



Ind AS 32 and Ind AS 109 - Financial
Instruments
Classification, recognition and
measurement

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In a nutshell

- Comprehensive standards on financial instruments issued under the Companies (Indian Accounting Standards) Rules, 2015.
- Financial instruments to be classified as per substance rather than legal form.
- All financial instruments are initially measured at fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss (FVTPL), transaction costs.
- Subsequent to initial recognition, financial assets should be measured at amortised cost, fair value through other comprehensive income (FVTOCI) or FVTPL. Amortised cost classification is permissible for debt instruments only if they meet both the business model test and the contractual cash flow characteristics test.
- All equity investments in the scope of Ind AS 109 are to be measured at fair value in the statement of financial position, with value changes recognised in profit or loss, except for those equity investments for which the entity has irrevocably elected to present value changes in other comprehensive income (OCI).
- For financial liabilities, two measurement categories exist: FVTPL and amortised cost. Financial liabilities held for trading are measured at FVTPL, and all other financial liabilities are measured at amortised cost unless the fair value option is applied.
- For financial assets, reclassification is required between FVTPL, FVTOCI and amortised cost, if and only if the entity's business model objective for its financial assets changes so its previous model assessment would no longer apply. Classification must be done prospectively. No reclassification allowed for equity investments measured at FVTOCI, or where the fair value option has been exercised for financial assets. Reclassifications of financial liabilities in and out of FVTPL category are prohibited.

Executive summary

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Currently under Indian GAAP, there is no comprehensive literature for accounting for financial instruments. While AS 13, *Accounting for Investments* deals with the accounting for investments in the financial statements and related disclosure requirements, it does not cover the classification and measurement of financial liabilities. While some other standards cover some other aspects of financial instruments, e.g. AS 11 *The Effects of Changes in Foreign Exchange Rates* covers certain forward exchange contracts, the requirements in the Indian standards were never as robust as in the International Standards.

With the issuance of the Companies (Indian Accounting Standards) Rules, 2015, the position now changes as all specified companies (other than banks, non-banking financial companies and insurance companies) will now have to follow the Indian Accounting Standards (Ind AS). Ind AS contains comprehensive standards that deal with financial instruments and introduce concepts that are relatively new in India.

The distinction between equity and liability itself will now need careful consideration with the substance rather than legal form driving the classification. It is expected that a lot more instruments may now get reclassified as a financial liability from equity. The potential change in classification of preference shares and certain other instruments from equity and the consequential recognition of dividends paid on such instruments as interest cost may impact financial ratios. The impact of this change on debt covenants, if any, should be ascertained.

Under Indian GAAP, the use of fair value is limited to current investments which are required to be recognised at the lower of cost and fair value. Long term investments are always recognised at cost less permanent diminution in value. Under Ind AS, an entity will be required to classify financial assets as subsequently measured at either amortised cost or fair value on the basis of both the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial asset. A reclassification is required when there is a change in the business model. Therefore, a substantial amount of judgment will now be required to determine the correct classification. There will also be a need to track historical data to ascertain whether the business model test is met. Systems and processes associated with gathering historical information, information relating to fair values etc. may need to be modified to support the capture of additional data elements that may not currently be supported by legacy systems.

All equity investments within the scope of Ind AS 109 are to be measured on the balance sheet at fair value with the default recognition of gains and losses in profit or loss which could lead to income statement volatility. Only if the equity investment is not held for trading can an irrevocable election be made at initial recognition to measure it at FVTOCI with only dividend income recognised in profit or loss. The valuations market in India is not mature and obtaining the fair value of unquoted instruments may also prove to be a challenge.

Ind AS 109 does not require an assessment or separation of embedded derivatives for financial assets. Instead if there are exotic features, the instrument is likely to fail the contractual cash flow characteristics test and be measured at FVTPL in its entirety (by virtue of it not qualifying for amortised cost accounting or failing the FVTOCI category for debt instruments).

For financial liabilities which are usually recognised at par value under Indian GAAP, there will henceforth be two measurement categories: FVTPL and amortised cost. Financial liabilities held for trading will be measured at FVTPL, and all other financial liabilities will be measured at amortised cost unless the fair value option is applied.

These changes can impact organisations in the area of key performance indicators, product portfolio, risk management, budgeting and planning, and reporting and regulatory compliance.

Standards dealing with financial instruments under Ind AS

Under Ind AS, three Standards deal with accounting for financial instruments.

- Ind AS 32 *Financial Instruments: Presentation* deals with the presentation and classification of financial instruments as financial liabilities or equity and sets out the requirements regarding offset of financial assets and financial liabilities in the balance sheet.
- Ind AS 107 *Financial Instruments: Disclosures* sets out the disclosures required in respect of financial instruments.
- Ind AS 109 *Financial Instruments* contains guidance on the recognition, derecognition, classification and measurement of financial instruments, including impairment and hedge accounting.

In this publication on Ind AS 32 and Ind AS 109, we deal with the classification, recognition and measurement aspects of financial instruments.

At the outset, it may be noted that fair value of financial instruments should be determined in accordance with the principles enunciated in Ind AS 113 *Fair Value Measurement*.

Financial instruments

The definition of a financial instrument is broad. A financial instrument is defined as any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. Trade receivables and payables, bank loans and overdrafts, issued debt, equity and preference shares, investments in securities (e.g. shares and bonds), and various derivatives are just some of the examples of financial instruments. In addition, some contracts to buy or sell non-financial items that would not meet the definition of financial instruments are specifically brought within the scope of the financial instruments Standards on the basis that they behave and are used in a similar way to financial instruments.

3.1 Financial assets

A financial asset is any asset that is:

- cash;
- an equity instrument of another entity;
- a contractual right:
 - to receive cash or another financial asset from another entity; or
 - to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
- a contract that will or may be settled in the entity's own equity instruments under *certain circumstances*.

Examples of financial assets are investments in equity instruments, investments in debt instruments, trade receivables, cash and cash equivalents, derivative financial assets.

3.2 Financial liabilities

A financial liability is any liability that is:

- a contractual obligation
 - to deliver cash or another financial asset to another entity; or
 - to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
- a contract that will or may be settled in the entity's own equity instruments under *certain circumstances*.

It should be noted that the equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of the entity's own equity instruments is an equity instrument if the exercise price is fixed in any currency. This is a deviation from IAS 32 *Financial Instruments: Presentation* where a conversion option to acquire a fixed number of equity shares for a fixed amount of cash in entity's functional currency only is treated as equity. Thus, a conversion option embedded in foreign currency convertible bonds is treated as embedded derivative which is not the case under Ind AS 32.

3.3 Equity

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

The presentation by the issuer of a financial instrument or its component parts as liability or equity is determined based on principles of classification contained in Ind AS 32.

Principles of liability/equity classification

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A financial instrument or its component parts should be classified by the issuer upon initial recognition as a financial liability or an equity instrument according to the substance of the contractual arrangement, rather than its legal form, and the definitions of a financial liability and an equity instrument. For some financial instruments, although their legal form may be equity, the substance of the arrangements is that they are liabilities. A preference share, for example, may display either equity or liability characteristics depending on the substance of the rights attaching to it.

The appropriate classification as a financial liability, equity or a combination of both, is determined by the entity when the financial instrument is initially recognised and that classification is not generally changed subsequently unless the terms of the instrument change. As exceptions to this general principle, there are certain circumstances in which reclassification may be appropriate even though the terms of the instrument have not changed. In addition, when the specific requirements for puttable instruments and instruments that contain an obligation to deliver a pro rata share of net assets at liquidation no longer apply or start to apply, reclassification may be appropriate.

When classifying a financial instrument in the consolidated financial statements, an entity should consider all of the terms and conditions agreed upon between members of the group and the holders of the instrument. For example, a financial instrument issued by a subsidiary could be classified as equity in the subsidiary's individual financial statements and as a liability in the consolidated financial statements if another group entity has provided a guarantee to make payments to the holder of the instrument.

4.1 Contractual obligation to deliver cash or another financial asset

The key feature in determining whether a financial instrument is a liability is the existence of a contractual obligation of one party (the issuer) to deliver cash or another financial asset to another party (the holder), or to exchange financial assets or liabilities under conditions that are potentially unfavourable. In contrast, in the case of an equity instrument (e.g. ordinary shares) the right to receive cash in the form of dividends or other distributions is at the issuer's discretion and, therefore, there is no obligation to deliver cash or another financial asset to the holder of the instrument. There is an exception to this rule for certain puttable instruments and instruments with an obligation to deliver a pro rata share of net assets only at liquidation.

Items such as deferred revenue and warranty obligations require delivery of goods or services rather than an obligation to deliver cash or another financial asset and, therefore, are not financial liabilities. Obligations to pay tax, company registration fees and other similar charges are obligations to pay cash. However, these are statutory rather than contractual requirements and, therefore, they are not financial liabilities. Similarly, constructive obligations (as defined in Ind AS 37 *Provisions, Contingent Liabilities and Contingent Assets*) do not arise from contracts and are not financial liabilities.

Liability characteristics are established in practice in a number of ways, as demonstrated below.

4.1.1 Mandatory redemption and/or mandatory interest payments

When an instrument requires mandatory redemption by the issuer for a fixed or determinable amount, a contractual obligation to deliver cash at redemption exists and, therefore, the instrument includes, and is presented as a liability. An exception to this principle applies for certain puttable instruments and certain instruments that contain an obligation to deliver a pro rata share of net assets at liquidation.

Example 4.1.1A: Mandatorily redeemable preference shares

Entity A issues preference shares that are mandatorily redeemable at par in 10 years. A contractual obligation to deliver cash exists for the repayment of principal - the issuer cannot avoid the outflow of cash in Year 10. Therefore, the preference shares should be classified as a financial liability.

Perpetual instruments provide the holder with no right to require redemption. However, the terms of such instruments often require the issuer to make coupon payments into perpetuity. A perpetual instrument with a mandatory coupon is a liability in its entirety because the whole of its value is derived from the stream of future coupon payments.

Example 4.1.1B: Perpetual coupon-bearing preference shares

A perpetual instrument is issued at a par amount of CU100 million requiring coupon payments of 8 percent to be made annually. Provided that 8 percent is the market rate of interest for this type of instrument when issued, the issuer has assumed a contractual obligation to make a future stream of 8 percent interest payments. The net present value of the interest payments is CU100 million and represents the fair value of the instrument. The preference shares should be classified as a financial liability.

