a foreign currency to acquire a fixed number of the entity's own equity instruments to be an equity instrument if the exercise price was fixed in any currency (i.e. functional or foreign currency) .

Ind AS 32 made the aforementioned exception⁷ only in the case of an equity conversion option embedded in a convertible bond denominated in a foreign currency, even though it explicitly recognised at several other places that other instruments could also contain equity conversion options. Given this position, it does not seem that the above exception could be extended by analogy to equity conversion options embedded in other types of financial instruments denominated in a foreign currency such as preference shares.

Accordingly, ITFG concluded that the equity conversion option forming part of terms of issue of preference shares under discussion would be a (derivative) financial liability of entity Y Ltd. (*ITFG 17, Issue 11*)

7. IAS 32 does not have this exception and conversion option denominated in a foreign currency does not meet the 'fixed amount of cash' criterion.



Measurement of compound financial instrument

For compound financial instruments, entities are required to follow 'split accounting' by separately classifying and recognising the liability (mandatory coupon payable at a fixed interest rate) and equity components (principal component convertible into a fixed number of equity shares).

While measuring the liability and equity components, the entity first determines the fair value of the liability component (assuming there is no embedded derivative) by computing the present value of the contractually determined stream of future cash flows. These cash flows are discounted at the rate of interest applied at that time by the market to instruments of comparable credit status and providing substantially the same cash flows, on the same terms, but without the equity component (such as a conversion option in case of CCDs).

It would be computed as below for the following instruments:

- **CCDs:** CCDs with a mandatory coupon, issued for a period of 10 years, convertible into a fixed number of shares at the end of their term are in the nature of a compound instruments. The liability component of the debentures would be computed by discounting the interest cash outflows on the compulsorily convertible debentures for 10 years at the incremental borrowing rate applicable to the entity for a comparable 10 year loan. (*ITFG 13, Issue 10*)
- **FCCB:** FCCBs issued at an interest rate of six per cent per annum for a period of five years, which provide a holder an option to convert them into fixed number of shares are in the nature of a compound instrument. The liability component of the FCCB would be measured at fair value by discounting the scheduled payments of interest and principal under the instrument at an interest rate applied at that time by the market to instruments of comparable credit status, providing substantially the same cash flows on the same terms, but without the conversion option (market interest rate). (*ITFG 15, Issue 1*)
- **RNCPS:** The liability component represents a contractual obligation to redeem the preference shares in cash. Accordingly, the fair value of the liability component on initial recognition would be computed as the present value of the eventual redemption amount discounted at the market interest rate. (*ITFG 15, Issue 2*)

The equity component would be measured at the residual amount, after deducting the fair value of the financial liability component from the fair value of the entire compound instrument. (*ITFG 13, Issue 10* and *ITFG 15, Issues 1 and 2*)

- **Optionally convertible preference shares with discretionary dividend and an embedded call option:** In case of entity K which issued optionally convertible preference shares with discretionary non-cumulative dividend at par in its functional currency with an embedded call option (since per the terms of issue the holder had an embedded call option throughout the five year period)

In accordance with Ind AS 32, the initial carrying amount of the compound financial instrument would be allocated to its equity and liability components. Further, Ind AS 109 deals with the measurement of financial assets and financial liabilities. Equity instruments are instruments that evidence a residual interest in the assets of an entity after deducting all of its liabilities. Therefore, when the initial carrying amount of a compound financial instrument is allocated to its equity and liability components, the equity component is assigned the residual amount after deducting from the fair value of the instrument as a whole the amount separately determined for the liability component. The value of any derivative features (such as a call option) embedded in the compound financial instrument other than the equity component (such as an equity conversion option) is included in the liability component. The sum of the carrying amounts assigned to the liability and equity components on initial recognition is always equal to the fair value that would be ascribed to the instrument as a whole. No gain or loss arises from initially recognising the components of the instrument separately.

Accordingly, entity K would be required to first determine the carrying amount of the liability component by measuring the fair value of a similar liability (including any embedded non-equity derivative features) that does not have an associated equity component. The carrying amount of the equity component would be the residual amount, computed by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole. The value of the derivative feature embedded in the compound financial instrument (the call



option in this case), would be included in the liability component.

However, the ITFG noted that in the given case, entity K had a contractual obligation to pay the par amount to the holder of a preference share at any point in time. Hence, the liability component had a demand feature attached. Thus, while measuring the fair value of the liability component, reference to Ind AS 113 would be required to be made.

