Ind AS 109 Financial Instruments

RECOGNITION, MEASUREMENT & DE-RECOGNITION

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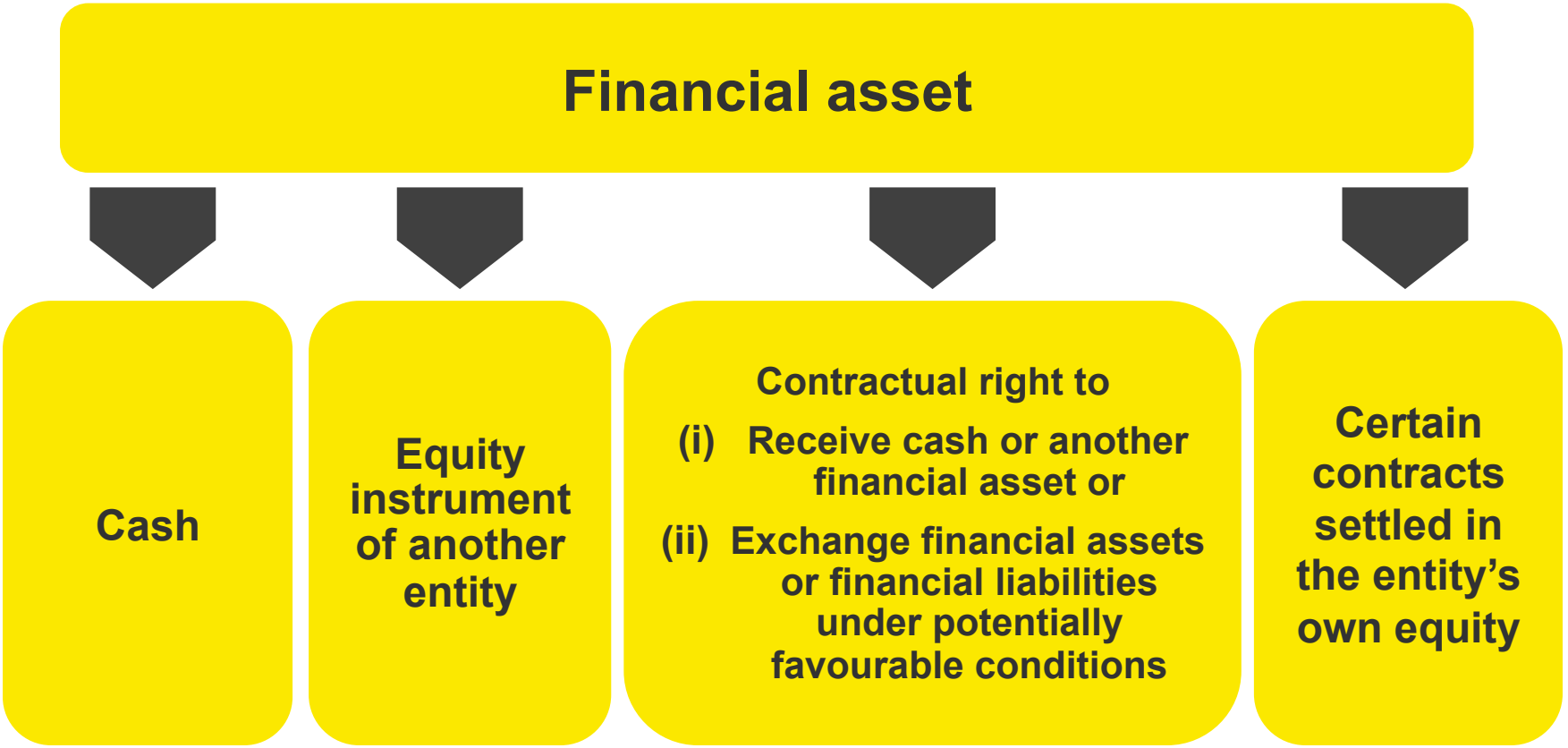
Financial instrument

Financial asset



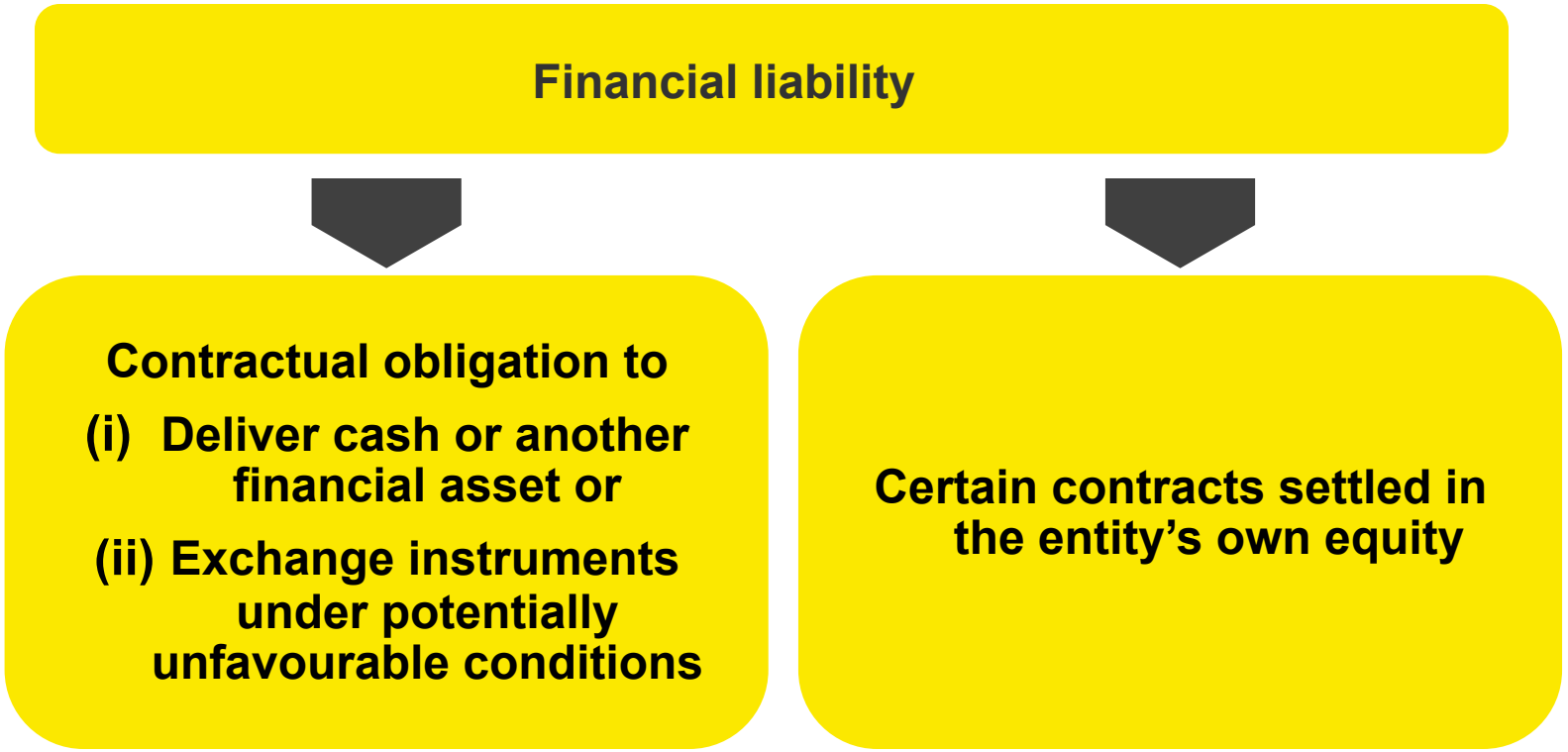
Exercise – Identify financial assets?

S No.	Item	Classification	Reason
1	Investment in equity shares	Financial asset	Definition of financial asset specifically includes equity instrument of another entity
2	Investment in bond and debentures	Financial asset	Contractual right to receive cash/other financial assets
3	Loans and receivables	Financial asset	Contractual right to receive cash/other financial assets
4	Deposits given	Financial asset	Contractual right to receive cash/other financial assets
5	Trade and other receivables	Financial asset	Contractual right to receive cash/other financial assets
6	Perpetual debt instrument held	Financial asset	Contractual right to receive cash/other financial assets
7	Cash and cash equivalents	Financial asset	Definition of financial asset specifically includes cash

Exercise – Identify financial assets?

S No.	Item	Classification	Reason
8	Bank balance	Financial asset	Contractual right to receive cash
9	Inventories	Not a financial instrument	Does not fulfil definition, no contractual right to receive cash/other financial assets
10	Property, plant and equipment	Not a financial instrument	Does not fulfil definition, no contractual right to receive cash/other financial assets
11	Intangible assets	Not a financial instrument	Does not fulfil definition, no contractual right to receive cash/other financial assets
12	Prepaid expenses	Not a financial instrument	Does not fulfil definition. Right to receive service or product, but no right to receive cash or financial instrument
13	Advance received for goods and services	Not financial instrument	Does not fulfil definition. Obligation to deliver service or product, but no obligation to deliver cash or financial instrument
14	Gold	Not financial instrument	Does not fulfil definition. Though gold is a highly liquid investment, it does not present right to receive cash or another financial asset

Financial liability



Exercise – Identify financial liability?

S No.	Item	Classification	Reason
1	Deposits received	Financial liability	Contractual obligation to pay cash
2	Trade and other payables	Financial liability	Contractual obligation to pay cash
3	Mandatory redeemable preference shares	Financial liability	Contractual obligation to pay cash
4	Finance lease obligation	Financial liability	Contractual obligation to pay cash
5	Financial guarantee	Financial asset / financial liability	Contractual right/obligation to receive/pay cash, even if those are contingent on certain events
6	Deferred revenue	Not financial instrument	Does not fulfil definition. No contractual obligation to pay cash or another financial asset
7	Warranty obligations	Not financial instrument	Does not fulfil definition. No contractual obligation to pay cash or another financial asset
8	Income taxes/ Deferred tax	Not financial instrument	Does not fulfil definition. Income taxes are statutory assets or liability but not contractual assets or liability

Case Study

Case Study – Contractual obligation to deliver cash or other financial assets

ABC Limited , high profile Company has a strong history of dividend. The subscribers to these shares expect the regular dividend pay out and it is highly probable that the Company will be pay the dividend on regular basis.