Many traditional debt instruments such as bonds and bank loans involve both mandatory redemption and interest payments.

Other instruments may require a mandatory distribution of a percentage of the profits of an entity (to the extent that such profits are generated) rather than of a traditional interest payment. Such an instrument meets the definition of a liability because it is a contractual obligation of the issuer to deliver cash or another financial asset to the holder. The issuer has no discretion over paying out a percentage of its profits.

4.1.2 Contractual obligation that is not explicit

An obligation may be established indirectly through the instrument's terms and conditions. Ind AS 32 gives two examples of how such an obligation could be created.

- A financial instrument may contain a non-financial obligation that must be settled if, and only if, the entity fails to make distributions or to redeem the instrument. If the entity can avoid a transfer of cash or another financial asset only by settling the non-financial obligation, the financial instrument is a financial liability.
- A financial instrument is a financial liability if it provides that, on settlement, the entity will deliver either cash or another financial asset, or its own shares whose value is determined to exceed substantially the value of the cash or other financial asset. Although the entity does not have an explicit obligation to deliver cash or another financial asset, the holder of the asset has in substance been guaranteed a minimum amount equal to at least the cash/ other financial asset settlement option amount.

Example 4.1.2: Perpetual instrument with coupon step-up and dividend pusher

Issuer A issues a perpetual instrument with the following terms.

- CU100 million notional with annual 8 percent interest payments for 8 years. Issuer A has a call option embedded in the instrument that allows the instruments to be repurchased at the end of Year 8, and every year after, for CU100 million.
- If the instrument is not called by the issuer at the end of Year 8, the interest on the instrument increases to 14 percent per annum (commonly referred to as a 'step-up' feature).
- The interest payments before and after the call date are only payable if Issuer A pays a dividend on its ordinary shares which are classified wholly as equity (commonly referred to as a 'dividend pusher').
- Issuer A has consistently chosen to pay dividends on its ordinary shares. Issuer A's cost of borrowing for a similar debt instrument when the perpetual instrument is issued is for approximately 8 percent.

Issuer A does not have an indirect or a direct obligation to pay cash or other financial asset in respect of the perpetual instrument. The instrument is therefore classified wholly as equity.

Issuer A has no obligation to pay interest because it can always avoid paying interest by exercising its discretion and not paying dividends on its ordinary shares. Issuer A has no obligation to exercise its right to call the instrument at the end of Year 8 because the call right is an option and Issuer A could always choose not to exercise that right. Because the instrument is perpetual, there is no redemption date and, therefore, the instrument does not contain any contractual obligation to pay cash or another financial asset.

In determining the substance of the contractual arrangement, an entity must assess whether the terms of the instrument provide the issuer with discretion as to whether to deliver cash or another financial asset. In the circumstances described, Issuer A has discretion as to whether or not it wishes to pay an ordinary dividend. Even though it may be highly likely that Issuer A will choose to pay ordinary dividends and, as a result, will be required to pay interest under the perpetual instrument, the high likelihood is of itself not sufficient for the instrument to be classified as a financial liability. Similarly, although it may be very likely that Issuer A will pay interest on the perpetual instrument and will exercise its call option at the end of Year 8 (thus making the instrument economically equivalent to an 8-year loan), this of itself is not sufficient for the instrument to be classified as a financial liability.

4.1.3 Contingent settlement provisions

Financial instruments may be structured such that the obligation to deliver cash or another financial instrument arises only on the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument. The issuer does not have an unconditional right to avoid the obligation to deliver cash or another financial instrument and, therefore, such instruments are financial liabilities of the issuer unless:

- the contingent settlement provision that could require payment in cash or another financial asset is not genuine; or
- settlement in cash or another financial asset can only be required in the event of liquidation of the issuer; or
- the instrument meets the specified criteria for a puttable instrument or an obligation arising on liquidation to be classified as equity.

'Genuine' is generally understood to be not spurious or counterfeit, i.e. a genuine provision is one that is authentic and has commercial substance. A provision that is extremely rare, highly abnormal and very unlikely to occur is not considered genuine.

Future events that are beyond the control of both the issuer and the holder of the instrument include:

- a change in macroeconomic, industry and other indices such as a stock market index, consumer price index, growth in gross domestic product or total sector production;
- changes in law, government regulations, and other regulatory requirements (such as changes in taxation, pricing controls or accounting requirements); and
- changes in the key performance indicators of the issuer that are beyond the control of both the issuer and the holder such as revenues, net income or debt to equity ratio.

Example 4.1.3A: Contingent settlement provisions: change in accounting or tax law

Entity A issues preference shares bearing 5 percent non-cumulative dividends that are at the discretion of the issuer. The shares will be redeemed if the applicable taxation or accounting requirements were to change.

The contingent event of a change in taxation or accounting requirements is deemed to be genuine.

The requirement for redemption on change of taxation or accounting requirements represents a contingent settlement provision (i.e. it is an uncertain future event beyond the control of both the issuer and the holder of the instrument).

As the contingent event is genuine and can result in the issuer having to deliver cash or another financial asset at a time other than the Entity A's liquidation, the instrument is classified as a financial liability.

However, the 5 percent dividend is at the discretion of Entity A and, consequently, is equity of Entity A. Therefore, the preference share contain both debt and equity features, i.e. it is a compound instrument.

Example 4.1.3B: Contingent settlement provisions: initial public offering (1)

Entity B issues shares for CU1 million. Dividends are discretionary. Entity B must redeem the shares for par in the event of a flotation/initial public offering (IPO) of the entity. Entity B cannot guarantee a successful flotation/IPO, but it does have discretion as to whether or not to instigate proceedings to float or to seek an IPO. Given that Entity B can avoid redeeming the shares by avoiding the flotation/IPO, the instrument is classified as equity.

Example 4.1.3C: Contingent settlement provisions: initial public offering (2)

Entity C issues shares for CU1 million. Entity C must redeem the shares at par in the event that Entity C is not subject to a successful flotation/Initial Public Offering (IPO) within five years from the date of issue of the shares. Entity C cannot guarantee a successful flotation/IPO, but it does have discretion as to whether or not to instigate proceedings to float or to seek an IPO.

Given that the contingent event (a successful flotation/IPO) is not in the control of Entity C, it is a contingent settlement provision. The contingent settlement provision is considered genuine, it is potentially payable other than at liquidation, and the shares do not meet the puttable exception in Ind AS 32. Because Entity C cannot avoid redeeming the shares for cash, the instrument contains an obligation to pay cash that creates a financial liability.

Example 4.1.3D: Contingent settlement provisions: change of control

Entity D issues preference shares for CU1 million. Entity D must redeem the preference shares at par in the event that control of Entity D changes. A change in control is defined in the terms of the preference shares as a change in ownership of at least 51 percent of the ordinary shares of Entity D.

Given that the contingent event (the sale of ordinary shares in Entity D by one set of shareholders to another) is not in the control of the Entity D, it is a contingent settlement provision. Because Entity D cannot avoid redeeming the preference shares, the instrument is classified as a financial liability.

4.2 Equity instruments

In classifying a financial instrument as a liability or equity, equity classification is appropriate only if the instrument fails the definition of a financial liability as detailed above.

The key requirement in determining whether an instrument is equity is the issuer's unconditional ability to avoid delivery of cash or another financial asset. That ability is not affected by:

- the history of making distributions;
- an intention to make distributions in the future;
- a possible negative impact on the price of ordinary shares of the issuer if the distributions are not made on the instrument concerned;
- the amount of the issuer's reserves;
- an issuer's expectations of a profit or loss for the period; or
- an ability or inability of the issuer to influence the amount of its profit or loss for the period.

Provided that dividends are at the discretion of the issuer, it is irrelevant whether dividends are cumulative or non-cumulative.

Once a dividend is properly declared and the issuer is legally required to pay it, a contractual obligation to deliver cash comes into existence and a financial liability for the amount of the declared dividend should be recognised. Similarly, a liability arises upon liquidation to distribute to the shareholders the residual assets in the issuer, i.e. any remaining assets after satisfying all of its liabilities.

The existence of an option whereby the issuer can redeem equity shares for cash does not trigger liability classification because the issuer retains an unconditional right to avoid delivering cash or another financial asset. A contractual obligation would only arise at the point when the issuer exercised its right to redeem. This principle applies to all instruments that are not derivatives over own equity.

Specific rules apply to derivatives over own equity. For example, a purchased call option over a fixed number of shares will allow the issuer to buy back shares at a fixed price in the future. The issuer always has a choice as to whether it wishes to pay cash, because it always has a choice as to whether it wishes to exercise its option. However, this instrument is only treated as equity if it is gross physically settled in all cases when the issuer chooses to exercise, i.e. the option can never be net settled.

Instruments are frequently issued with a link to dividend payments on other types of instruments, most commonly ordinary shares. A 'dividend stopper' is a contractual term that requires no dividend to be paid on the ordinary shares if the payment is not made on another specified instrument. A 'dividend pusher' is a term that requires a dividend to be paid on a specified instrument if a dividend payment is made on ordinary shares.

Provided that the link is to the dividends on an instrument like an ordinary share where the issuer has discretion as to whether or not to pay a dividend, neither a 'dividend pusher' or a 'dividend stopper' of itself result in the instrument concerned being classified as a liability. This is because the issuer retains discretion as to whether or not to pay on the instrument, albeit that the decision will need to be made in conjunction with the decision on whether to pay dividends on ordinary shares. The issuer continues to have an unconditional right to avoid the outflow of cash (or other financial assets).

Example 4.2A: Dividend stopper

Entity Y issues 6 percent cumulative, non-redeemable preference shares with discretionary dividends that are subject to the availability of distributable reserves. The directors of Entity Y can decide at each period end whether and the extent to which a dividend will be paid on the preference shares. The terms of the instrument include a dividend stopper, i.e. if no dividend is paid on the preference shares, then no dividend is paid on Entity Y's ordinary shares.

The payment of dividends on the preference shares is entirely at Entity Y's discretion (albeit the decision will need to be made in conjunction with the decision on whether to pay dividends on ordinary shares). For this reason, the issuer continues to have an unconditional right to avoid the outflow of cash (or other financial assets) and, therefore, the preference shares are equity.

Example 4.2B: Dividend pusher

Entity M issues non-redeemable preference shares bearing 6 percent discretionary non-cumulative dividends that are subject to the availability of distributable reserves. The directors of Entity M can decide at each period end whether and the extent to which a dividend will be paid on the preference shares. The payment of dividends on Entity M's ordinary shares is also discretionary. However, the terms of the instrument include a dividend pusher, i.e. if a dividend is paid on Entity M's ordinary shares, then a dividend must be paid on the preference shares.