As per Ind AS 113, the fair value of a financial liability with a demand feature (e.g. a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

Therefore, in accordance with the above, the whole price of the preference shares would be allocated to the liability component and no amount would be assigned to the equity component. (ITFG 17, Issue 9)

On initial recognition, Ind AS 109 requires entities to classify financial assets into the amortised cost, FVOCI or at FVTPL categories based on the business model within which they are held and the nature of their contractual cash flows.

Classification of financial assets

The classification determines the basis on which such financial assets are subsequently measured. Entities may hold financial assets within a business model, which has an objective to either:

- Hold assets in order to collect contractual cash flows ('held to collect')
- Both collect contractual cash flows and sell financial assets ('held to collect and for sale'), or
- Hold assets for sale ('held for sale').

Financial assets held within a 'held to collect' business model are generally managed by collecting the cash flows generated by the asset over its life. However, Ind AS 109 clarifies that entities need not hold all instruments until maturity. Thus, it becomes necessary to consider the frequency, value and timing of sales in prior periods, and expectations about future sales activities when assessing the business model. In this context, Ind AS 109 states that sales of instruments could be consistent with a 'held to collect' business model if they are infrequent (though significant in value) or are insignificant in value both individually and in aggregate (even if frequent). Ind AS 109, however, does not define 'infrequent' or 'insignificant'.

There is no 'rule of thumb' in terms of an indicative percentage to determine 'infrequent number of sales' or sales that are 'insignificant in value', considering the differing quantum, configuration and nature of financial assets in various entities. Management should, therefore, exercise judgement and establish criteria to identify situations in which sales of financial assets occurring before maturity may be consistent with a 'held to collect' business model. (Frequently asked questions (FAQs) issued by the ASB of the ICAI on elaboration of terms used in Ind AS 109).

Measurement of financial assets

On initial recognition, a financial asset or a financial liability is measured at fair value plus or minus directly attributable transaction costs, unless:

- The instrument is classified as at FVTPL, in which case transaction costs are not included, or
- The instrument is a trade receivable that is initially measured at the transaction price as defined in Ind AS 115.

Normally, the fair value on initial recognition is the transaction price as described in Ind AS 109 i.e. the fair value of the consideration given or received for the financial instrument. If part of the consideration given or received is for something in addition to the financial instrument, then the entity separately measures the fair value of the financial instrument in accordance with Ind AS 113.

Low interest and interest free financial instruments⁸

An entity may sometimes receive or give certain interest-free or low interest financial instruments, e.g. inter company loans, government loans, interest-free security deposits, etc., the transaction price of which may not necessarily reflect an instrument's fair value. In such a case, the fair value of the instrument is computed in accordance with Ind AS 113.

Ind AS 113 requires entities to maximise the use of quoted prices or other relevant observable inputs. However, if these are not available, a valuation technique may also be used, such as a present value technique with inputs that include future cash flows and discount rates that reflect assumption that market participants would apply in pricing the financial instrument. The difference between the fair value of the instrument and the transaction price on initial recognition of the instrument would be accounted for separately. The accounting treatment for these will depend upon the nature of the element included in the instrument.

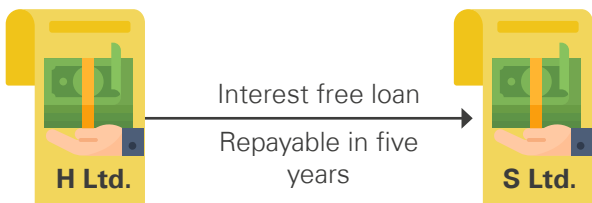
8. EAC- January 2019 edition of the ICAI Journal 'The Chartered Accountant'

There has been significant debate and diversity in the accounting treatment for interest-free refundable security deposits, specifically on adjustment of time value of money. Accounting for security deposits is dependent on their nature and the purpose for which these have been placed as well as the terms of the contract.

The ITFG considered an interest-free refundable security deposit given by an entity (for example, a lease deposit). Since the deposit represents the entity’s contractual right to receive cash from the holder of the deposit, it is a financial asset in accordance with Ind AS 32. ITFG stated that where the effect of time value of money is material, the refundable security deposit would be discounted and be shown at its present value at the time of initial recognition. With regard to the rate at which these would be discounted, the entity should evaluate on the basis of its own facts and circumstances. Further, whether the effect of time value of money is material should be determined on the basis of overall consideration of total cash flows, etc. The difference between the transaction price and the fair value as determined above should be accounted in accordance with Ind AS 109. (ITFG 15 (revised), Issue 7)

For example, in case of an interest free rent deposit paid to a lessor, the difference between the present value of deposit and the amount of deposit paid would form the part of the Right-Of-Use (ROU) asset and would be depreciated over the lease term⁹.