Question : Whether the payment of dividend is a financial liability?

Response :

There is no contractual obligation on ABC limited to pay cash or any other financial assets. Thus, the payment of dividend is not a financial liability.

Thus asset and liability classification shall be based on contractual rights and obligations. Aspects such as probability of outflow or constructive obligation due to market expectations are not considered.

Equity instruments

Equity instruments

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

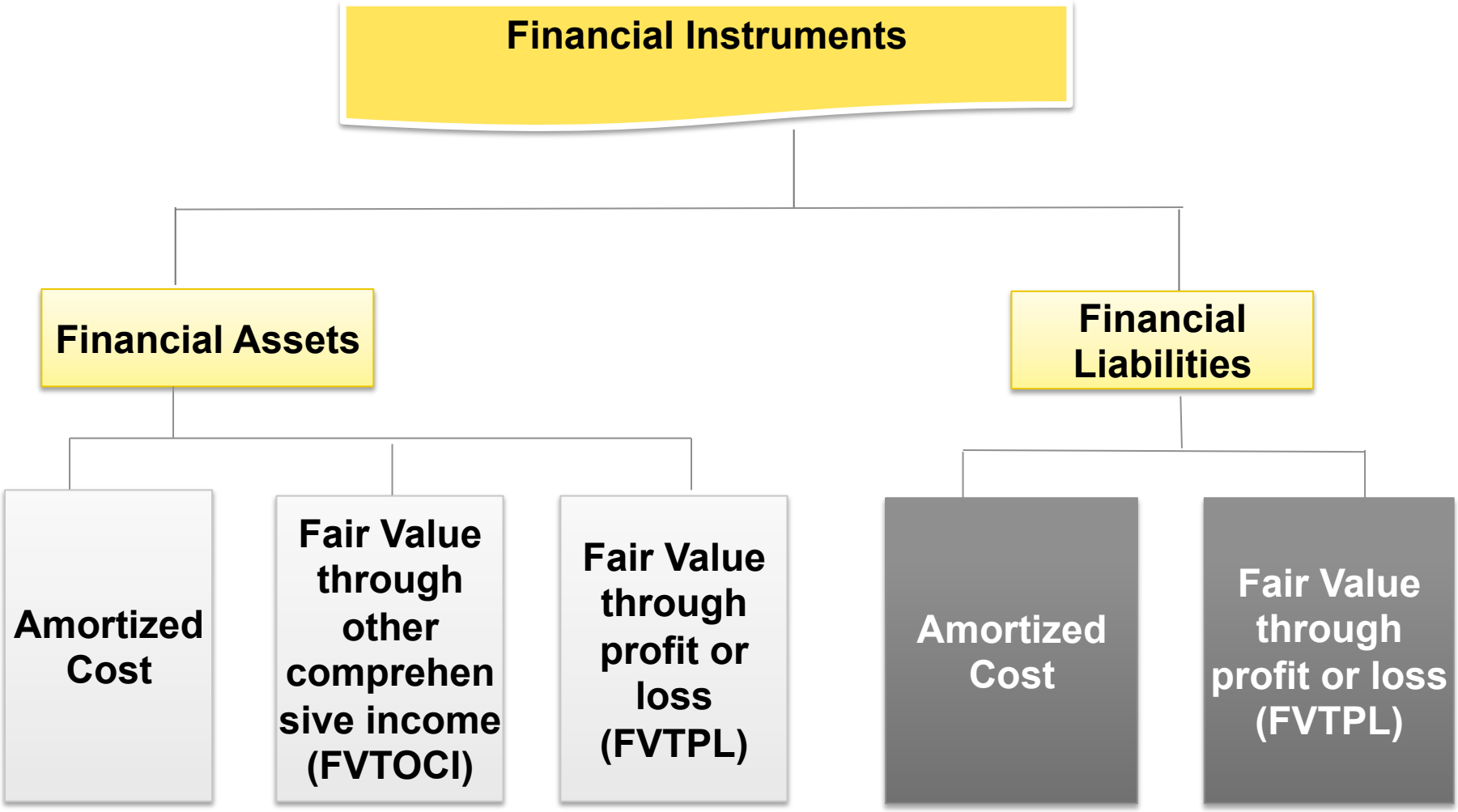
Examples

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

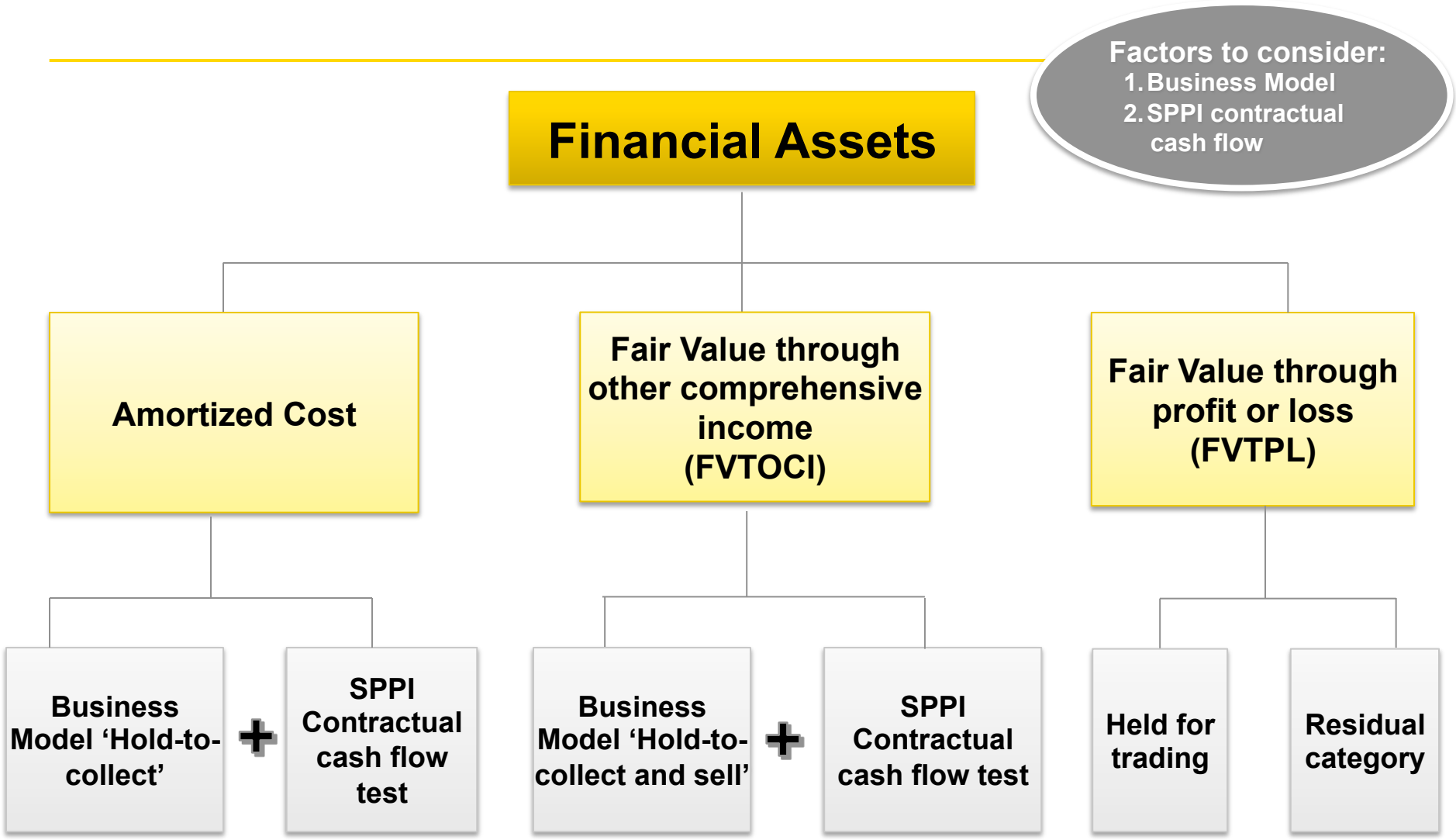
Exercise – Identify applicable IFRS

S No.	Financial instrument	Whether out of scope?		Applicable IFRS
		IFRS 9	IAS 32	
1	Interest in subsidiaries	Yes	Yes	IFRS 10/ IAS 27
2	Interests in associates	Yes	Yes	IAS 28/ IAS 27
3	Interest in joint ventures	Yes	Yes	IAS 28/ IAS 27
4	Employers' rights and obligations under employee benefit plans	Yes	Yes	IAS 19
5	Rights and obligations under an insurance contract	Yes	Yes	IFRS 4

Classification of financial instruments



Classification of financial assets



1. What is Amortized Cost

Particulars	Amount
Initial Recognition (Fair value / Transaction value)	XXXX
Less : Principal repayment	XXXX
Add /Less : Cumulative amortization (EIR)	XXXX
Less : Impairment / un-collectability	XXXX
Amortized costs	**XXXX**

- Effective interest rate (EIR) method is used to calculate the amortized costs of a financial asset or a financial liability as well as the allocation & recognition of interest revenue or expense in income statement.

- Transactions costs are the incremental costs that are directly attributable to the acquisition or issue of any financial assets or liability.

1. Amortised cost

- Financial asset (FA) classified as subsequently measured at amortised cost **if it meets <u>both</u> of following criteria**:

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

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

- **Examples of FA classified and accounted for at amortised cost:**
  - Trade receivables
  - Investments in government bonds (not held for trading)
  - Investments in term deposits (at standard interest rates)
  - Loan receivables with 'basic' features

- Equity instrument can never be classified at amortized costs.

Case study – Amortised costs

Case Study

Situation I

- An entity purchased a debt instrument for $1,000.
- The instrument pays interest of $60 annually and had 10 years to maturity when purchased. The entity intends to hold the asset to collect the contractual cash flows.

Situation II

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

Response:

Situation I

- Entity's objective is to hold the asset to collect the contractual cash flows and not to sell the assets.
- Thus, the debt instrument would meet the '**hold-to-collect' business model test**.

Situation II

- The sale was not expected on initial classification and does not affect the classification (i.e. there is no retrospective reclassification).
- Thus, the debt instrument would still meet the '**hold-to-collect' business model test**.