Because the payment of dividends on its ordinary shares is discretionary, Entity M continues to have an unconditional right to avoid the outflow of cash (or other financial assets) and, therefore, the preference shares are equity.

Compound instruments

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The terms of a financial instrument may be structured such that it contains both equity and liability components (i.e. the instrument is neither entirely a liability nor entirely an equity instrument). Such instruments are defined as compound instruments. An example of a compound instrument is a bond that is convertible, either mandatorily or at the option of the holder, into a fixed number of equity shares of the issuer. Compound instruments come in many forms and are not restricted solely to convertible instruments. The liability and equity components of a compound instrument are required to be accounted for separately.

The requirement to separate out the equity and financial liability components of a compound instrument is consistent with the principle that a financial instrument must be classified in accordance with its substance, rather than its legal form. A compound instrument takes the legal form of a single instrument, while the substance is that both a liability and an equity instrument exist.

For example, a convertible bond that pays fixed coupons and is convertible by the holder into a fixed number of ordinary shares of the issuer has the legal form of a debt contract; however, its substance is that of two instruments:

- a financial liability to deliver cash (by making scheduled payments of coupon and principal) which exists as long as the bond is not converted; and
- a written call option granting the holder the right to convert the bond into a fixed number of ordinary shares of the entity.

The economic effect of the instrument is substantially the same as issuing simultaneously (i) a debt instrument with an early settlement provision and (ii) warrants to issue ordinary shares.

5.1 Separating the liability and equity components

Separation of the instrument into its liability and equity components is made upon initial recognition of the instrument and is not subsequently revised. The method used is as follows:

- firstly, the fair value of the liability component is calculated, and this fair value establishes the initial carrying amount of the liability component; and
- secondly, the fair value of the liability component is deducted from the fair value of the instrument as a whole, with the resulting residual amount being recognised as the equity component.

This method of allocating the liability and equity components is consistent with the definition of equity as a residual interest in the assets of an entity after deducting all of its liabilities. It ensures that no gain or loss arises on the initial recognition of the two components.

The fair value of the liability component on initial recognition is the present value of the contractual stream of future cash flows (including both coupon payments and redemption amount) discounted at the market rate of interest that would have been applied to an instrument of comparable credit quality with substantially the same cash flows, on the same terms, but without the conversion option.

Example 5.1: Convertible debt

Entity A issues 2,000 convertible bonds on 1 January 20X5. The bonds have a 3-year term, and are issued at par with a face value of CU1,000 per bond, resulting in total proceeds of CU2 million. Interest is payable annually in arrears at an annual interest rate of 6 percent. Each bond is convertible, at the holder's discretion, at any time up to maturity into 250 ordinary shares. When the bonds are issued, the market interest rate for similar debt without the conversion option is 9 percent.

On initial recognition, the contractual cash flows of the liability component are valued first, and the difference between the proceeds of the bond issue (being the fair value of the instrument in its entirety) and the fair value of the liability is assigned to the equity component. The present value (i.e. fair value) of the liability component is calculated using a discount rate of 9 percent (i.e. the market interest rate for similar bonds with the same credit standing having no conversion rights). The calculation, which excludes the income tax entries, is illustrated below.

Proceeds of bond issue (A)		2,000,000
Present value of principal at the end of 3 years*	1,544,367	
Present value of interest (CU120,000 payable annually in arrears for 3 years**)	303,755	
Total liability component (B)		<u>1,848,122</u>
Residual equity component (A-B)		151,878

*present value of principal amount at 9 percent:
 $2,000,000/(1.09)^3 =$ 1,544,367

** present value of interest (CU120,000) payable at the end of each of 3 years:

interest at end of year 1: $120,000/1.09 =$	110,092
interest at end of year 2: $120,000/(1.09)^2 =$	101,002
interest at end of year 3: $120,000/(1.09)^3 =$	<u>92,661</u>
Total net present value of interest payments	303,755

Upon initial recognition of the convertible instrument in the financial statements of the issuer, the following entries are recorded.

	CU	CU
Dr Cash	2,000,000	
Cr Financial liability		1,848,122
Cr Equity		151,878

To recognise the recognition of convertible instrument.

Any transaction costs are allocated between the debt component and the equity component using their relative fair values.

The financial liability component will be subsequently measured in accordance with the measurement requirements in Ind AS 109 depending on its classification (either as a financial liability at FVTPL, or as an 'other' liability, measured at amortised cost using the effective interest method).

The equity component will not be remeasured.

5.2 Separating the liability and equity components when the instrument has embedded derivatives

In addition to the financial liability and equity components, a compound instrument may also have embedded derivatives. For example, the instrument may contain a call option exercisable by the issuer. The value of any such embedded derivative features must be allocated to the liability component. Thus, the carrying amount of the liability component is established by measuring the fair value of a similar liability (with similar terms, credit status and embedded non-equity derivative features) but without an associated equity component. The carrying amount of the equity component is then determined by deducting the fair value of the liability component from the fair value of the compound instrument as a whole.

A further assessment is required to establish whether the embedded derivative is closely related to the liability component. This assessment is made before separating the equity component. No gain or loss arises from initially recognising the components of the instrument separately.

Example 5.2: Convertible debt with issuer call

A CU functional currency entity issues a bond with a principal amount of CU60 million carrying a coupon of 5 percent payable annually in arrears. The instrument is issued for proceeds of CU60 million. The instrument is convertible into a fixed number of equity shares of the issuer after a specified date. The instrument has no fixed maturity. However, it contains an issuer call option that allows the issuer to redeem the bond at par at any point in time.

It is established that the value of a similar bond, of similar credit status with similar features except that it does not contain a call or equity conversion option at current market rates would be CU57 million. Based on an option pricing model, it is further determined that the value of the issuer purchased call option on a similar bond without a conversion option is an asset of CU2 million.

The value allocated to the liability and equity components should be as follows.

Liability component: CU55 million (CU57 million less CU2 million)

This reflects the inclusion of the value of the additional embedded derivative feature (asset) in the liability component.

Equity component: CU5 million (CU60 million - CU55 million)

This represents the equity residual arrived at by subtracting from the fair value of the whole instrument the fair value of the liability component (which includes the value of the embedded derivative feature in the form of the purchased call feature).

The guidance in Ind AS 109 will need to be considered in assessing whether the embedded derivative is closely related to the host contract or whether, subsequent to issuance of the bond, it will be accounted for separately at FVTPL.

5.3 Conversion of a compound instrument

Upon conversion of a compound instrument, equity is issued and the liability component is derecognised. The original equity component recognised at inception remains in equity (although it may be reclassified from one line item of equity to another). No gain or loss is recognised on conversion.

Example 5.3: Convertible debt: issue of new shares

Assume the facts are as in example 5.1, but the date now is 31 December 20X6 (i.e. the end of Year 2 of the instrument's life). Assume that, due to a rapidly rising share price, all holders of the bonds exercise their right to convert them into a fixed number of equity instruments of Entity A at 31 December 20X6.

The liability has been accounted for at amortised cost using the effective interest method.

At 31 December 20X6, the following applies:

- the amortised cost carrying amount of the liability (determined using the effective interest method) just before conversion is CU1,944,954;
- the original equity component just before conversion still stands at the original CU151,878; and
- upon conversion, 500,000 equity shares will be issued (250 equity shares per bond x 2,000 bonds issued) with each equity share having a nominal value of CU1.

The accounting entries on conversion are as follows.

		CU	CU
Dr	Bond	1,944,954	
Cr	Equity		1,944,954

To remove the liability from the statement of financial position and recognise the issue of shares as a result of conversion.

The original component of equity, CU151,878, may be reclassified to another line item within equity.

5.4 Early redemption of a compound instrument

When an entity redeems or repurchases a convertible instrument before its maturity through a tender offer (without altering the conversion feature), the consideration paid (including any transaction costs) is allocated to the liability and equity components at the date of the early redemption/early repurchase. The method used to make this allocation is the same as that used to make the original allocation of the proceeds of the issue of the instrument between the liability and equity components upon initial recognition.

To the extent that the amount of the consideration allocated to the liability component exceeds the carrying amount of the liability component at that time, a loss is recognised in profit or loss. Conversely, to the extent that the consideration allocated to the liability component is smaller than its carrying amount, a gain is recognised in profit or loss.

The amount of consideration allocated to equity is recognised in equity with no gain or loss being recognised (the equity component that is not eliminated may be reclassified to another line item within equity).

5.5 Treatment of mandatorily convertible instruments

An entity may issue an instrument that at the end of its life is mandatorily convertible into a fixed number of its equity shares (rather than conversion being at the option of the holder). This instrument is, in substance, a prepaid forward purchase of the entity's equity shares. Because the instrument carries an obligation for the issuer to make fixed interest payments during the life of the mandatorily convertible instrument, the instrument also includes a financial liability component.

5.6 Foreign currency denominated convertible debt

An entity may issue an instrument denominated in a foreign currency (a currency other than the functional currency of the entity) that is convertible into a fixed number of ordinary shares of the entity. Such an instrument contains a written option to exchange a fixed number of equity instruments for a fixed amount of cash that is denominated in a foreign currency.

A derivative contract over an entity's own equity is accounted for as equity only when it will be settled exclusively by the entity delivering (or receiving) a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset.

As stated in section 3.2, an equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of the entity's own equity instruments is an equity instrument if the exercise price is fixed in any currency.

Example 5.6A: Foreign currency denominated convertible debt

Entity A has a functional currency of Indian Rupees. Entity A issues a convertible bond denominated in US dollars that, if converted, will result in the gross physical delivery of fixed number of Entity A's INR denominated shares.

The conversion option is treated as equity because under Ind AS 32, a conversion option to acquire a fixed number of equity shares for fixed amount of cash in any currency is treated as equity.

As per IAS 32, the equity conversion option in case of foreign currency convertible debt (FCCBs) is a derivative liability, embedded in the bond. Fair value of the option is based on the share prices of the company and consequently will affect the fair value of derivative liability. Gains or losses arising on account of this embedded derivative should be recognised in profit or loss.

Example 5.6B: Foreign currency denominated convertible debt (As per IAS 32)

Entity A has a functional currency of Indian Rupees. Entity A issues a convertible bond denominated in US dollars that, if converted, will result in the gross physical delivery of a fixed number of Entity A's INR denominated shares.