In a scenario a subsidiary company (S Ltd.) received an interest-free loan from its holding company (H Ltd.). The subsidiary is under an obligation to repay the loan at the end of five years. In accordance with Ind AS 109, S Ltd. is required to initially recognise the loan at its fair value determined according to the principles laid down in Ind AS 113.



ITFG considered the accounting treatment of the difference between the loan amount and the fair value of the loan at initial recognition in the books of S Ltd.

ITFG clarified that since S Ltd. is under an obligation to repay the loan provided to it by H Ltd., the loan represents a financial liability of the subsidiary and should be so recognised. Additionally, on a consideration of the substance of the transaction and in the absence of any factors that lead to a different conclusion as to its nature, the excess of the loan amount over the fair value of the loan at initial recognition should appropriately be regarded as an equity infusion by the parent and should therefore, be credited directly to equity. (ITFG 18, Issue 3)

In assessing whether the interest charged on a loan is at a below market rate, an entity should consider the terms and conditions of the loan, local industry practice and local market circumstances. Evidence that a loan is at market rates might include the interest rates currently charged by the entity, or by other market participants for loans with similar remaining maturities, cash flow patterns, currency credit risk, collateral and interest basis.

Interest, dividends, losses and gains on financial instruments

Ind AS 32 requires interest, dividends, losses and gains on financial instruments to be recognised either in the statement of profit and loss or in equity, depending on the classification of the financial instruments or components of financial instruments to which they pertain.



9. Question 52 from education material on Ind AS 116, Leases, published in January 2020 by the ICAI



Dividends on financial liabilities

As per Ind AS 32, dividends paid on financial instruments that are classified as financial liabilities, would be presented as 'interest expense', and accounted for accordingly.

Ind AS 10, *Events after the Reporting Period* states that when entities declare dividends to holders of equity instruments after the reporting period, they should not recognise a liability for those dividends at the end of the reporting period.

Dividend/interest on financial instruments or components classified as liabilities are 'interest expenses', and hence, should accrue at the end of the reporting period, irrespective of when the dividend is declared (even after the reporting period) or paid. If the liability is classified and subsequently measured at amortised cost, the dividend/interest would be computed using the EIR method and debited to interest expense (in the statement of profit and loss). (ITFG 7, Issue 6)

Accounting for accumulated arrears of dividend on cumulative preference shares on transition to Ind AS

A loss-making entity (P) issued cumulative preference shares prior to transition to Ind AS. Other facts are as below:

- It did not pay dividend to its preference shareholders
- The accumulated arrears of cumulative preference dividend were disclosed as 'contingent liability' in the notes to the financial statements
- On transition to Ind AS, the preference shares were classified as financial liability in accordance with the principles of Ind AS 32.

ITFG clarified that preference shares that are classified in entirety as a financial liability are accounted for under Ind AS 109 in the same manner as a redeemable debenture or a typical loan. This implies, inter alia, that the dividends on the preference shares are accrued in the same manner as interest on debentures or loans.

In the given situation, the preference shares would be classified as financial liability in their entirety (the covenants of their terms of issue relating to dividends would represent a contractual obligation of P to pay such dividends). Accordingly, these dividends would be accrued in the same manner as interest on debentures or loans.

At the date of transition, the amortised cost of the preference shares (which includes unpaid dividend) would be computed retrospectively from the date of their issue using the EIR method (Ind AS 101 does not provide any mandatory exception or optional exemptions for such financial instrument).

While computing the amortised cost of the preference shares using the EIR method, the dividends that have accrued but not paid would be reflected in the carrying amount of the liability.

In accordance with Ind AS 101, the difference between the amortised cost and the carrying amount of the preference shares as per the previous GAAP would be adjusted directly in retained earnings (or, if appropriate, another category of equity) as at the date of transition.

Further, dividend for periods after the date of transition would be accrued in each period, in the same manner as interest, and if unpaid would get reflected in the amortised cost as at the end of the period.

(ITFG 20, Issue 3)

When an instrument is classified as a financial liability, all coupon payments are recognised as part of finance costs in the statement of profit and loss under the EIR method¹⁰.

In the above case, if the dividends were discretionary, then the issuer considers whether unpaid dividends are added to the redemption amount of the preference shares. If any unpaid dividends are added to the redemption amount and the entity does not have the unconditional ability to avoid redemption before liquidation, then the dividends are not in substance discretionary and the entire instrument including the discretionary dividend feature is a financial liability. Furthermore, if an entity is or may be obliged to redeem the instrument at fair value, then unpaid dividends are implicitly added to the redemption amount if the payment of dividends decreases the fair value of the instrument being redeemed.