2. What is OCI

- Other comprehensive income comprises items of income and expense that are not recognised in profit or loss as required or permitted by other IFRS.
- Certain examples of items in Other Comprehensive Income.

OCI Items	
To be reclassified to Profit or loss in subsequent periods	Not to be reclassified to Profit or loss in subsequent periods
1. Gain or loss on hedge of a net investment	**1**. Re-measurement gains/ (losses) on defined benefit plans
2. Net movement on cash flow hedges	**2**. Revaluation of land and buildings
3. Net (loss)/gain on FVTOCI debt securities	**3**. Net (loss)/gain on FVTOCI equity Securities
4. Exchange differences on translation of foreign operations	

- **Current tax and deferred tax relating to the items recognised in OCI shall be recognised in OCI only.**

2.1 FVOCI – Debt Instruments

- Financial asset (FA) is measured at fair value through OCI (FVOCI) **if it meets both of following criteria**:
  - a) **'Hold-to-collect and sell' business model test -** Objective is achieved by both holding the financial asset in order to collect contractual cash flows and selling the financial asset, AND
  - b) **'SPPI' contractual cash flow characteristics test -** Contractual terms give rise to cash flows that are **Solely Payments of Principal and Interest (SPPI)** on the principal amount outstanding.

- Intention of the entity is to sell the instrument before the investment matures.

- **Examples of FA classified and accounted for at FVOCI:**
  - Investments in government bonds where the investment period is likely to be shorter than maturity.
  - Investments in corporate bonds where the investment period is likely to be shorter than maturity.

Case study

Case study :

- Entity A has surplus funds – INR 10 million
- A has has not yet found suitable investment opportunity so it buys medium dated (3 year maturity) high quality government bonds in order to generate interest income.
- If a suitable investment opportunity arises before the maturity date, the entity will sell the bonds and use the proceeds for the acquisition of a business operation. It is likely that a suitable business opportunity will be found before maturity date.

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

Response:

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

2.1 FVOCI – Debt Instruments Accounting requirement

- For Debt instruments classified as FVOCI, accounting requirements are as follows:

#	Nature of Item	Accounting treatment
1	Interest income	▪ To be recognised in profit or loss using the effective interest rate method
2	Credit impairment losses/reversals	▪ To be recognised in profit or loss
3	Other changes in the carrying amount on re-measurement to fair value	▪ To be recognized in OCI
4	Recycle to PL	▪ Cumulative fair value gain or loss recognised in OCI is recycled to profit or loss **when the related financial asset is derecognised**

- For debt instruments that are classified as FVOCI, entities will need to track both the amortised cost and fair value. The amounts recorded in profit or loss will reflect amortised cost and the balance sheet will reflect the fair value of the financial asset.

2.2 FVOCI – Equity Instruments Accounting requirement

- **Default Approach –**
  - IFRS 9 requires all equity investments to be measured at fair value.
  - All changes in fair value to be recognised in profit or loss.

- **New FVOCI category option – Equity investments** (not held for trading)
  - Entities can make an irrevocable election at initial recognition to classify the instruments as at FVOCI.
  - Such option is available instrument by instrument i.e. (item by item)
  - All subsequent changes in fair value being recognised in OCI
  - Dividends received on equity investments to be recognised in profit or loss.

- **FVOCI category for equity investments is a new measurement category when compared to IAS 39.**
- **Under this new category,**
  - **On disposal, cumulative change in fair value to remain in OCI and not recycled to PL**
  - **Entities may transfer amounts between reserves within equity (i.e. between the FVOCI reserve and retained earnings)**

3. FVTPL

- Fair value through profit or loss **(FVTPL)** is the **residual category** in IFRS 9.
- **Financial asset (FA) classified and measured at FVTPL if FA is:**
  - A held-for-trading financial asset
  - A debt instrument that does not qualify to be measured at amortised cost or FVOCI
  - An equity investment which the entity has not elected to classify as at FVOCI
- **Held for trading means the financial assets / liabilities are acquired for the purpose**
  - Sale or repurchase in the near term;
  - Short term profit making
- **Examples of FA classified and accounted for at FVTPL are:**
  - Derivatives that have not been designated in a hedging relationship, e.g.:
    - Interest rate swaps
    - Commodity futures/option contracts
    - Foreign exchange futures/option contracts
  - Investments in shares that the entity has not elected to account for at FVOCI.
  - Contingent consideration receivable from the sale of a business.

- **Under IFRS 9, consideration is first given to whether a financial asset is to be measured at amortised cost and FVOCI and, if it is not, it will be measured at FVTPL.**

Case Study

Case study :

- Entity B owns five retail chains
- It sold one of its retail chains to Entity C.
- As part of the purchase consideration, Entity B is entitled to additional consideration of INR 3 million if the retail chain meets certain profit targets over the next 3 years.

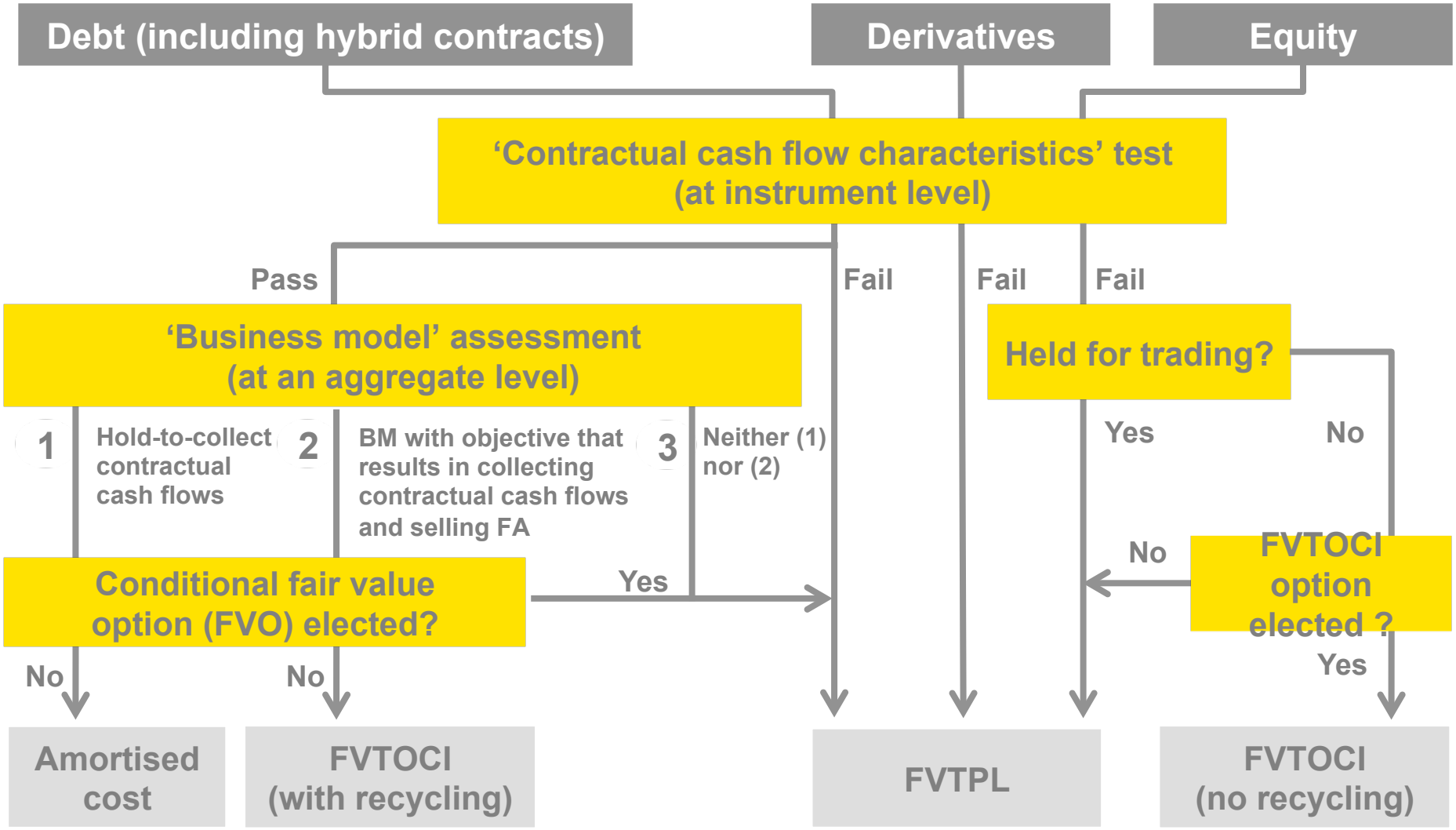
Question: How should Entity B classify the contingent consideration receivable?

Response:

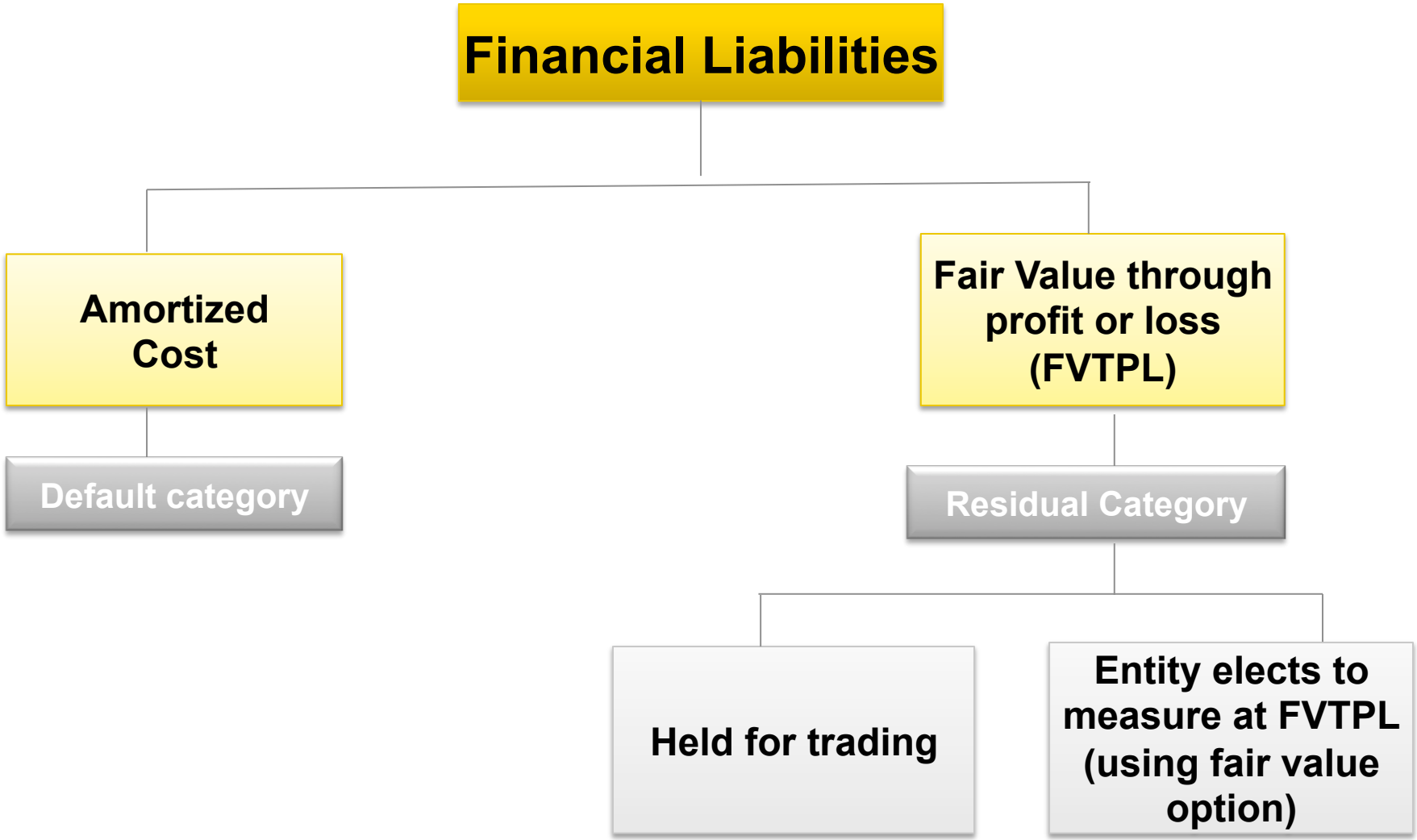
- The terms of the contingent consideration receivable fails the SPPI cash flow characteristics test because the payment is linked to the future profitability of the retail chain which has been sold.

- The contingent consideration receivable is **measured at fair value through profit or loss.**

Synopsis of key aspects of the new model for financial assets



Classification of financial Liabilities



Classification of financial liabilities – an overview

Financial liabilities has been classified into two categories:

Category	Main use	Examples
Fair value through profit or loss	▪ Financial liabilities that are held for trading (including derivatives). ▪ Financial liabilities that are designated as FVTPL the entity on initial recognition ▪ Contingent consideration recognised by an acquirer in a business combination	▪ Interest rate swaps ▪ Commodity futures/ option contracts ▪ Contingent consideration payable arising from one or more business combinations.
Amortised Cost	▪ All liabilities not in the above category	▪ Trade payables ▪ Bank borrowings

Initial Recognition & Measurement

Initial Recognition

- An entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the **entity becomes party to the contractual provisions of the instrument**
- When an entity first recognises a financial asset, it must be classified as either:-
  - Amortized costs
  - Fair value through OCI
  - Fair value through PL

Initial Measurement

- On initial recognition, financial assets or financial liabilities are measured at **FAIR VALUE**.
- If the financial assets or financial liabilities are not recognized at fair value, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability are adjusted against the fair value.

Initial Measurement – Transaction cost

- Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial instrument

Examples of costs that qualify as transaction costs	Examples of costs that do not qualify as transaction costs
▪ Fees and commissions paid to agents, advisers, brokers and dealers	▪ Debt premiums or discounts
▪ Levies by regulatory agencies and securities exchanges	▪ Financing costs
▪ Transfer taxes and duties	▪ Internal administration costs
▪ Credit assessment fees and registration charges	▪ Holding costs of financial instruments

Case study

Case study : Transaction cost

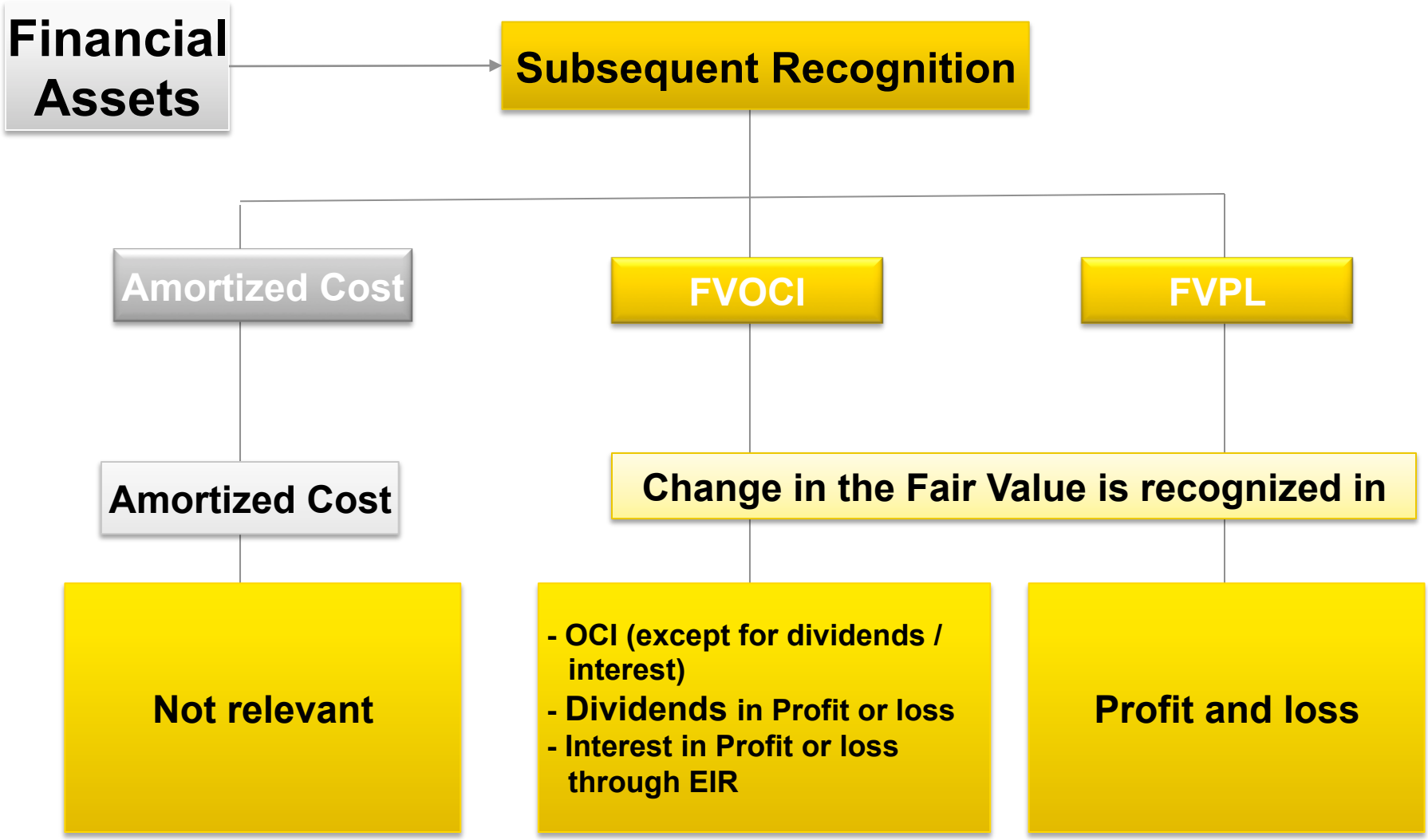
- An entity purchases a financial asset for $1,000.
- Transaction costs of $20 were incurred on the purchase.

At what value, the Company should recognize the such financial assets?

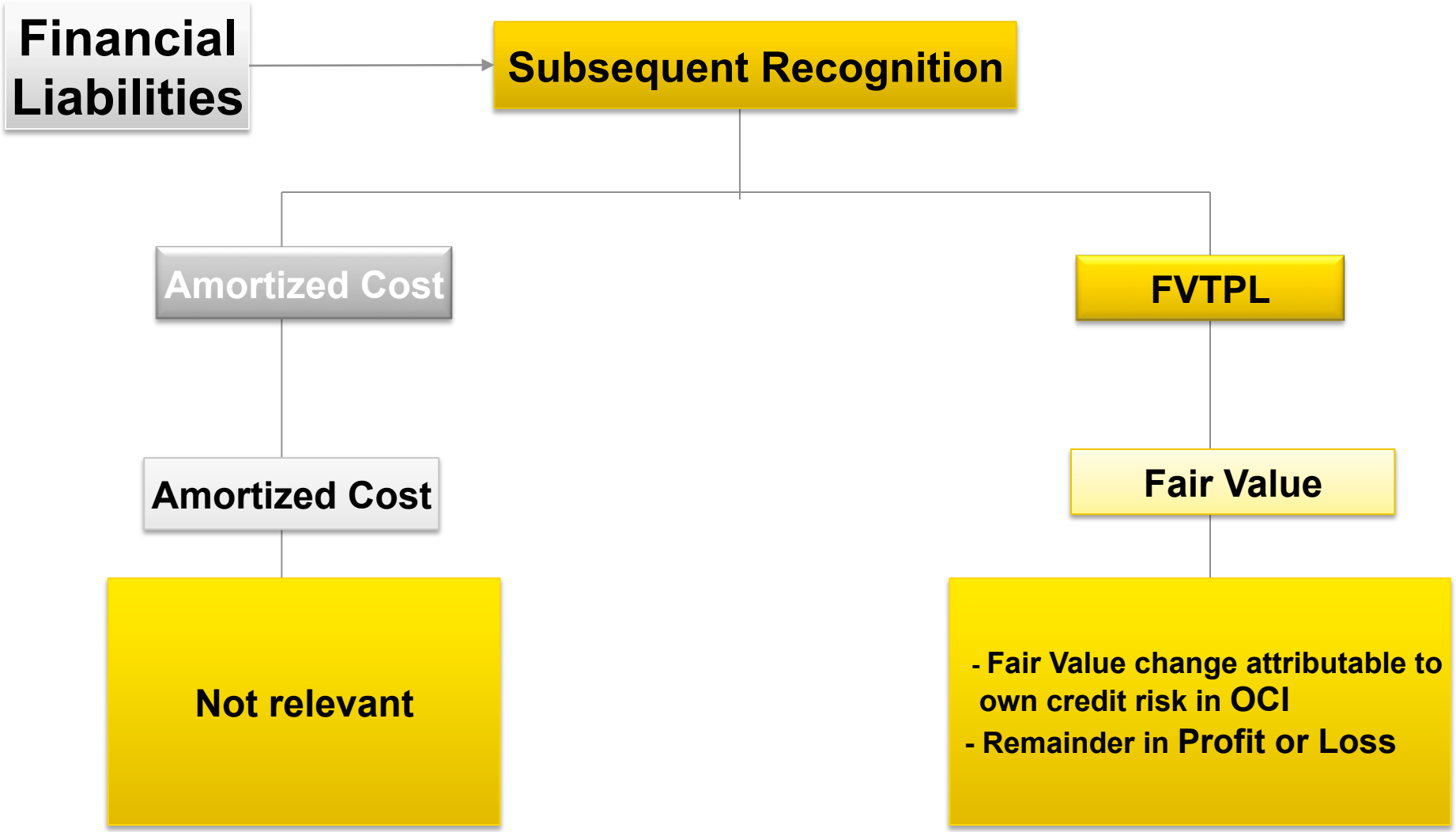
Response:

- If the asset is classified as Amortised costs or FVOCI, then such financial asset is initially measured at $1,020.
- If the asset is classified as FVPL, then such financial asset is initially measured at $1000 and the $20 would be expensed to profit or loss immediately.

Subsequent Measurement – Financial Assets



Subsequent Measurement – Financial Liabilities



Liability Vs Equity - Presentation

Liability vs Equity – Presentation

- On issue, financial instruments should be classified as liabilities or equity in accordance with the **substance of the contractual arrangement** on initial recognition.
- Some financial instruments may take the legal form of equity, but are in substance liabilities.
- An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Settlement in own equity instruments

Settlement in own equity instruments

- A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments.

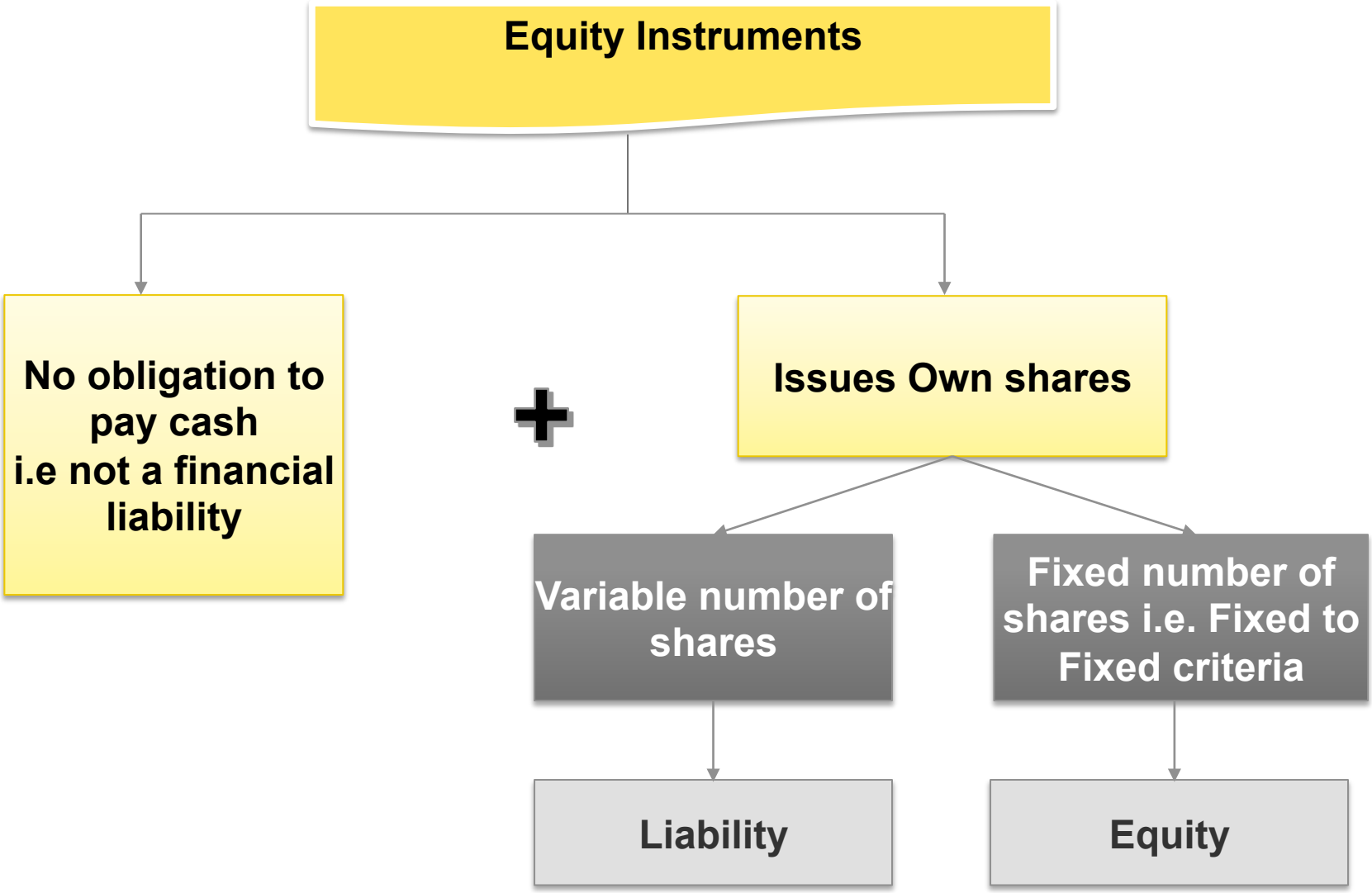
- **A financial liability will arise when:**
  - There is a contractual obligation to deliver cash or another financial asset, to exchange financial assets or financial liabilities, under conditions that are potentially unfavourable to the issuer;
  - There is a non-derivative contract to deliver, or be required to deliver, a ***variable number*** of own equity instruments;
  - There is a derivative that will or may be settled ***other than*** by issuing a fixed number of own equity instruments.

- **An instrument is an equity if, and only if, both conditions are met:**

  (1) The instrument includes no contractual obligation:
  - To deliver cash or another financial asset to another entity
  - To exchange financial assets/ liabilities with another entity under conditions that are potentially unfavorable to the issuer.

  (2) If the instrument will or may be settled in the issuer's own equity instruments, it is:
  - A non-derivative that includes **no** contractual obligation for the issuer to deliver a variable number of own equity instruments ***i.e. Fixed no. of shares.***
  - A derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments **i.e *Fixed no. of shares.***

Classification of financial instruments



Case Study

Case Study - Settlement in own equity instruments

1) **Fixed number of Shares**

ABC Limited enters into a contract to deliver 5,000 of its own ordinary shares to a third party in settlement of an obligation.

Since the number of shares is fixed in the contract to meet the obligation, it is an equity instrument. There is no obligation to transfer cash, another financial asset or an equivalent value.

2) **Variable number of shares (Based on market price)**

PQR Limited enters into a contract which require to settle a contractual obligation using its own shares in an amount that equals the contractual obligation.

Since the number of shares to be issued will vary depending on the MP of the shares at the date of the contract or settlement. If the contract was agreed at a different date, a different number of shares may be issued. Although cash will not be paid, the equivalent value in shares will be transferred. The contract is a financial liability.

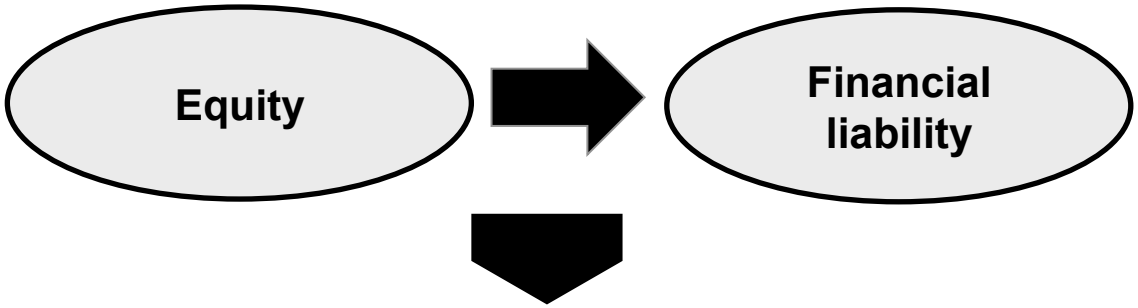
3) **Variable number of shares (Based on market price)**

XYZ Limited has an option contract to buy gold. If exercised, it will be settled, on a net basis, in the company's shares based on the share price at the date of settlement.

Since the Company has an option to buy gold, the contract is a derivative contract and to be recognized as a financial assets or liability. However, the Company has to issue the variable number of shares in both cases, therefore it is a financial liability.