The convertible bond will be classified in its entirety as a financial liability because, upon conversion, a fixed amount of shares will be delivered in exchange for a variable amount of functional currency cash, being the forgiveness of the bond obligation.

Treatment of interest, dividends, gains and losses and other items

The classification of a financial instrument or a component of a financial instrument as either a financial liability or an equity instrument determines the treatment of interest, dividends, and other gains and losses relating to that instrument or component of that instrument. Interest, dividends, losses and gains relating to a financial liability, or to a component of a compound instrument that is a financial liability, are recognised as income or expense in profit or loss. Distributions to holders of equity instruments should be recognised by the entity directly in equity. Similarly, transaction costs of an equity transaction are accounted for as a deduction from equity. Income tax relating to distributions to holders of an equity instrument and to transaction costs of an equity transaction should be accounted for in accordance with Ind AS 12 *Income Taxes*.

The following items are treated as income or expense in profit or loss:

- interest payments on a bond issued by an entity;
- dividend payments on preference shares that are classified as financial liabilities;
- gains and losses associated with redemption or refinancing an instrument classified as a financial liability (notwithstanding the fact that the instrument may take the legal form of a share);
- gains and losses related to the carrying amount of an instrument that is a financial liability notwithstanding the fact that the instrument gives the holder a right to participate in the residual interest of an entity (e.g. certain puttable instruments such as units in a mutual fund that fail equity classification); and
- costs of an equity transaction that is abandoned.

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

Dividends that are non-discretionary represent a financial liability (or, depending on the other terms of the shares, a component of a larger financial liability) to provide cash (or another financial asset) to shareholders. In accordance with Ind AS 32, such dividends are recognised as income or expense in profit or loss.

The obligation to pay non-discretionary dividends will be measured either at amortised cost (using the effective interest method) or at fair value depending on the classification of the financial liability to which the dividends relate. Unlike discretionary distributions to holders of equity instruments, recognition does not depend on declaration of the dividend.

The following items are accounted for within equity:

- dividend payments on shares classified wholly as equity; and
- incremental directly attributable costs incurred in successfully issuing or acquiring an entity's own equity instruments (including transaction costs, regulatory fees, amounts paid to regulatory, legal, accounting and other professional advisers, printing costs, stamp duties).

The amount of transaction costs accounted for as a deduction from equity in the period is disclosed in line with the requirements of Ind AS 1 *Presentation of Financial Statements*. Ind AS 32 does not specify where in equity the transaction costs should be recognised and will depend upon regulatory requirements if any.

Example 6A: Effective interest rate and dividends for a compound instrument

Entity A issues a non-cumulative preference share that is mandatorily redeemable for cash of CU10 million in 10 years' time. During the life of the instrument, dividends are payable at the discretion of Entity A. The non-cumulative preference share is issued for CU8 million.

The non-cumulative redeemable preference share is a compound instrument. The liability component is determined as the present value of the eventual redemption amount of CU10 million discounted at the rate at which the entity could issue a similar instrument with a similar credit standing but without the feature of discretionary dividends during its life.

Assuming the liability component is equal to CU7.8 million, the residual amount of CU0.2 million will be treated as the equity component. The unwinding of the discount (between the redemption of CU10 million and its present value of CU7.8 million) on the liability component is accounted for using the effective interest method as an interest expense and reported in profit or loss. Any discretionary dividends actually declared and paid are treated as relating to the equity component and, therefore, are classified as an equity distribution.

Transaction costs that are incremental and directly attributable to the issue of a compound financial instrument (i.e. they would have been avoided if the compound instrument had not been issued) are allocated to the liability and equity components in proportion to the allocation of the proceeds. Cost that relate jointly to more than one transaction (for instance a joint and concurrent offering of some equity instruments and an issue of instruments classified as liabilities) are allocated using a basis that is rational and consistent with similar transactions.

Example 6B: Transaction costs: placing and new issue of shares

Entity B places its privately held ordinary shares that are classified as equity with a stock exchange and simultaneously raises new capital by issuing new ordinary shares on the stock exchange. Transaction costs are incurred in respect of both transactions. Because the issue of new shares is the issue of an equity instrument, but the placing of the existing equity instruments with the exchange is not, the transaction costs will need to be allocated between the two transactions. Transaction costs in respect of the new shares issued will be recognised in equity whereas the transaction costs incurred in placing the existing shares with the stock exchange will be recognised in profit or loss.

Financial assets and financial liabilities - initial recognition

An entity should recognise a financial asset or a financial liability in its balance sheet when, and only when, the entity becomes party to the contractual provisions of the instrument and also classify the same according to measurement basis.

Examples of initial recognition of arrangements as financial assets and financial liabilities are:

- Unconditional receivables and payables are recognised as assets or liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash.
- Issued debt is recognised as a liability when the entity that issues it becomes a party to the contractual terms of the debt and, consequently, has a legal obligation to pay cash to the debt holder.
- A derivative is recognised as an asset or a liability on the commitment date, rather than on the date on which settlement takes place. At inception, the fair values of the right and obligation created by the derivative may be equal in which case the fair value of the derivative will be zero.

Arrangements that are not recognised as financial assets and financial liabilities are:

- Planned future transactions, no matter how likely, are not assets and liabilities because the entity has not become a party to a contract.
- Derivative contracts to buy or sell non-financial items that are scoped out of Ind AS 109 are not recognised as financial assets and financial liabilities because they are executory contracts.
- Assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognised until at least one of the parties has performed under the agreement.

Under Ind AS 109, a 'regular way' purchase or sale of financial assets can be recognised (and derecognised) using either 'trade date accounting' or 'settlement date accounting'.

7.1 Financial assets and liabilities - initial measurement

Ind AS 109 requires that a financial asset (except for certain trade receivables) or a financial liability should be measured at initial recognition at its fair value plus or minus, for financial assets or financial liabilities not subsequently measured at FVTPL, transaction costs that are directly attributable to the acquisition or issue of the financial asset or the financial liability. Trade receivables that do not contain a significant financing component (determined in accordance with Ind AS 115 *Revenue from Contracts with Customers*) are initially measured at their transaction price and not at fair value.

If the fair value of a financial asset or a financial liability at initial recognition differs from the transaction price and part of the consideration is not for something other than the financial instrument (e.g. for goods or services or capital contribution or deemed distribution) and if the fair value is evidenced by a quoted price in an active market for an identical asset or liability or based on a valuation technique that uses only data from observable markets, then, the difference is recognised as a gain or loss on initial recognition ('day 1 profit or loss'). In all other cases, the 'day 1 profit or loss' is included in the carrying amount of the asset or liability and, after initial recognition, is recognised as gain or loss only to the extent that it arises from a change in a factor (including time) that market participants would take into account when pricing the asset or liability.

7.1.1 Transaction costs

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

Transaction costs include fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and security exchanges, and transfer taxes and duties. However, debt premiums or discounts, financing costs, internal administrative costs and holding costs are not transaction costs. In practice, the interpretation of this definition may require significant judgement.

The consequences of the treatment of transaction costs on initial measurement are:

- For debt instruments subsequently measured at amortised cost or FVTOCI, transaction costs are included in the calculation of effective interest rate (EIR) - in effect, they are amortised through profit or loss over the term of the instrument.
- For investments in equity instruments designated as at FVTOCI, the transaction costs remain in equity and are not subsequently reclassified to profit or loss. An entity may choose to reclassify within equity the cumulative gain or loss (which includes transaction costs), for example, when the investment in equity instrument is derecognised.
- For financial instruments classified as at FVTPL, transaction costs are recognised in profit or loss immediately on initial recognition.

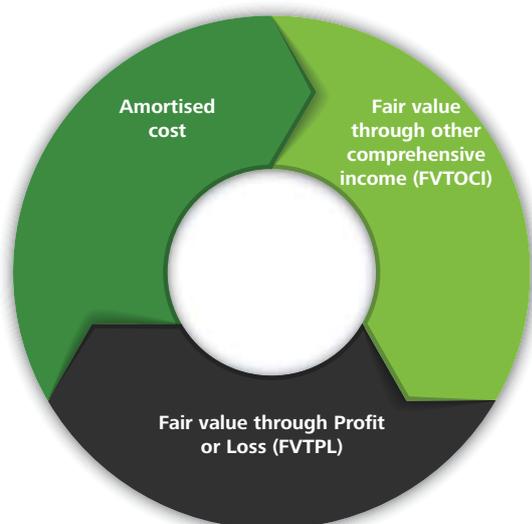
Example 7.1.1: Transaction costs

An entity acquires a financial asset for CU100 plus a purchase commission of CU2 that is measured at FVTOCI.

Initially, the entity recognises the asset at CU102. The reporting period ends one day later, when the quoted market price of the asset is CU100. If the asset were sold, a commission of CU3 would be paid. On that date, the entity measures the asset at CU100 (without regard to the possible commission on sale) and recognises a loss of CU2 in other comprehensive income. If the financial asset is measured at FVTOCI, the transaction costs are amortised to profit or loss using the effective interest method.