Also, an entity should evaluate implication on Minimum Alternate Tax (MAT) computation under the Income-Tax Act, 1961 (IT Act) with regard to dividend on preference shares.

10. EIR is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset/liability. It is used to compute the gross carrying amount of financial assets or the amortised cost of financial liabilities.

Dividend distribution taxes

Ind AS 12, *Income Taxes* provides that when an entity pays dividend to its shareholders, it may be required to pay a portion of the dividends to the taxation authorities on behalf of shareholders. In many jurisdictions, this amount is referred to as a withholding tax. Such an amount paid or payable to taxation authorities is charged to equity as a part of the dividends.

It has been clarified that DDT, in substance, is a payment by the company on behalf of shareholders and therefore, would be covered in guidance of Ind AS 12. Further, the presentation of DDT paid on dividends to be consistent with the presentation of the transaction that created those income tax consequences. Therefore, the presentation of dividend and DDT in an entity's SFS would be as follows:

- **Financial instruments classified as debt:** Dividend on the financial instruments and DDT thereon should be charged to the statement of profit and loss.
- **Financial instrument classified as equity:** Dividend on the financial instruments and DDT thereon should be recognised in equity and presented in the statement of changes in equity. *(Revised FAQ on Presentation of Dividend and Dividend Distribution Tax issued by the ASB of the ICAI)*

In another issue, ITFG clarified that when the preference shares are classified as a liability in their entirety the related DDT should be regarded as part of interest cost and should form part of EIR calculation. *(ITFG 17, Issue 2)*

Recognition of interest income

Ind AS 109 requires interest revenue on financial assets at amortised cost or FVOCI (investments in debt instruments) to be computed using the EIR method, wherein the EIR is applied to the gross carrying amount of a financial asset, except in certain circumstances.

Dividend income on an investment in a debt instrument would be recognised in the form of 'interest income' by an investor. However, the manner in which income would be computed and recognised would depend on the classification and measurement category of the investment in a debt instrument, as determined as per Ind AS 109.



The manner of computation of income and its recognition as per Ind AS 109 is explained below:

- **Debt instrument subsequently measured at amortised cost:** The interest income is computed by applying the EIR to the gross carrying amount of the financial asset, when the instrument is not 'credit-impaired'. Instruments are said to be credit impaired if they are unable to meet their financial contractual obligations due to detrimental cash flows. Interest income on such assets is computed in the manner specified below:
 - Where the asset was credit-impaired on its purchase or on origination: Interest income is computed on such assets by applying the credit adjusted EIR to the amortised cost of the financial asset
 - Where the asset has subsequently become credit impaired: Interest is computed by applying EIR to the amortised cost of the financial asset during the period that the asset is considered as credit impaired. When the credit risk improves so that the financial asset is no longer credit impaired, interest income is computed by applying the EIR to its gross carrying amount.
- **Debt instrument is classified and measured at FVOCI:** Interest income is recognised in the statement of profit and loss in accordance with the EIR method.
- **Debt instrument is classified and measured at FVTPL:** Interest income is generally presented as part of the fair value gains or losses on the instrument or may be presented separately in the statement of profit and loss. An entity is required to disclose its accounting policy on this aspect in its financial statements. *(ITFG 8, Issue 9)*



ITFG has also provided further clarification for a financial asset while classifying under amortised cost and FVOCI (debt) categories.

Therefore, in accordance with Ind AS 109, to be classified as amortised cost or FVOCI (debt) category, a financial asset must meet the following two conditions:

- Business Model Test and
- Contractual Cash flow Characteristic test (SPPI test).

Ind AS 109 provides guidance on the SPPI and business model test.

The ITFG considered an example of a redeemable preference shares as a debt instrument with legal form of income as dividend. In order to assess if SPPI test is met for a redeemable preference share, an entity would need to evaluate if the dividend is discretionary or non-discretionary.

Where payment of dividend is not at the discretion of the issuer, the contractual cash flows (dividends and redemption proceeds) associated with the preference share would be akin to those associated with a plain-vanilla loan or other plain-vanilla debt instrument unless the cash flows do not meet the SPPI test.

On the other hand, where the payment of dividend on the preference share, whether cumulative or non-cumulative, is at the discretion of the issuer, the contractual cash flows characteristics differ from those of a basic lending arrangement as interest is also a contractual cash flow in a basic lending arrangement.