Reclassification

Reclassification from equity to liability

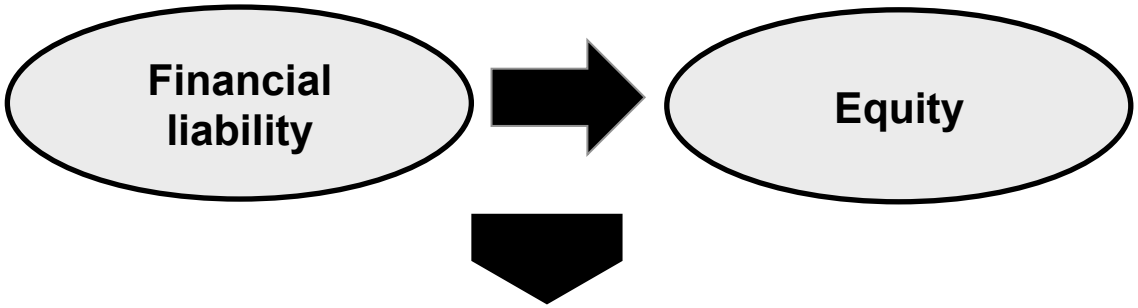


- Derecognise carrying amount of equity instrument
- Recognise liability at fair value
- Difference between the Equity & Liability shall be recognised in Equity

Example:

- ABC Ltd issued perpetual shares for $ 100 that carry the right to receive discretionary dividends (classified as equity). ABC Ltd amends the terms such that redemption is required in the event of a change of control of the company.
- Fair value of the perpetual shares are $ 120
- On reclassification, recognise an adjustment in equity for $ 20

Reclassification from liability to equity



- Derecognise carrying amount of financial liability
- Recognise equity instruments (consideration paid) at fair value if reliably measurable, or if not reliably measurable then at fair value of derecognised liability.
- Recognise difference in profit or loss

Example:

- ABC Ltd exchanges debt (carrying amount $ 100) for equity (fair value $ 120)
- Derecognise liability and recognise equity instruments and a loss of $ 20 in profit or loss

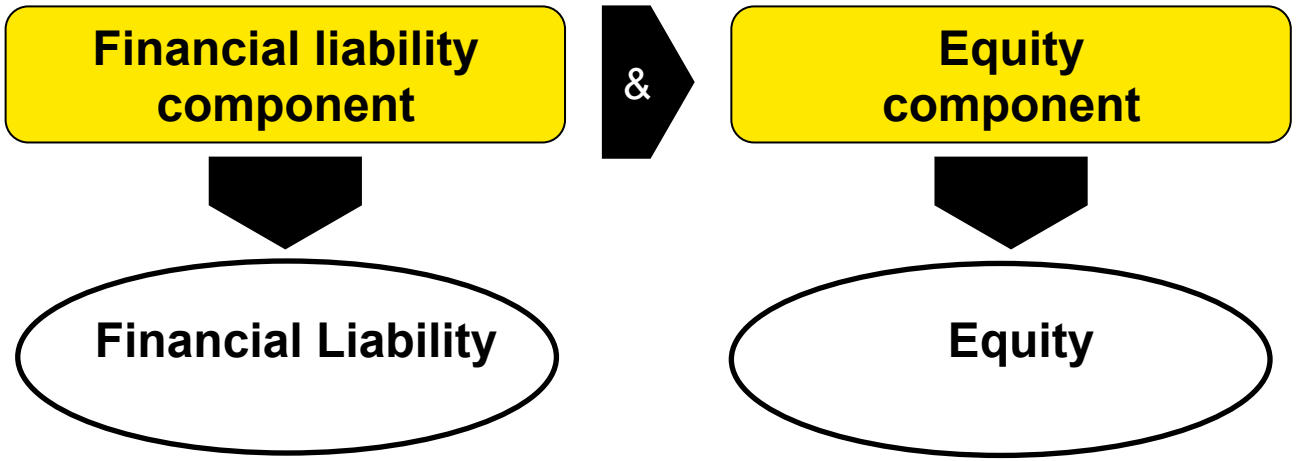
Compound instruments

Compound instruments – Background

- A compound financial instrument has a legal form of a single instrument, whereas the substance is that both liability and equity instrument exist.
- The issuer of a non-derivative financial instrument should evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity instrument.
- Such components are classified separately as financial liabilities, financial assets or equity instruments.
- Example:

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

Compound instruments – Split Accounting



Split accounting
Issuer of compound instruments classifies the liability and equity components of the compound instrument separately as financial liability and equity

Compound instruments – How to do split accounting

Fair value of entire compound instrument (e.g. convertible bond $ 100)

1. Determine fair value of liability component including any embedded derivatives (e.g. $ 60)

Financial Liability

2. Residual equity instrument (e.g. conversion option $ 40)

Equity

Case study

- Company J issues 2000 convertible bonds.
- The bonds have a 3 year term, and are issued at par with a face value of INR1,000 per bond, giving total proceeds of INR 2,000,000.
- Interest is payable annually in arrears at a nominal annual interest rate of 6% (i.e. INR120,000 per annum).
- Each bond is convertible at any time up to maturity into 250 ordinary shares. When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is 9% per annum.
- The entity incurs issue costs of INR100,000.

Solution

Split Accounting

Year	Particulars	Cash Flow	Discount Factor (@9%)	PV
1	Interest	120,000	1/1.09	110,092
2	Interest	120,000	1/1.092	101,001
3	Interest & principal	2,120,000	1/1.093	1,637,029
	Total liability component			**1,848,122**
	Value of equity component (Balancing Figure)			151,878
	Total proceeds			**2,000,000**

Allocation of Transaction costs between equity and Liability

Particulars	Liability component	Equity component	Total
Gross proceeds	1,848,122	151,878	2,000,000
Issue costs (pro-rata)	(92,406)	(7,594)	(100,000)
Net proceeds	**1,755,716**	**144,284**	**1,900,000**

Solution (continued)

Year	Opening liability	Interest @ 10.998%	Cash paid	Closing liability
1	1,755,716	193,094	(120,000)	1,828,810
2	1,828,810	201,134	(120,000)	1,909,944
3	1,909,944	210,056	(2,120,000)	–
Total finance cost		**604,284**		

The INR144,284 (151,878 minus 7,594) credited to equity is not subsequently re-measured.

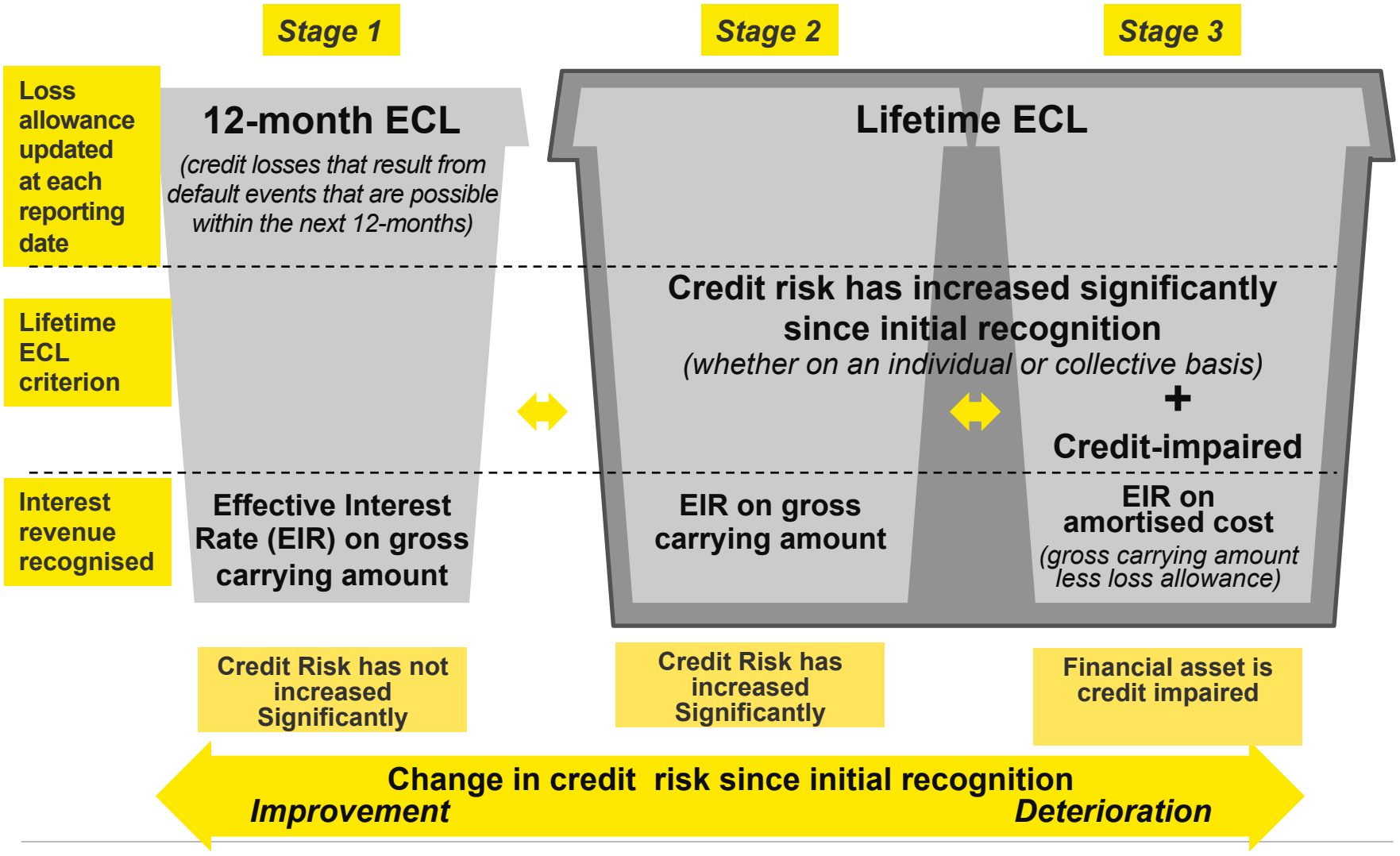
Impairment- Financial instruments

Expected credit loss model

Scope and variation of the expected credit loss model

#	Scope of ECL requirements	General approach	Simplified approach
1	**IFRS 9 *Financial Instruments***		
	▪ Trade receivables that do not contain a significant financing component		✓
	▪ Trade receivables that contain a significant financing component	Policy election at entity level	
	▪ Other debt financial assets measured at AC or at FVOCI	✓	
	▪ Loan commitments and financial guarantee contracts not accounted for at FVTPL	✓	
2	**IFRS 15 *Revenue from Contracts with Customers***		
	▪ Contract assets that do not contain a significant financing component		✓
	▪ Contract assets that contain a significant financing component	Policy election at entity level	
3	**IAS 17 *Leases***		
	▪ Lease receivables	Policy election at entity level	

General Approach



ECL

Expected credit loss (ECL) = EAD * PD * LGD

- **Exposure at default (EAD)** will be the gross amount of debt financial asset or borrowing.

- **Probability of default (PD)** is the likelihood that a loan will not be repaid and will fall into default. It must be calculated for each borrower. The credit history of the borrower and the nature of the investment must be taken into consideration when calculating PD. External ratings agencies such as Standard and Poors or Moody's may be used to get a PD; however, banks can also use internal rating methods. PD can range from 0% to 100%. If a borrower has 50% PD it is considered a less risky company vs. a company with an 80% PD.