Financial assets - classification and subsequent measurement

Under Ind AS 109, financial assets are classified according to the measurement basis. Subsequent to initial recognition, the financial assets are measured at:

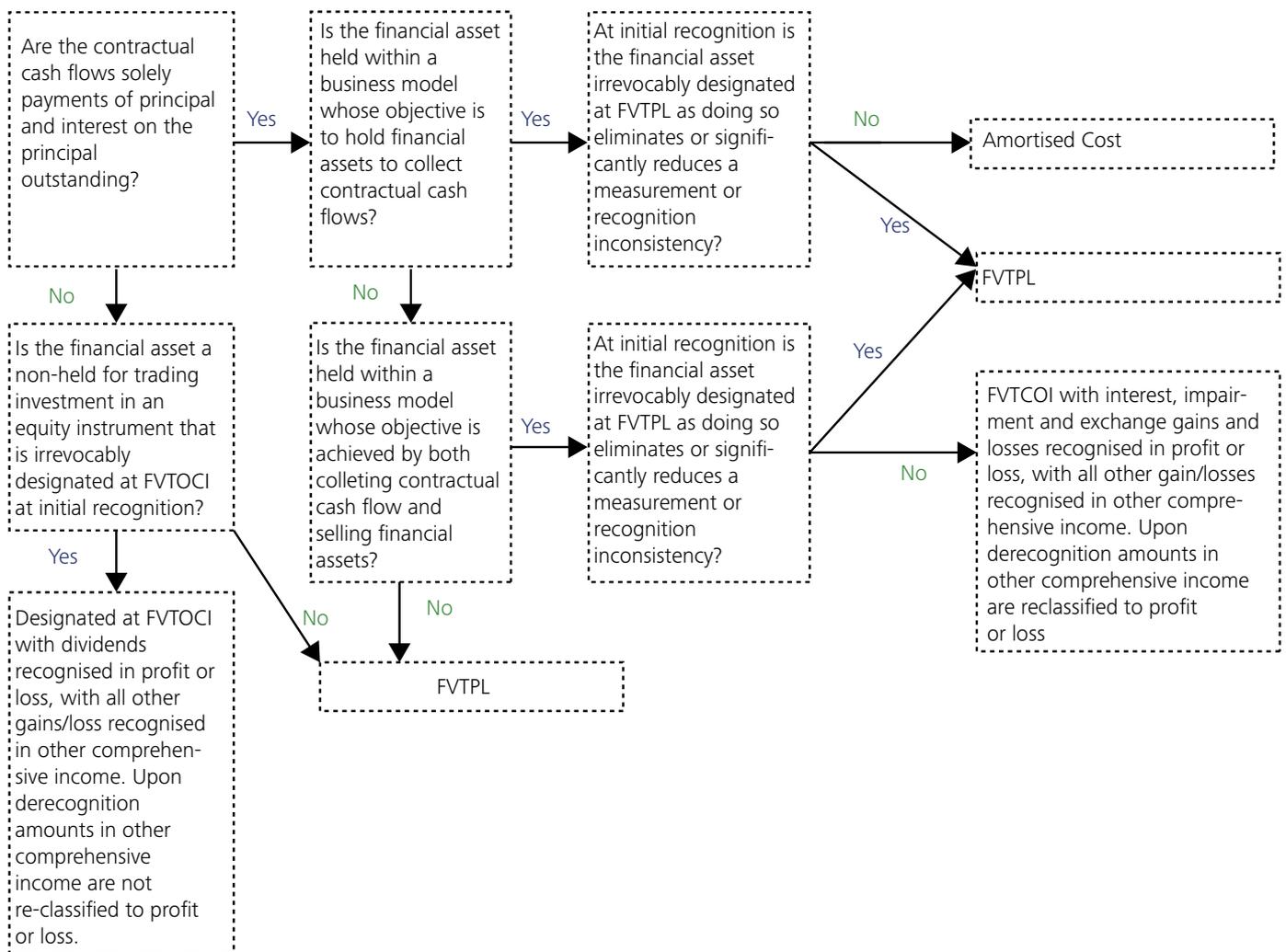


Investment in equity instruments are required to be measured at FVTPL, except that investment in equity instruments meeting certain criteria may be irrevocably designated as at FVTOCI on initial recognition.

Except for financial assets that are designated at initial recognition as at FVTPL, the classification of a financial asset is based on:

- the entity's business model for managing the financial assets; and
- the contractual cash flows characteristics of the financial asset.

The flow chart below summarises the classification model at initial recognition only.



The classification categories that are possible for different financial assets are summarised below:

Measurement category	Type of financial asset		
	Derivative instrument*	Investment in an equity instrument **	Investment in a debt instrument ***
Amortised cost			■
FVTOCI			■
• classified			■
• elected at initial recognition		■	
FVTPL			■
• classified	■	■	■
• elected at initial recognition			■

Footnotes:

* a derivative instrument is an asset that meets the definition of a derivative in Appendix A of Ind AS 109

** an investment in an equity instrument is a non-derivative financial asset that meets the definition of equity in Ind AS 32 from the perspective of the issuer. This does not include puttable instruments that contain a financial obligation but that are presented as equity by the issuer.

*** other financial assets in the scope of Ind AS 109 are investments in debt instruments (e.g. loans, receivables, debt securities).

8.1 Business model assessment

8.1.1 Business model to hold assets to collect contractual cash flows

Financial assets that are held within a business model whose objective is to hold assets in order to collect contractual cash flows are managed to realise cash flows by collecting contractual payments over the life of the instrument. That is, the entity manages the assets held within the portfolio to collect those particular contractual cash flows (instead of managing the overall return on the portfolio by both holding and selling assets).

In determining whether cash flows are going to be realised by collecting the financial assets' contractual cash flows, it is necessary to consider the frequency, value and timing of sales in prior periods, the reasons for those sales and expectations about future sales activity. However sales in themselves do not determine the business model and therefore cannot be considered in isolation. Instead, information about past sales and expectations about future sales provide evidence related to how the entity's stated objective for managing the financial assets is achieved and, specifically, how cash flows are realised. An entity must consider information about past sales within the context of the reasons for those sales and the conditions that existed at that time as compared to current conditions.

Although the objective of an entity's business model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those instruments until maturity. Thus an entity's business model can be to hold financial assets to collect contractual cash flows even when sales of financial assets occur or are expected to occur in the future.

The business model may be to hold assets to collect contractual cash flows even if the entity sells financial assets when there is an increase in the assets' credit risk.

Sales that occur for other reasons, such as sales made to manage credit concentration risk (without an increase in the assets' credit risk), may also be consistent with a business model whose objective is to hold financial assets in order to collect contractual cash flows.

If more than an infrequent number of such sales are made out of a portfolio and those sales are more than insignificant in value (either individually or in aggregate), the entity needs to assess whether and how such sales are consistent with an objective of collecting contractual cash flows. Whether a third party imposes the requirement to sell the financial assets, or that activity is at the entity's discretion, is not relevant to this assessment. An increase in the frequency or value of sales in a particular period is not necessarily inconsistent with an objective to hold financial assets in order to collect contractual cash flows, if an entity can explain the reasons for those sales and demonstrate why those sales do not reflect a change in the entity's business model. In addition, sales may be consistent with the objective of holding financial assets in order to collect contractual cash flows if the sales are made close to the maturity of the financial assets and the proceeds from the sales approximate the collection of the remaining contractual cash flows.

8.1.2 Business model to hold assets both to collect contractual cash flows and to sell

There are various objectives that may be consistent with this type of business model. For example, the objective of the business model may be to manage everyday liquidity needs, to maintain a particular interest yield profile or to match the duration of the financial assets to the duration of the liabilities that those assets are funding. To achieve such an objective, the entity will both collect contractual cash flows and sell financial assets.

Compared to a business model whose objective is to hold financial assets to collect contractual cash flows, this business model will typically involve greater frequency and value of sales. This is because selling financial assets is integral to achieving the business model's objective instead of being only incidental to it. However, there is no threshold for the frequency or value of sales that must occur in this business model because both collecting contractual cash flows and selling financial assets are integral to achieving its objective.

8.2 Contractual cash flows characteristics test

For a financial asset that is a debt instrument to be measured at amortised cost or FVTOCI, its contractual terms must give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. For the purposes of applying this requirement, principal is the fair value of the financial asset at initial recognition, however that principal amount may change over the life of the financial asset (for example, if there are repayments of principal). Interest consists of consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin.

The assessment as to whether contractual cash flows are solely payments of principal and interest is made in the currency in which the financial asset is denominated.

In practice only debt instruments held are capable of meeting the contractual cash flows characteristics test discussed above. Derivative assets and investments in equity instruments will not meet the criteria.

Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with a basic lending arrangement. In a basic lending arrangement, consideration for the time value of money and credit risk are typically the most significant elements of interest. However, in such an arrangement, interest can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time. In addition, interest can include a profit margin that is consistent with a basic lending arrangement. However, contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices, do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. An originated or a purchased financial asset can be a basic lending arrangement irrespective of whether it is a loan in its legal form.

8.2.1 Consideration for the time value of money

Time value of money is the element of interest that provides consideration for only the passage of time. That is, the time value of money element does not provide consideration for other risks or costs associated with holding the financial asset. In order to assess whether the element provides consideration for only the passage of time, an entity applies judgement and considers relevant factors such as the currency in which the financial asset is denominated and the period for which the interest rate is set.

8.2.2 Fixed cash flows

A non-prepayable fixed rate instrument that has a fixed return provides the holder with consideration for the time value of money.

Example 8.2.2: Zero coupon bond

Entity W acquires a zero coupon bond that was originally issued by Entity X. The terms of the bond require repayment of CU10 million by Entity X in 3 years and is not prepayable. The terms of the bond do not include a contractual interest rate.

Whether Entity W acquired the zero coupon bond at the date it was originally issued by Entity X or at a later date does not affect the assessment as to whether the asset can be classified at amortised cost or FVTOCI by Entity W. At the date of acquisition, Entity W has a financial asset that provides a fixed return of interest and repayment of principal. The fixed return is the difference between the amount paid to acquire the bond and the amount due from Entity X at redemption.

8.2.3. Floating rate loans

A financial asset that has a variable rate of interest that consists of consideration for the time value of money, the credit risk associated with the principal amount outstanding during a particular period of time (the consideration for credit risk may be determined at initial recognition only, and so may be fixed) and other basic lending risks and costs, as well as a profit margin, will meet the contractual cash flow characteristics test.

Example 8.2.3A: Floating rate loan

Entity S lends CU10 million to Entity T. The terms of the loan require Entity T to repay CU10 million in 3 years and the loan is not prepayable. The interest rate on the loan is based on LIBOR plus 2 percent on CU10 million payable in arrears at the anniversary date of the lending. The rate of LIBOR is determined in advance, i.e. at the start of each annual period. There are no other features in the contractual terms that result in any variability in the contractual cash flows.

Even though the interest on the loan is partly fixed and partly variable, the variable element is determined by reference to a market interest rate and therefore, for Entity S, the loan gives rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. Consequently, the contractual cash flows characteristics test is met.

A floating contractual interest rate would not be regarded as consideration for the time value of money and for the credit risk of the borrower if the changes in the contractual floating interest rate do not move in the same direction as the interest rate index (i.e. when the interest rate index increases the contractual floating interest rate decreases, and vice versa).

Example 8.2.3B: Adjustments to the coupon for changes in credit risk of the issuer

Entity Q lends CU10 million to Entity P. The terms of the loan require repayment of CU10 million by Entity P in five years.

The interest rate is payable yearly in arrears and is calculated as follows:

- fixed rate of 6 percent (considered to be compensation for the time value of money); plus
- a credit margin that initially reflects the credit risk of the borrower at the date the loan is originated and is automatically adjusted on an annual basis during the loan term to reflect changes in the borrower's credit risk.