Accordingly, a preference share with a discretionary dividend feature cannot be said to represent a basic lending arrangement. Hence, such a preference share fails the SPPI test and cannot, therefore, be classified as at amortised cost or FVOCI. Therefore, such preference share would be classified at FVTPL.

In case the preference shares meet the SPPI test and business model test then the dividend income would be accounted for using EIR method provided the instrument is classified under either at amortised cost or FVOCI.

In case, it does not meet above tests or the entity has chosen the fair value option, the instrument would be classified at FVTPL and the entity would give disclosures for its accounting policy in accordance with disclosure requirements contained in Ind AS 107. *(ITFG 17, Issue 4)*

EIR - Transaction costs

On initial recognition of an instrument, Ind AS 109 requires entities to identify transaction costs and fees that are an integral part of the EIR of such instruments. These transaction costs and fees (such as origination

and processing fees) are treated as an adjustment to the EIR and are amortised over the expected life of the instrument.

(Please refer chapter 10 on Other topics- Borrowing Costs for more details on capitalisation of DDT paid on preference shares dividend and processing charges to the cost of qualifying asset) *(ITFG 13, Issue 1 and ITFG 14, Issue 1)*

Undisbursed loans

Processing fees paid relating to term loans are in the nature of origination fees and are adjusted in the EIR of the term loan. However, where the loan is drawn down in tranches, processing fees need to be evaluated for each tranche separately.

For undisbursed term loans, the processing fees should be accounted for as follows:

- **Where it is probable that the undisbursed term loan will be drawn down in the future:** The processing fee pertaining to the loan should be considered as a transaction cost under Ind AS 109, and amortised to the statement of profit and loss over the period of the loan tranche it pertains to, when it is drawn down. Until then, the amount would be recognised as a deferred expense in the balance sheet.
- **Where it is not probable that the undisbursed portion of the term loan will be drawn down in the future:** The entire processing fee pertaining to the loan should be recognised as an expense on a straight-line basis, over the term of the loan. *(ITFG 10, Issue 2)*

However, further clarity may be required on the period over which the processing fees should be amortised, i.e. whether this is the remaining drawdown period or the tenor of the disbursed component of the loan.

If, on the other hand, the fees paid by the entity are in the nature of facility or commitment fees for ensuring availability of funds during the draw-down period of a loan, we consider that it may be appropriate to recognise such fees on the undrawn component as an expense over the facility commitment period. In that scenario, the fees would relate to arranging the loan facility, and are intended to compensate the bank for keeping funds available during the commitment period. This commitment period could be shorter than the term of the loan (relating to the component that may have been drawn down).

Modification of financial instruments

The terms of financial instruments may be renegotiated, resulting in a modification in the timing and/or amount of contractual cash flows of the instrument. The modified terms need to be evaluated to ascertain the extent of modification, which would determine the accounting treatment for the transaction.

Modification of terms that do not result in derecognition

Where the modification of a financial instrument would result in revised cash flows whose timing and amount is not substantially¹¹ different from those of the original instrument, such modification would not result in derecognition of the instrument. In this case, the gross carrying amount of the instrument is recalculated by discounting the modified contractual cash flows using the original EIR. Any difference between this recalculated amount and the existing gross carrying amount (of financial assets or amortised cost of financial liabilities) is recognised in the statement of profit and loss as a modification gain or loss.

If a debt instrument is in default in a particular financial year (say year 1), and the terms of the instrument have been renegotiated in the next financial year (say year 2) (prior to approval of the financial statements), the modification gain or loss on the renegotiated debt instrument would be recognised in the financial year in which the renegotiation contractually takes place (i.e. year 2). (*ITFG 13, Issue 6*)

Modification of terms that result in derecognition of a financial liability

As per Ind AS 109, a financial liability is derecognised when it is extinguished – i.e. it is discharged or cancelled or expires. This may happen when:

- Payment is made to the lender, e.g. when the issuer of a debt instrument redeems the instrument
- The borrower is legally released from primary responsibility for the financial liability, or
- There is an exchange between an existing lender and borrower of debt instruments with substantially different terms or a substantial modification of the terms of an existing debt instrument.

To determine whether there is a substantial modification of terms, entities need to consider both quantitative and qualitative factors.

Quantitative and qualitative factors are described as below:

Quantitative assessment: Terms are considered to have been substantially modified when the net present value of the cash flows under the new terms, including any fees paid, net of any fees received and discounted using the original EIR differ by at least 10 per cent from the present value of the remaining cash flows under the original terms (this is also called as the '10 per cent test').