- **Loss given default (LGD)** is the fractional loss due to default.
  LGD = 1 – Recovery Rate (RR)

- **Recovery Rate (RR)** is defined as the proportion of a bad debt that can be recovered.

ECL – Case study Cond…

Example

- A borrower (Company X) takes out a loan from Bank ABC for $10 million (EAD). Company X pledges $3 million collateral against this loan (for simplicity, let's say the collateral is cash). The Company's PD is determined by analysing their credit risk aspects (evaluate the financial health of the borrower, taking into account economic trends, borrower relationship with the bank, etc.) For Company X, the PD is 0.60. This means that the Company is extremely risky; the probability of them defaulting on the loan is 60%.

- **EAD =** 10 million
- **PD = 0.60**
- **LGD = 1 – Recovery Rate (RR)**
  So, LGD= 1- 0.30 = 0.70 or **70%.**

Expected credit loss (ECL) = EAD * PD * LGD

= $10 million * 0.60 * 70% *
= $4.2 million

Bank ABC can expect to lose $4.2 million

Simplified approach: Provision matrix

- According to the simplified approach, for trade receivables and contract assets that do not contain a significant financing component, an entity shall always measure loss allowance at an amount equal to lifetime expected credit losses.

- A provision matrix could be used to estimate ECL for these financial instruments.

- For example, an entity may set up the following provision matrix based on its historical observed default rates, which is adjusted for forward-looking estimates:
  - non-past due: 0.3% of carrying value
  - 30 days past due: 1.6% of carrying value
  - 31-60 days past due: 3.6% of carrying value
  - 61-90 days past due: 6.6% of carrying value
  - more than 90 days past due: 10.6% of carrying value

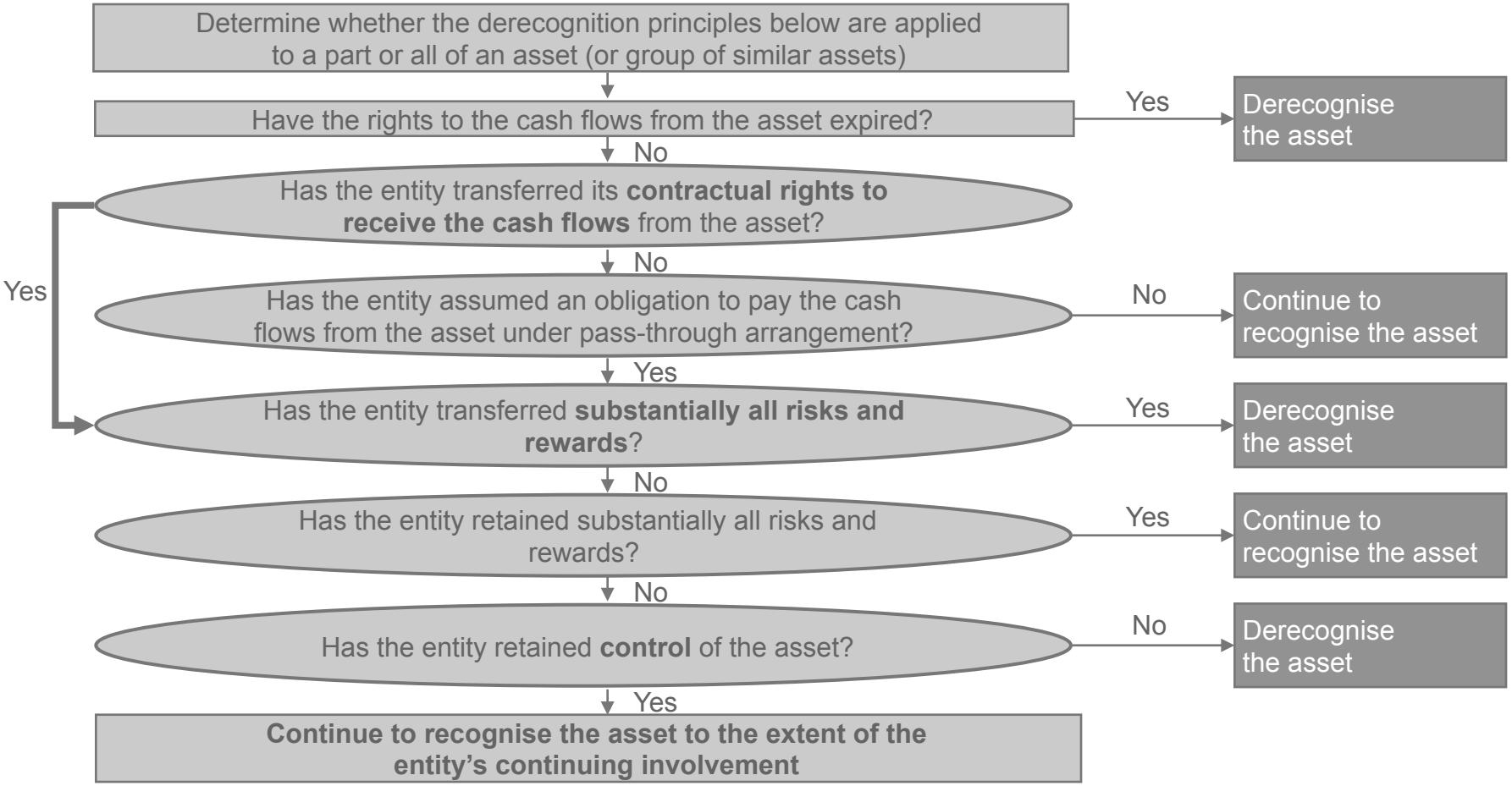
ECL on related party transactions

- IFRS 9 does not provide any practical expedients for
  a) Loan receivable from Related party,
  b) Loan receivable from KMP
  c) Intercompany loan receivables

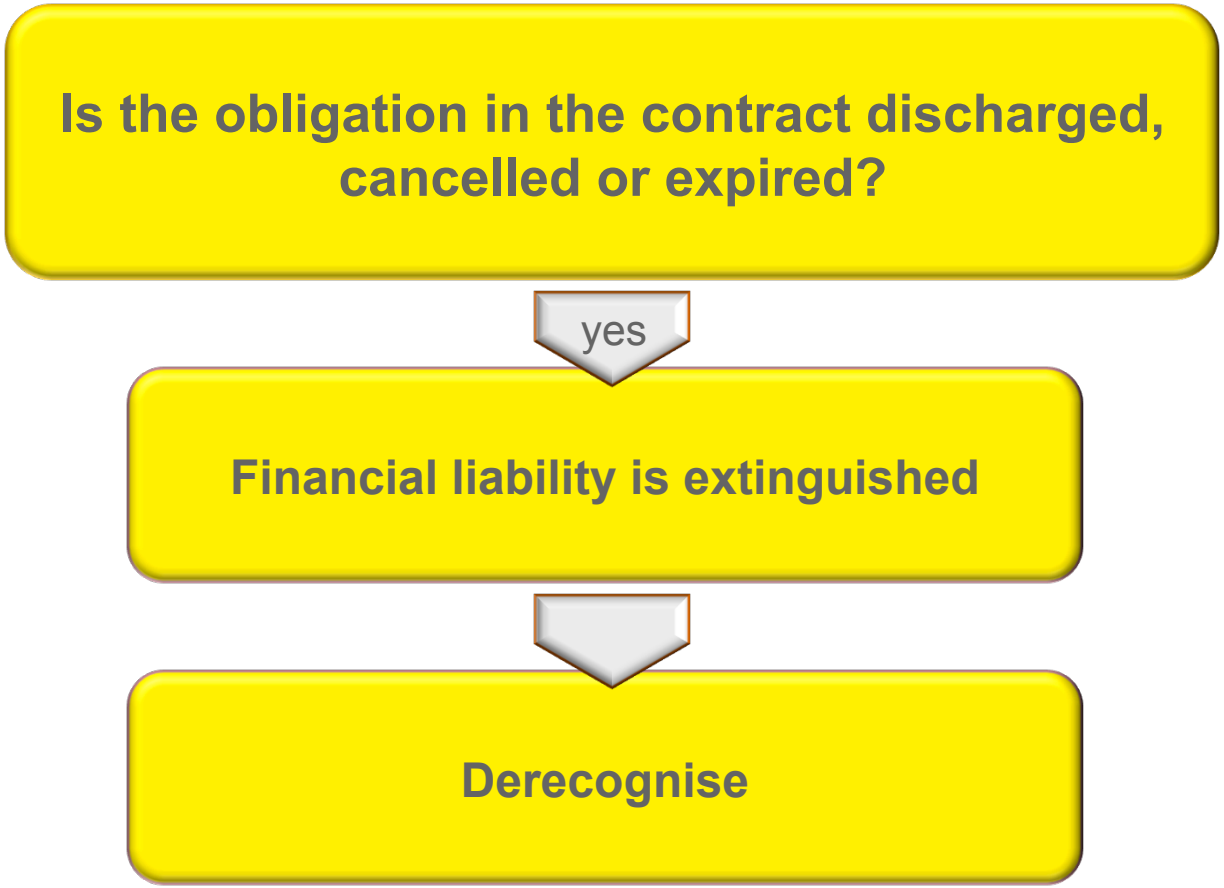
- This means that expected credit losses would be applicable on related party transactions.