Assuming that all contractual terms other than automatically adjusting the credit margin represent solely payments of principal and interest, the inclusion of credit risk adjusted margin would result in the instrument passing the contractual cash flow characteristics test.

Example 8.2.3C: Increased interest rate if issuer redemption option not exercised

Entity B invests in a debt security that bears a floating interest rate (e.g. interest rate index plus 2 percent) for the first three years. At the end of Year 3, the issuer has the option to redeem the note at principal plus unpaid contractual interest. If the issuer does not redeem, the interest rate margin on the floating interest rate increases by a fixed amount (i.e. the same interest rate index plus increased margin) until maturity at the end of Year 5.

The financial asset contains no other terms that would fail the contractual cash flow characteristics test.

Although there is optionality regarding the life of the instrument, with a linked change in interest rate, under either option the cash flows of the instrument represent principal and interest on the principal amount outstanding. A similar instrument (i.e. with the margin over the floating rate index stepping up after a point in time) which did not include an issuer redemption option would meet the 'solely payments of principal and interest' condition. The addition of the issuer redemption option does not alter this conclusion.

8.2.4 Prepayment options

A contract may permit the issuer to prepay, or the holder to put back, a debt instrument before maturity. Whether a prepayment option passes the contractual cash flows characteristics test will depend on what events are needed to occur that then permit the issuer to prepay or the holder to put back, and how much is the prepayment amount. Generally, both factors are important in determining whether the financial asset gives rise only to contractual cash flows that are a return of principal and interest on the principal outstanding.

When the amount and/or timing of contractual cash flows are contingent on a future event, consideration must be given to the nature of the event. While the nature of the contingent event in itself is not a determinative factor in assessing whether the contractual cash flows are solely payments of principal and interest, it may be an indicator.

Therefore, a prepayment option that is exercisable only when an event happens that is unrelated to the risks associated with a basic lending arrangement, for example, a return not based on the time value of money, credit risk of the borrower and liquidity risk of the instrument, may not pass the contractual cash flows characteristics test. The inclusion of risks unrelated to a basic lending arrangement may not provide a return of principal and interest on the principal outstanding.

Example 8.2.4A: Prepayment option linked to credit quality of the borrower

Entity F borrows CU10 million from a bank. The borrowing agreement permits the bank to demand early repayment if Entity F's credit ratings slips three notches relative to the rating when the borrowing was made.

The contingent feature within the early repayment term is consistent with a return of principal and interest on the principal outstanding as the contingent event is directly linked to the credit risk of the borrower. The credit risk of the borrower is a risk that is reflected in a basic lending arrangement.

Example 8.2.4B: Lender's option to demand early repayment contingent on covenant breach

Entity E lends CU10 million to Entity F at a fixed interest rate; the loan is repayable in 3 years. Entity E has the right to demand early repayment at par plus accrued interest if Entity F's interest cover ratio (ratio of profit before interest cost to interest cost) falls below a specified level.

Even though the prepayment option is contingent on a future event (i.e. the future interest cover ratio), the prepayment option does not breach the contractual cash flows characteristics test because the feature protects the lender from the risk of non-payment by the borrower in circumstances where the borrower is subject to low profitability.

Example 8.2.4C: Borrower's option to prepay at a premium

Entity B lends CU10 million to Entity C at a fixed interest rate; the loan is repayable in 3 years. Entity C has the right to prepay the loan after the first anniversary of the loan at CU10 million plus any accrued interest plus a prepayment penalty

The prepayment option written by Entity B as part of the loan to Entity C does not breach the contractual cash flows characteristics test because the right to prepay merely results in the acceleration of the payment of principal outstanding. Compensation for accrued interest and a reasonable penalty which aims to compensate Entity B for reinvestment risk (because Entity C is more likely to prepay the loan when interest rates have fallen) would not breach the contractual cash flows characteristics test.

8.2.5 Extension options

A contract may permit the issuer to extend the term of the borrowing, or permit the holder to extend the term of its lending. Whether an extension option passes the contractual cash flows characteristics test will be influenced by what events are needed to occur that then permits the issuer or holder to extend the term of the instrument, and what are the terms of the instrument following extension and for the remaining life. Both factors are important in determining whether the financial asset gives rise only to contractual cash flows that are a return of principal and interest on the principal outstanding.

8.2.6 Perpetual debt instruments

The fact that an instrument is perpetual (i.e. it has no stated maturity date) does not in itself mean that the contractual cash flows are not payments of principal and interest on the principal amount outstanding. Consideration will need to be given to the contractual interest rate, which will include whether it provides for consideration for the time value of money, credit risk of the borrower, liquidity risk, and a profit margin for the lender. Variability in the contractual cash flows due to factors other than this will generally result in the instrument failing the contractual cash flows characteristics test.

A perpetual instrument is like a stream of continuous (multiple) extension options. Such options will result in contractual cash flows that are payments of principal and interest on the principal amount outstanding if the contractual cash flows following each interest payment (i.e. each extension option) are themselves considered solely payments of principal and interest on the principal amount outstanding.

A perpetual interest may also be prepayable by the issuer, or the holder may demand early repayment. The prepayment feature shall be considered in the same way as a prepayment feature on redeemable debt, i.e. one that is not perpetual and has a specified term.

8.2.7 Leverage

Leverage is a contractual cash flow characteristic of some financial assets. Leverage increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest. Stand-alone option, forward and swap contracts are examples of financial assets that include such leverage. Thus, such contracts do not meet the contractual cash flow characteristics test and cannot be subsequently measured at amortised cost or FVTOCI.

Such instruments will be classified as at FVTPL (unless designated as an effective hedging instrument in a cash flow hedge or as a hedge of a net investment in a foreign operation).

Leverage is regarded as a multiple greater than one. Therefore, a contractual cash flow that is linked to, say, LIBOR multiplied by 1.1 would be regarded as leveraged

Example 8.2.7: Contractual leveraged return

Entity L invests in a debt instrument that has an interest rate linked to LIBOR. The contractual return is LIBOR plus 100 basis points except when LIBOR is greater than 6 percent. For the period when LIBOR is greater than 6 percent, the contractual interest return changes to LIBOR multiplied by 1.5 (i.e. if LIBOR was 7 percent, the contractual interest return would increase to 10.5 percent). The debt instrument is not regarded as having contractual terms that give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding and, therefore, must be measured subsequent to initial recognition at FVTPL.

8.3 Criteria for amortised cost measurement

Two conditions need to be satisfied to measure a financial asset at amortised cost:

- The assets must be held in a business model whose objective is to collect the contractual cash flows (as opposed to an objective of realising fair value through sale) (the business model test); and
- The contractual cash flows are solely payments of principal and interest on principal, where interest is the compensation for the time value of money and credit risk (the contractual cash flows characteristics test).

Because both the above conditions (the business model test and the contractual cash flow characteristics test) must be met for amortised cost measurement, the order in which the tests are performed is irrelevant. However, in practice, it is likely that the business model test will be considered first, because it is performed at a higher level of aggregation and not for each financial asset individually.

8.4 Criteria for measurement at FVTOCI

A financial asset should be measured at FVTOCI if both of the following conditions are met:

- The asset is held in a business model in which assets are managed both in order to collect contractual cash flows and for sale (the business model test); and
- The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (the contractual cash flows characteristics test).

For a typical debt instrument, the classification would be as under:

Test	Debt Instrument				
Business Model Test ?	1. Hold to collect	2. Hold to collect and sales	Either 1 or 2	Neither 1 nor 2	Neither 1 nor 2
Cash Flow test ?	Met	Met	Not Met	Not Met	Met
Classification	Amortised cost*	FVTOCI*	FVTPL	FVTPL	FVTPL

*except if FVTPL designation is elected

8.4.1 Designation of equity instruments as at FVTOCI

At initial recognition, an entity may make an irrevocable election to present in other comprehensive income subsequent changes in fair value of an investment in equity instrument that is not held for trading nor contingent consideration recognised by an acquirer in a business combination to which Ind AS 103 Business Combinations applies. This election is made on an instrument-by-instrument (i.e. share-by-share) basis.

8.5 Criteria for measurement at FVTPL

Any financial asset that does not qualify for amortised cost measurement or measurement at FVTOCI must be measured subsequent to initial recognition at FVTPL (except in the case of an investment in an equity instrument irrevocably designated as at FVTOCI). In addition, financial assets that are held for trading or designated at initial recognition as at FVTPL must be measured subsequent to initial recognition at FVTPL.

8.5.1 Financial assets held for trading

A financial asset is held for trading if:

- it is acquired principally for the purpose of selling it in the near term;
- on initial recognition it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
- is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

8.5.2 Designation of certain financial assets as at FVTPL

An entity may, at initial recognition, irrevocably designate a financial asset that meets the conditions for amortised cost measurement or measurement at FVTOCI as at FVTPL if that designation eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would have occurred if the financial asset had been measured at amortised cost or FVTOCI respectively.

Investment in equity instruments are required to be measured at FVTPL, except that investment in equity instruments meeting certain criteria may be irrevocably designated as at FVTOCI on initial recognition.

8.6 Subsequent measurement

The classification of financial instruments determines how they are subsequently measured.

8.6.1 Amortised cost

The amortised cost category applies only to debt instrument financial assets that meet the specified criteria (see section 8.3 above). Amortised cost measurement requires the application of the effective interest method.

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

Gains and losses resulting from fluctuations in fair value are not recognised for financial assets classified in the amortised cost measurement category.

8.6.2 FVTOCI

Two types of financial assets are measured at FVTOCI:

- Investments in particular equity instruments that may irrevocably be designated at initial recognition as at FVTOCI (see section 8.4.1 above). If this election is made, only dividend income that does not clearly represent a recovery of part of the cost of the investment is recognised in profit or loss, with all other gains and losses (including those relating to foreign exchange) recognised in OCI. Those gains and losses remain permanently in equity and are not subsequently transferred to profit or loss even on derecognition. However, the entity may transfer the cumulative gain or loss within equity.
- Debt instruments measured at FVTOCI: For these, changes in fair value should be recognised in OCI except for:
 - interest calculated using the effective interest rate;
 - foreign exchange gains and losses; and
 - impairment gains and losses,

until the financial asset is derecognised or reclassified.

When the financial asset is derecognised, the cumulative gain or loss previously recognised in OCI is reclassified from equity to profit or loss as a reclassification adjustment under Ind AS 1 *Presentation of Financial Statements*.