Qualitative assessment: The purpose of a qualitative assessment is to identify substantial differences in the terms of the modification that by their nature are not captured by a quantitative assessment.

Substantial modification of terms would lead to derecognition of the original loan and recognition of the new (modified) loan, at its fair value. The difference between the amount derecognised and the fair value of the new loan is treated as a modification gain or loss and recognised in the statement of profit and loss. Expenses incurred on such modification, including transaction costs should be assessed to determine their accounting treatment.

Refinancing arrangements

When an entity enters into a refinancing arrangement for its old loan facility, wherein it takes a new loan to pay off its old loan facility, this arrangement is considered as a modification resulting in derecognition of the old loan. Such a transaction involves various fees, including processing fees for the new loan and prepayment premium for the old loan. The accounting treatment for the transaction would be as follows:

- **Original loan:** The difference between the carrying amount of the original loan repaid (or extinguished) and the consideration paid on extinguishment would be recognised in the statement of profit and loss.
- **Unamortised processing fees on old loan:** These would be charged to the statement of profit and loss.
- **Prepayment premium:** Refinancing of the old loan is in the nature of a modification in the terms of the loan that would lead to derecognition of the old loan. Accordingly, the prepayment fees paid by the entity would be considered as costs or fees incurred on extinguishment of the loan, and would be included as a part of gain or loss on extinguishment of the loan (in the statement of profit and loss).
- **New loan processing fees:** Processing fees on the new loan facility are not a modification/renegotiation

11. As per Ind AS 109, the extent of modification needs to be determined considering qualitative and quantitative factors.



fee. Instead, these are an integral part of originating the new loan and would be considered as a transaction cost that is included in the computation of EIR of the new loan. (*ITFG 12, Issue 4*)

It is imperative to note that modification of accounting treatment (described above) may not apply to situations where the contractual terms of a loan are modified/restructured due to financial difficulties. Entities would have to analyse the relevant facts and circumstances to determine whether the modified loan should be derecognised and the consequent impact on costs and fees incurred in relation to the origination or modification of the loan.

Restructuring of loan

Where a non-performing loan was transferred to an Asset Reconstruction Company (ARC) and was restructured by the ARC, the borrower (say B Ltd.) was required to assess whether this would lead to derecognition of the existing loan. The restructuring involved:

- A hair cut by ARC for some portion of the loan
- Partial settlement of the loan by issue of fully paid-up equity shares at traded market price and
- The balance loan amount would be paid in installments over seven years at a revised interest rate, which was linked to the Marginal Cost of funds-based Lending Rate (MCLR).

The guidance given in Ind AS 109 relating to extinguishment of a liability and modification of debt provides that an entity should derecognise a financial liability (or a part of a financial liability) from its balance sheet only when it is extinguished or is substantially modified.

In the given case, it was clarified that B Ltd. would be required to assess whether change of the lender (assignment of loan) from bank to the ARC is a legal release from the primary liability to the bank.

Accordingly, if B Ltd. concluded that:

- **Change of lender results in legal release from primary liability:** It should derecognise entire amount of the existing loan and the new arrangement with ARC would be accounted for as a new loan. The difference between the carrying amount of the financial liability extinguished and the consideration paid (including any non-cash assets transferred or liabilities assumed) would be recognised in the statement of profit and loss.
- **Change of lender does not result in legal release from primary liability:** It should consider whether there is a substantial modification of terms of the existing financial liability (or part of it) based on the quantitative and qualitative assessment.
- In this case, ITFG highlighted that there were no additional factors that would require B Ltd. to perform a qualitative analysis. Therefore, if the quantitative threshold of 10 per cent is met, then modification of terms should be considered to be substantial and vice-versa.
- In this case, a part of the loan had been settled by way of issue of equity shares of B Ltd. Therefore, fair value of the equity shares should be accounted for in accordance with Appendix D, *Extinguishing Financial Liabilities with Equity Instruments* to Ind AS 109 and guidance contained in Ind AS 109. With respect to the balance portion, the modifications relate to terms that were captured by the quantitative test (i.e. the haircut, rescheduling of repayment, and change in interest rate). Accordingly, if the modification of balance loan was considered to be substantial, then B Ltd. would be required to derecognise the balance loan and recognise the new modified loan. Any difference between the carrying amount of the original loan and new modified loan would be recognised in the statement of profit and loss. (*ITFG 16, Issue 3*)



Hedge accounting

Ind AS 109 permits an entity to apply hedge accounting principles to its derivative transactions if it meets the qualifying criteria specified in the standard. Ind AS 109 specifies that 'a cash flow hedge is a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction, and could affect profit or loss.' In a cash flow hedge the fair value gains or losses on the derivative hedging instrument are recognised in reserves and recycled to the statement of profit and loss when the hedged item/hedged transaction affects profit or loss.

An entity that has, under paragraph D13AA of Ind AS 101, continued its previously adopted policy of capitalising foreign exchange differences on its long-term foreign currency loan will not recognise these foreign exchange differences in profit or loss. These foreign exchange differences form part of the carrying value of the related fixed asset and are depreciated over the balance useful life of the asset.

An entity that has availed of the option available under paragraph D13AA of Ind AS 101 and continues to capitalise (to the cost of the related asset) the foreign exchange differences arising from a long-term foreign currency loan, has no corresponding foreign currency exposure (arising from that loan) that affects profit or loss. Accordingly, cash flow hedge accounting under Ind AS 109 would not be applicable to any foreign currency derivatives transacted to hedge the foreign currency risk of such foreign currency loans. The derivatives would therefore be considered as held for trading and any change in fair value recognised in profit or loss. (*ITFG 3, Issue 10*)

Disclosure

Market risk disclosures for certain instruments

As per Ind AS 107, entities are required to provide quantitative and qualitative disclosures of their exposure to various financial risks arising from financial instruments. Ind AS 107 also requires disclosure of an entity's objectives, policies and processes for managing those risks and other concentrations of risk. Additionally, with respect to market risk, in addition to disclosing the exposure to foreign currency risk, interest rate risk, and other price risk, an entity is required to provide an analysis of sensitivity to these risks. This sensitivity analysis reflects how profit or

loss and equity would be affected by reasonably possible changes in the relevant risk variable at the reporting date.

Paragraph D13AA of Ind AS 101 permits an entity to continue the policy (if selected under AS) of capitalising/transferring to reserves the foreign exchange differences arising from translation of long-term foreign currency monetary items recognised prior to the date of implementation of Ind AS. The financial risk related disclosure requirements of Ind AS 107 would also apply to such long-term foreign currency monetary items (for which the option under paragraph D13AA of Ind AS 101 has been availed). This is because, the entity still remains exposed to foreign currency risk in respect of such instruments, and these could lead to an indirect impact in the statement of profit and loss or equity, for example through depreciation or amortisation of the capitalised amount of exchange differences. (*ITFG 13, Issue 8*)





EAC opinions

Expected Credit Loss (ECL) on the amount due in the course of business from government organisations¹²

Ind AS 109 provides guidance for impairment recognition of ECL on financial instruments. Further, the use of practical expedients when measuring ECL, if they are consistent with the principles provided therein, is permitted by Ind AS 109.

EAC considered a situation in which A Ltd. (a government entity) is mainly engaged in business with central government, state government, autonomous bodies or public sector undertakings.

In accordance with Ind AS 109, A Ltd. applies ECL model for measurement and recognition of impairment loss for financial assets.

As a practical expedient A Ltd. has adopted 'simplified approach' using the provision matrix method for recognition of expected loss on its trade receivables.

EAC deliberated on whether Ind AS 109 provides an exemption from application of ECL model.

The EAC concluded that the impairment requirements of Ind AS 109 are mandatory and there are no exceptions. Trade receivables are measured at amortised cost then they are subject to the impairment requirements of Ind AS 109.

Computation of EIR on borrowings¹³

The EAC deliberated on the issue related to accounting for guarantee fee paid to the Government of India in relation to the loan taken from the foreign lender (since Government of India is not directly a party/lender in given situation).

Ind AS 109 requires that the fees paid or received between parties to the contract that are an integral part of the EIR and transaction costs are to be considered while applying EIR method.

Ind AS 109 further provides that transaction costs are incremental costs that are directly attributable to the acquisition or issue of a financial liability and an incremental cost is one that would not have been incurred if the entity had not acquired or issued the financial instrument.

Accordingly, in the above situation, the EAC clarified, the guarantee fee paid (initially as well as subsequently) is an incremental cost which is directly attributable to the acquisition of the loan

facility as this cost would not have been incurred if the entity had not incurred the loan liability.

Thus, the financial guarantee fee paid (initially as well as subsequently) by the entity should be considered for computation of EIR while measuring the loan liability at amortised cost in compliance with the provisions of Ind AS 109.

Treatment of financial liability under Ind AS 32 and Ind AS 109¹⁴

Please refer to similar guidance discussed in the chapter in earlier section on 'Low interest and interest free financial instruments'.