If a debt instrument asset is measured at FVTOCI, the amounts that are recognised in profit or loss are the same as the amounts that would have been recognised in profit or loss if the financial asset had been measured at amortised cost.

8.6.3 FVTPL

Assets classified as at FVTPL are measured at fair value. Gains and losses that arise as a result of changes in fair value are recognised in profit or loss, except for those arising on hedging instruments that are designated in effective cash flow hedges or hedges of net investments in foreign operations.

Gains and losses that arise between the end of the last reporting period and the date an instrument is derecognised do not constitute a separate 'profit/loss on disposal'. Such gains and losses will have arisen prior to the disposal, while the item is still being measured at FVTPL, and should be recognised in profit or loss when they occur.

8.6.4 Hedged items

Ind AS 109 includes specific requirements to be applied when accounting for a financial asset that is a hedged item.

8.6.5 Measurement of unquoted equity instruments

Ind AS 109 requires all investments in equity instruments and contracts on those instruments to be measured at fair value. However, Ind AS 109 also requires that in some limited circumstances, cost may be an appropriate estimate of fair value. That may be the case if insufficient more recent information is available to measure fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range. Cost is never the best estimate of fair value for investments in quoted equity instruments (or contracts on quoted equity instruments).

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

- a significant change in the performance of the investee compared with budgets, plans or milestones;
- changes in expectation that the investee's technical product milestones will be achieved;
- a significant change in the market for the investee's equity or its products or potential products;
- a significant change in the global economy or the economic environment in which the investee operates;
- a significant change in the performance of comparable entities, or in the valuations implied by the overall market;
- internal matters of the investee such as fraud, commercial disputes, litigation, changes in management or strategy;
- or
- evidence from external transactions in the investee's equity, either by the investee (such as a fresh issue of equity), or by transfers of equity instruments between third parties.

This list is not exhaustive. An entity is required to use all information about the performance and operations of the investee that becomes available after the date of initial recognition. To the extent that any relevant factors indicate that cost may not be representative of fair value, the entity is required to measure fair value.

For particular entities such as financial institutions and investment funds the cost of equity investments cannot be considered representative of fair value.

8.7 Reclassification of financial assets

An entity is required to reclassify financial assets when it changes its business model for managing financial assets.

Investments in equity instruments that are designated as at FVTOCI at initial recognition cannot be reclassified, since, the election to designate as at FVTOCI is irrevocable.

It is not appropriate for financial assets that are designated as at FVTPL to be reclassified after initial recognition.

Reclassifications are expected to be very infrequent. Such changes must be determined by the entity's senior management as a result of external or internal changes and must be significant to the entity's operations and demonstrable to external parties. Accordingly, a change in an entity's business model will occur only when an entity either begins or ceases to perform an activity that is significant to its operations; for example, when the entity has acquired, disposed of or terminated a business line.

The following are not changes in business model:

- a change in intention related to particular financial assets (even in circumstances of significant changes in market conditions);
- the temporary disappearance of a particular market for financial assets; and
- a transfer of financial assets between parts of the entity with different business models.

If there has been no change in the business model for managing financial assets, if the terms of the financial assets remain unchanged, or the terms of a financial asset change but the asset is not derecognised, reclassification is not permitted. If the terms of an instrument change sufficiently to warrant derecognition, this would not be a reclassification; instead, the old asset is derecognised and the new one is recognised. In cases where terms inherent in the instrument expire or take effect during the instrument's life, and the asset continues to be recognised, the changing terms would not change the classification assessment made at initial recognition.

Example 8.7A: Terms of instrument unchanged

Entity D lends CU10 million to Entity E; the loan is repayable in 5 years. The contractual return on the loan for the first three years is derived from movements in a specified equity price index. In Years 4 and 5, the contractual return is 5 percent of par.

At initial recognition, Entity D classifies the loan as a financial asset measured as at FVTPL because the loan does not pass the contractual cash flows characteristics test. The contractual return is linked to equity prices and, therefore, is not consistent with a basic lending arrangement.

Entity D is not permitted to reclassify the financial asset after Year 3, the period during which the contractual linkage to equity prices ceases, because the terms of the instrument have not changed since initial recognition and the original asset continues to be recognised.

When a financial asset converts into a different financial asset during the instrument's life, the entity must consider whether the original asset should continue to be recognised or whether, on conversion, the old instrument is derecognised and the new one is recognised.

Example 8.7B: Reclassification versus recognition and derecognition

Entity X invests in a convertible bond issued by Entity Y. Upon conversion, Entity X will receive a predetermined number of Entity Y's non-derivative equity instruments in exchange for giving up its right to receive the principal on the bond. On conversion, the convertible bond is derecognised and ceases to be measured at FVTPL. The equity instruments recognised may be classified as at FVTPL or designated as at FVTOCI at their initial recognition. The conversion does not give rise to a reclassification because the original instrument is derecognised.

If an entity reclassifies financial assets, it is required to apply the reclassification prospectively from the reclassification date defined as the first day of the first reporting period following the change in business model that results in the entity reclassifying financial assets. The reclassification applies prospectively from the reclassification date and therefore previously recognised gains, losses (including impairment gains or losses) or interest are not restated.

Ind AS 109 is not explicit as to how to interpret the “first day of the first reporting period following the change in business model” in the context of interim financial statements. Specifically, it is not clear whether the “first reporting period following the change in business model” is the next interim financial reporting period or the next annual financial reporting period.

On balance, it is appropriate to regard an interim period as a “reporting period” for this purpose. Therefore, when the next financial reporting period is an interim financial period, the start of that period will be the reclassification date. This is supported by paragraph 15B(l) of Ind AS 34 *Interim Financial Reporting* which requires disclosure in interim financial reports of “changes in the classification of financial assets as a result of a change in the purpose or use of those assets”, if those change are significant.

Example 8.7C: Date of reclassification for interim financial statements

Entity A changes its business model on 15 August 20X0 and, as a result, must reclassify all affected financial assets at the reclassification date (being the first day of the entity’s next reporting period) from amortised cost to FVTPL.

Entity A has the following period-ends:

- half-year interim period end: 30 September 20X0;
- third-quarter interim period end: 31 December 20X0; and
- annual period end: 31 March 20X1.

The reclassification date should be 1 October 20X0, being the first day of the entity’s next reporting period following the change in business model. Therefore, the third-quarter interim financial statements will reflect the effect of the reclassification of financial assets at 1 October 20X0. Further, it would not be appropriate to have multiple reclassification dates for a change in one business model. Therefore, the reclassification date of 1 October 20X0 also applies in the annual financial statements ending 31 March 20X1.

Financial statements	Measurement basis of financial assets subject to reclassification
Half-year interim financial statements ending 30 September 20X0	Amortised cost
Third-quarter interim financial statements ending 31 December 20X0	FVTPL
Annual financial statements ending 31 March 20X1	Six months at amortised cost and six months at FVTPL

8.7.1 Measurement on reclassification of financial assets

Ind AS 109 contains detailed requirements as to how to measure a financial asset when it is reclassified from one classification category to another. Below is a summary of the measurement requirements that apply at the reclassification date:

		RECLASSIFICATION TO		
		Amortised cost	FVTOCI	FVTPL
RECLASSIFICATION FROM	Amortised Cost		Recognise at fair value and the difference between fair value and closing amortised cost is recognised in OCI. The effective interest rate and measurement of expected credit losses are not adjusted.	Recognise at fair value and the difference between fair value and closing amortised cost is recognised in profit or loss. Interest revenue or impairment gains and losses are not required to be separately recognised following reclassification.
	FVTOCI	Closing fair value plus/minus the cumulative amount in OCI at the reclassification date becomes the new amortised cost gross opening carrying amount. The effective interest rate and measurement of expected credit losses are not adjusted. This adjustment affects OCI but does not affect profit or loss and therefore is not a reclassification adjustment under Ind AS 1.		Continue to measure at fair value with the cumulative amount in OCI reclassified immediately to profit or loss as a reclassification adjustment under Ind AS 1. Interest revenue or impairment gains and losses are not required to be separately recognised following reclassification.
	FVTPL	Closing fair value becomes the new amortised cost gross opening carrying amount. At the reclassification date, a new effective interest rate and measurement of expected credit losses will be determined.	Continue to measure at fair value with a new effective interest rate and measurement of a loss allowance for expected credit losses will be determined at the reclassification date.	

When a financial asset is reclassified from amortised cost to FVTOCI (or vice versa), the measurement of expected credit losses will not change as both classification categories apply the same impairment approach. However, the presentation and disclosure of the impairment allowance will differ.

Ind AS 1 requires certain specified disclosures when a financial asset is reclassified from amortised cost to FVTPL or is reclassified from FVTOCI to FVTPL.

Financial liabilities - classification and subsequent measurement

All financial liabilities are required to be classified and subsequently measured at amortised cost, except for:

- financial liabilities at FVTPL;
- financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies;
- financial guarantee contracts not designated as at FVTPL that are not accounted for under Ind AS 4 *Insurance Contracts*; and
- commitments to provide a loan at a below-market interest rate.

Financial liabilities that are designated as hedged items are subject to the hedge accounting requirements.

9.1 Financial liabilities at FVTPL

This category of financial liabilities can further be divided into the following two sub-categories:

- financial liabilities classified as held for trading; and
- financial liabilities designated by the entity as FVTPL. This is an option available in limited circumstances. The designation is irrevocable so that, once it has been made, the liability cannot subsequently be reclassified into another category during its life.

9.1.1 Financial liabilities classified as held for trading

A financial liability is held for trading if it falls into one of the following categories:

- financial liabilities incurred principally for the purpose of repurchasing them in the near term;
- financial liabilities that on initial recognition form part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; and
- derivative liabilities, unless the derivative is a financial guarantee contract or it forms part of a designated and effective hedging relationship.

The following are examples of liabilities that would be classified as held for trading and thus included in held for trading category:

- an interest rate swap that has negative fair value that is not accounted for as a hedging instrument;
- a derivative liability incurred upon writing a foreign exchange option that is not accounted for as a hedging instrument;
- an obligation to deliver financial assets borrowed by a short-seller (i.e. an entity that sells financial assets it has borrowed and does not yet own); and
- a quoted debt instrument that the issuer plans to buy back in the near term depending on movements in the debt instrument's fair value, i.e. a financial liability that is incurred with the intention to repurchase it in the near term.