Treatment of 'prepayment penalty' incurred for foreclosure of existing loan and availing new loan borrowings¹⁵

The EAC deliberated on the accounting treatment of the 'prepayment penalty' incurred for foreclosure of an existing loan and availing new loan/borrowing (from a new bank).

Transaction costs are the incremental costs which are directly attributable to the acquisition or disposal of a financial liability.

Ind AS 109 requires that at the time of initial recognition, financial liability should include only the transaction costs that are directly attributable to the acquisition or issue of the new financial liability and not the transaction cost of disposal of the existing financial liability.

In this case, EAC clarified that prepayment penalty is the transaction cost of disposal of the existing financial liability (loan) which is payable to the existing loan provider rather than the incremental cost of acquisition or issue of the new financial liability (new loan) from a new bank. Further, such a penalty is incurred to extinguish the existing liability and to get the benefits of a lower cost liability (loan). It is not incurred to acquire a new financial liability (loan). Therefore, this penalty could not be treated as directly attributable to the acquisition of the new financial liability and should be recognised as part of the gain or loss on extinguishment/derecognition of the old loan in the statement of profit and loss.

12. EAC-October 2018 edition of the ICAI Journal 'The Chartered Accountant'

13. EAC-August 2019 edition of the ICAI Journal, 'The Chartered Accountant'

14. EAC- January 2019 edition of the ICAI Journal 'The Chartered Accountant'

15. EAC- January 2019 edition of the ICAI Journal 'The Chartered Accountant'



Accounting for Funded Interest Term Loan (FITL) subsequent to restructuring of a loan taken from a shareholder¹⁶

Due to financial difficulties, an entity restructured its loan and availed a Funded Interest Term Loan (FITL).

As a result of restructuring agreement, the repayment terms of the original loans were extended and the interest accrued thereon was converted into another loan called FITL. Further, the entity under the previous Indian GAAP, derecognised the interest accrued and recognised FITL as an unsecured term loan under 'long-term borrowings' in its financial statements.

Ind AS 109 requires an entity to assess whether the modification in the terms of the borrowings would result in its derecognition and the recognition of a new liability. Further, Ind AS 101 prohibits retrospective application of the derecognition requirement (where such derecognition was prior to transition to Ind AS), unless the information required to apply the same was obtained at the time of initially accounting for those transactions.

Assuming that the entity in this case did not have the information required to apply the derecognition requirements retrospectively, in accordance with Ind AS 101, the entity should not reassess whether the derecognition of accrued interest on the old loans and recognition of the new loans (including the FITL) would have been appropriate under Ind AS.

Accounting for interest-free loan

Since the FITL is an interest-free loan (the EAC noted), entity would have to determine its fair value on initial recognition (i.e., at the time of the financial restructuring), being its discounted present value based on the prevailing market interest rate (for a similar instrument as to currency, term, type of interest rate and other factors with a similar credit rating) at the time of initial recognition.

Additionally, the EAC clarified that the amortised cost on the date of transition would then be determined by unwinding the discount for the period from the date of initial recognition to the transition date. The resultant adjustment, related to the unwinding of the discount, should be recognised in retained earnings on transition.

In the given situation the entity would be required to determine whether B Ltd. (while providing the loan) was acting as a shareholder or a lender. Thereafter the accounting treatment would be as below:

- **Where B Ltd. was acting in its capacity of a shareholder (by providing financial support in the form of interest-free funding):** The difference between the nominal amount and the fair value on initial recognition of the FITL would be recognised in an appropriate component of equity (as a non-reciprocal capital contribution by the shareholder) on transition to Ind AS (Similar to guidance of *ITFG 18, Issue 3*)
- **Where B Ltd. was acting as a lender (similar to an unrelated lender by providing financial restructuring package to its borrower due to financial difficulty):** The difference between the FITL amount and its fair value would generally be recognised in profit or loss, unless it qualifies for recognition as an asset or liability.

Government grant

If the lender is government entity then it needs to be evaluated if the lender is acting in its capacity of a government.

Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance*, provides that the government grants are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity.

The FITL is an interest-free loan extended by the lender to the entity as a consequence of a financial restructuring package due to financial difficulty. The interest-free benefit is, therefore, not in the nature of government assistance or benefits provided to similar entities in general. There are no further terms or conditions attached to the receipt of this benefit that need to be complied with by the entity. These factors indicate that the lender is not acting in its capacity as government in providing the interest-free FITL to the entity.

Hence, the EAC clarified that the FITL does not meet the definition of a government grant.

16. EAC-March 2019 edition of the ICAI Journal 'The Chartered Accountant'