9.1.2 Designation of financial liabilities as at FVTPL

A financial liability may upon initial recognition be designated as at FVTPL only in one of the following circumstances:

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

Example 9.1.2A: Fair value option: issued fixed rate debt

Entity A issues fixed rate debt. In order to economically hedge the fair value risk associated with interest payments on the fixed rate debt, Entity A concurrently enters into an interest rate swap with a bank (receive fixed, pay floating), which has the same terms and payment dates as the debt. The interest rate swap is a derivative that must be measured at FVTPL. Entity A does not wish to apply fair value hedge accounting because it does not wish to prepare any hedge documentation and it does not have the processes in place to monitor hedge effectiveness. By designating the fixed rate debt as at FVTPL on initial recognition, the entity will achieve a substantial offset in profit or loss against the fair value movements on the held for trading derivative. Because the instruments share a common risk (interest rate risk), Entity A will seek to demonstrate that applying the fair value option results in more relevant information because it significantly reduces a measurement inconsistency that would otherwise arise from measuring the derivative at FVTPL and measuring the debt at amortised cost.

Example 9.1.2B: Fair value option: lack of accounting mismatch

Entity A borrows (through a single instrument) CU1,000,000 from a third-party bank and, at the same time, uses some of the borrowing to acquire 10 similar financial assets each of a value of CU50,000 which are all classified as at FVTPL. Entity A wants to reduce the measurement inconsistency by designating the liability as at FVTPL. However, if all of the borrowing were accounted for at FVTPL, Entity A would create an accounting mismatch in profit or loss related to the portion of the borrowing (CU500,000) not matched by the financial assets measured at FVTPL. This accounting mismatch is comparable to the mismatch that would arise by not applying the fair value option in the first place. Therefore, Entity A cannot apply the fair value option to its financial liabilities because it would not significantly reduce the accounting mismatch between the assets and the liability.

- a group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel (as defined in Ind AS 24 *Related Party Disclosures*).
- in the case of a hybrid financial liability containing one or more embedded derivatives, an entity may designate the entire hybrid (combined) contract as at FVTPL unless:
 - the embedded derivative does not significantly modify the cash flows that otherwise would be required by the contract; or
 - it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative is prohibited (e.g. a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost).

Example 9.1.2C: Fair value option: commodity-linked debt

Entity Q issues a debt instrument that has interest payments linked to a basket of commodity prices. The linking to commodity prices is considered to be a non-closely related embedded derivative that would require separation and measurement at FVTPL. Entity Q may choose at initial recognition to designate the whole debt instrument as at FVTPL to avoid separating out the embedded derivative.

The election to designate a financial liability as at FVTPL has to be made at initial recognition of the financial liability and cannot subsequently be revoked. This is the case, even if the instrument giving rise to the mismatch is derecognised.

9.2 Classification of financial liabilities assumed in a business combination

When financial liabilities are assumed in a business combination, those liabilities should be classified in the consolidated financial statements of the acquirer into one of the permitted categories mentioned above. It is entirely possible that the classification of a financial liability for these purposes may differ from its classification in the financial statements of the acquiree. For example, the acquirer in its consolidated financial statements may choose to designate a financial liability as at FVTPL at initial recognition even though the acquiree may have classified it otherwise when it first recognised the liability. These differences can arise because 'initial recognition' from the acquirer's perspective is the date of acquisition of the subsidiary and its classification decisions are made at that date.

Ind AS 103 provides clear evidence stating that, at the acquisition date, the acquirer should make any classifications, designations concerning financial assets or financial liabilities assumed in a business combination in accordance with pertinent conditions at that date.

9.3 Subsequent measurement

Amortised cost of financial liabilities is determined using the effective interest method.

In case of financial liabilities measured at FVTPL, fair value gains and losses are recognised in profit or loss except that in the case of financial liabilities (other than loan commitments or financial guarantee contracts) that are designated at FVTPL, the gains or losses are required to be presented as follows:

- the amount of the change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability should be presented in OCI; and
- the remainder of the change in the fair value of the liability should be presented in profit or loss unless the treatment of the effects of changes in the liability's credit risk described above would create or enlarge an accounting mismatch in profit or loss (in which case all gains or losses are recognised in profit or loss).

In making the determination of whether recognising changes in the liability's credit risk in OCI will create or enlarge an accounting mismatch in profit or loss, an entity must assess whether it expects that the effects of changes in the liability's credit risk will be offset in profit or loss by a change in the fair value of another financial instrument measured at FVTPL. Such an expectation must be based on an economic relationship between the characteristics of the liability and the characteristics of the other financial instrument. That determination is made at initial recognition and is not reassessed.

All gains and losses on loan commitments and financial guarantee contracts that are designated as at FVTPL are recognised in profit or loss.

9.4 Hedged items

Ind AS 109 includes specific requirements to be applied when accounting for a financial liability that is a hedged item.

9.5 Reclassification of financial liabilities

Reclassifications of financial liabilities into and out of the FVTPL category are prohibited. The following changes in circumstances are not reclassifications:

- a derivative that was previously a designated and effective hedging instrument in a cash flow hedge or net investment hedge no longer qualifies as such; and
- a derivative becomes a designated and effective hedging instrument in a cash flow hedge or net investment hedge.

Foreign exchange gains and losses on financial assets and financial liabilities

A summary of how foreign exchange gains and losses are treated for various measurement bases of financial assets and financial liabilities is set out in the following table

Classification	Monetary or non-monetary item	Foreign exchange gains and losses from remeasurement (prior to its disposal)*
Amortised cost (whether a financial asset or financial liability)	Monetary item, calculated on the instrument's amortised cost.	Profit or loss
Debt instruments held that are measured at FVTOCI	Monetary item, calculated on the instrument's amortised cost.	Profit or loss (with the foreign currency element that is not based on amortised cost, being the translation on the difference between the fair value and the amortised cost is recognised in OCI along with other fair value gains or losses)
Equity instruments held that are measured at FVTOCI	Non-monetary item	OCI
FVTPL (whether a financial asset or financial liability)	Monetary or non-monetary	Profit or loss as part of the fair value gains and losses on the entire instrument.

* Assumes that the item is not being hedged for foreign currency risk, or is not a hedging instrument in a foreign currency hedge.

Transitional provisions with respect to the classification and measurement of financial instruments

- An entity should assess whether a financial asset meets the business model test and contractual cash flow characteristics test on the basis of the facts and circumstances that exist at the date of transition to Ind ASs.
- Time value of money is the element of interest that provides consideration for only the passage of time. However, in some cases, the time value of money element may be modified (i.e. imperfect). That would be the case, for example, if a financial asset's interest rate is periodically reset but the frequency of that reset does not match the tenor of the interest rate (for example, the interest rate resets every month to a one-year rate) or if a financial asset's interest rate is periodically reset to an average of particular short-term and long-term interest rates. In such cases, an entity must assess the modification to determine whether the contractual cash flows represent solely payments of principal and interest on the principal amount outstanding. If it is impracticable to assess a modified time value of money element on the basis of the facts and circumstances that exist at the date of transition to Ind ASs, the contractual cash flow characteristics test is applied without taking into account that requirement. An entity should disclose the carrying amount at the reporting date, of financial assets whose contractual cash flow characteristics have been assessed based on the facts and circumstances that existed at the date of transition to Ind ASs without taking into account the requirements related to the modification of the time value of money element until those financial assets are derecognised.
- If it is impracticable to assess whether the fair value of a prepayment feature is insignificant on the basis of the facts and circumstances that exist at the date of transition to Ind ASs, the contractual cash flow characteristics test is applied without taking into account the exception for prepayment features. An entity should disclose the carrying amount at the reporting date, of financial assets whose contractual cash flow characteristics have been assessed based on the facts and circumstances that existed at the date of transition to Ind ASs without taking into account the exception for prepayment features until those financial assets are derecognised.
- If it is impracticable (as defined in Ind AS 8) for an entity to apply retrospectively the effective interest method in Ind AS 109, the fair value of the financial asset or the financial liability at the date of transition to Ind ASs will be the new gross carrying amount of that financial asset or the new amortised cost of that financial liability at the date of transition to Ind ASs.
- A first-time adopter should assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of the conditions that existed at the later of the date it first became a party to the contract and the date a reassessment is required by Ind AS 109.

Impact of Ind AS 32 and Ind AS 109

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12.1 Classification

Currently under Indian GAAP, equity and preference shares are classified on the basis of their legal form and dividends payable on these instruments are recognised as an appropriation from earnings. Convertible debt is classified as a debt instrument. As per the requirements of Ind AS 32, capital instruments will have to be classified on the basis of the issuer's contractual obligation to deliver cash or other financial assets. Dividend on capital instruments classified as a financial liability is recognised as an interest expense. Convertible debt instruments are split between liability and equity components and accordingly classified in the financial statements. This reclassification between capital and debt and the consequential change in the classification of dividends paid on these as interest expense will impact financial ratios, e.g. capital gearing ratios, interest coverage ratios. These could have an impact on certain debt covenants and the same should be ascertained and addressed.

12.2 Recognition and measurement

Currently under Indian GAAP, all investments are categorised as long-term investments or current investments. A current investment is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made. Current investments are carried at the lower of cost and fair value. Long-term investments carried at cost less provision for diminution in value other than temporary.

The scenario completely changes under Ind AS 109 and financial assets including equity investments will have to be measured at fair value. At initial recognition, an entity may make an irrevocable election to present in OCI subsequent changes in fair value of an investment in equity instrument that is not held for trading in which case the changes in fair value are recognised in OCI. If such an election is not made, there will be a high degree of volatility in the income statement.

Entities will now need to assess their business models for holding financial assets. For some entities, such as non-financial corporations, the assessment may be relatively simple since their financial assets may be limited to trade receivables and bank deposits for which the amortised cost criteria are likely to be met. For entities that engage in a broader range of activities involving financial assets (e.g., lenders, investors in debt securities held for treasury activities and traders), complexities in the business model may require increased management judgement in ascertaining whether assets are held to collect contractual cash flows and/or for sale. Since part of the business model assessment is also dependent on the history of how entities have achieved the objective in the business model (for example, whether there has been significant recurring sales and reasons for such sales), entities should start tracking this information as soon as possible in order to have sufficient history to make the comparison.

Computation of fair values for unquoted investments may also pose an issue considering that there may not be enough independent valuers to determine these values.

Modification to the current IT systems may be necessary considering the shift to fair value accounting. A lot of information not readily traceable from accounting entries may have to be captured. The impact would be significant for the treasury function of corporates.

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