Derecognition of Financial Assets

Derecognition of Financial Assets

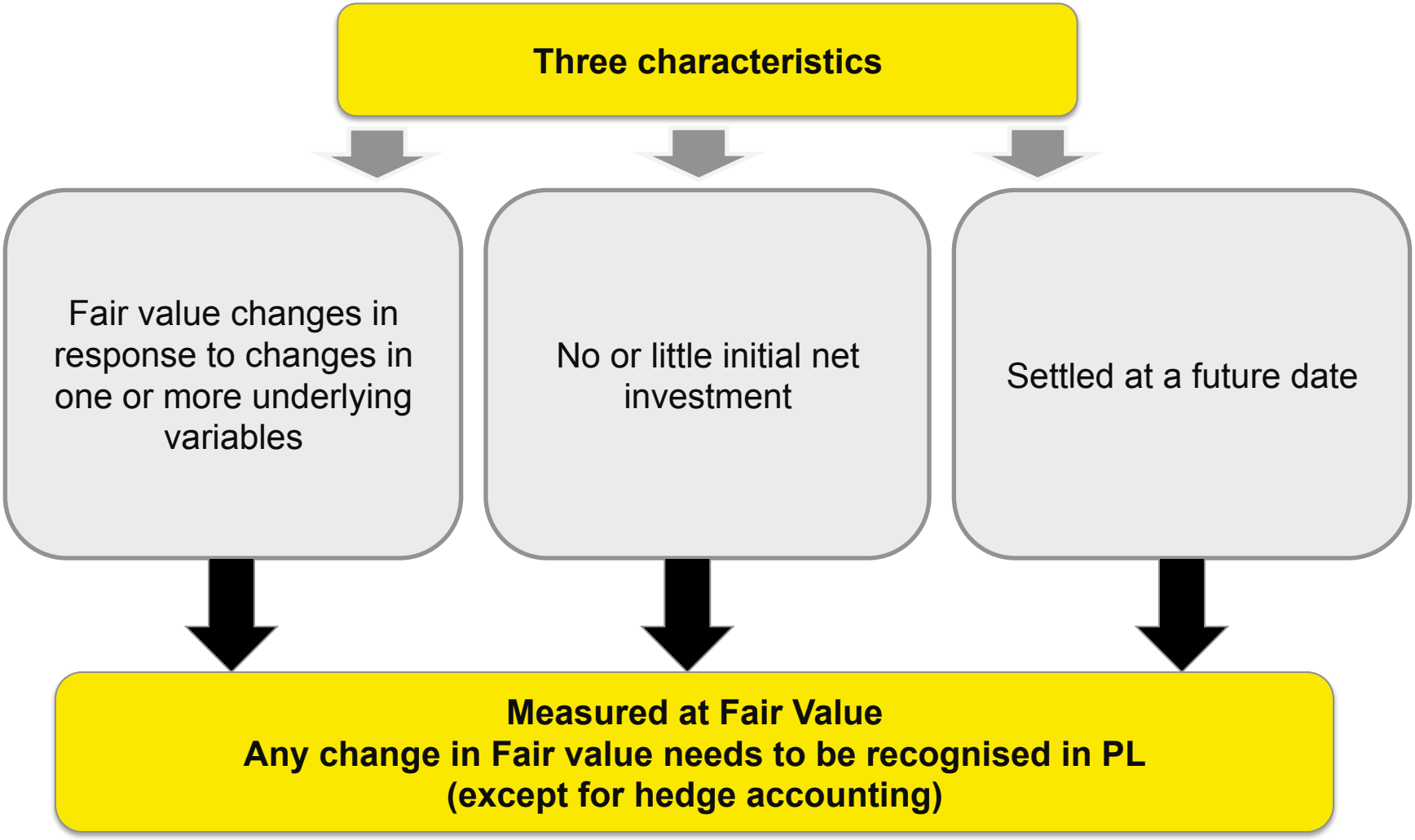


Derecognition of Financial Liabilities



Derivatives and embedded derivatives

Derivative definition

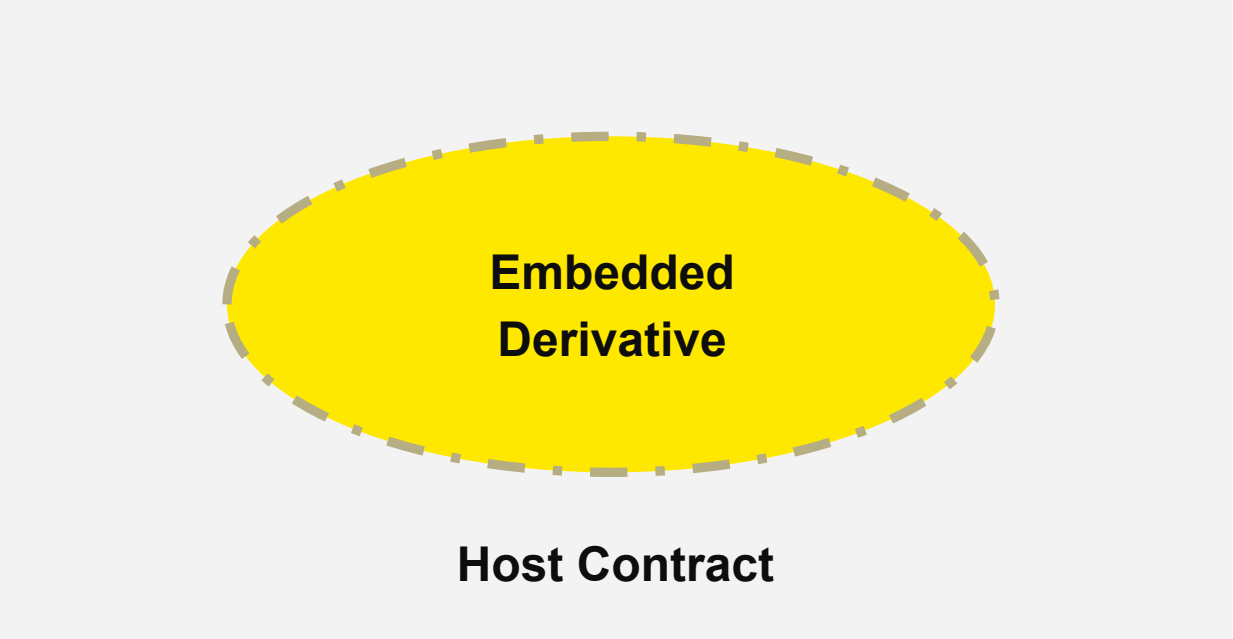


Examples of derivatives and underlyings

Type of contract	Main variable
Interest rate swap	Interest rate
FX forward	Foreign exchange rate
Commodity option	Commodity price
Credit default swap	Credit risk
Purchased or written stock call or put option	Equity price

Embedded derivatives

Hybrid Instrument



Host Contract may be Debt , Equity, Executory Contract, Lease, Insurance

Embedded derivative may be Interest rate index, Commodity Index, Equity index

Examples of embedded derivatives

S.No.	Particulars	Host Contract	Embedded Derivative
1	**Company A holds a bond which is convertible into the ordinary shares of Company B**	Bond Asset	Conversion option of Bond into shares
2	**Company A enters into a lease contract with an inflation factor such that each year, rentals are adjusted for changes in Risk Price Index (RPI)**	Lease contract	Adjustment to RPI
3	**Company A sells PPE to Company B of USD 1 lac. Both the Companies are located in India.**	Sale Contract	INR / USD foreign Exchange

It is not necessary to separate the embedded derivative and account it as derivative.

Case Study

Case Study : Embedded derivative

- A US company with $ as its functional currency buys raw materials for use in production from a UK company that has £ as its functional currency. The transaction is denominated in €.

Is there any embedded derivative ?

Response :

1) There are now two elements to the contract:
   (a) Contract to buy/sell goods; and
   (b) Movement on the $/€ and £/€ exchange rates.
2) Since the value of the contract is dependent on third currency, this results into an embedded derivative.
3) The contract to buy/sell goods is the host contract. The movement in exchange rates is the embedded derivative.
4) As € is not the functional currency of either party to the transaction, hence the embedded derivative is not closely related to the host contract and therefore to be accounted for separately.

Hedge accounting

Objective of hedge accounting

Application of hedge accounting permits to:

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

Solves accounting mismatch in profit or loss

- Hedge accounting is voluntary.
- If hedge accounting is not used, hedged items and hedging instruments are accounted for in the same manner as other financial asset and liabilities.

Qualifying hedging instruments

Derivatives

Separable embedded derivatives

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

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

Written options may be designated only for hedging of **purchased** options

Qualifying hedge items

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

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

➢ Hedge accounting is not applied to transactions between entities or segments in the same group (neither in consolidated financial statements nor separate financial statements).

A question for you: Qualifying hedged items

Are the following items qualifying hedged items?

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

Response :

1. Not allowed, because **only highly probable forecast transactions** are eligible hedged items.
2. Allowed as a hedged item (liability).
3. Allowed, as IFRS 9 allows designating portions of net investments as hedged items.
4. Not allowed, IFRS 9 generally precludes derivatives from being the hedged item and therefore it is not allowed.
5. Allowed, because hedge accounting is now allowed for hedges of net positions.

Types of hedges

Main types of hedging relationships

Fair value hedge

Hedge of **exposure to changes in fair value** of a recognised asset or liability that is attributable to a particular risk and that will affect the reported profit and loss.

Gain or loss on the hedged item and hedged instrument shall be recognised in profit and loss.

Cash flow hedge

Hedge of **exposure to variability in cash flows** that is attributable to a particular risk associated with

- Recognised asset or liability or
- Highly probable forecast transaction

that could affect profit or loss

Gain or loss on the hedging instrument (effective hedge) is recognised in OCI and ineffective hedge in profit and loss.

Case study : Fair value hedge

Case Study :

Romeo owns inventories of 5,000 tonnes of timber which it purchased three months ago for $50,000. Management is concerned that the price of timber might fall, which would have an effect on the selling price of the products that will use the timber. It has therefore entered into a futures contract to sell the timber at an agreed price of $60,000 on 31 March 2016.

At 31 December 2015, Romeo's year end, the fair value of the timber has fallen to $48,000 and the futures price for delivery on 31 March 2016 is now $58,000. Management has designated the timber as a hedged item and the futures contract as the hedging instrument and the hedge is deemed to be effective.

Response

If hedge accounting is not used

The futures contract will be recognised as a derivative asset at a value of $2,000 (60,000 - 58,000) and the inventory will still be measured at cost of $50,000. The accounting entries would be:

Particulars	Dr./Cr	Amount ($)
Derivative asset	Dr.	2,000
Profit or loss	Cr.	2,000

Case study : Fair value hedge (continued)

The gain on the futures contract is recognised immediately in profit or loss but no loss would be recognised on the value of inventory, causing a mis-match.

If hedge accounting is used

The futures contract will still be recognised as a derivative asset of $2,000 but the value of inventory will now be measured at fair value of $48,000, so matching the gain and loss in the profit or loss in the same period. The accounting entries would be:

S. No.	Particulars	Dr./Cr	Amount $)
1	Derivative asset	Dr.	2,000
	Profit or loss	Cr.	2,000
2	Profit or loss	Dr.	2,000
	Inventory	Cr.	2,000

This time both the gain and the loss affect profit or loss in the same period; hedge accounting has facilitated matching the upside with the downside.

Case study: Cash flow hedges

Case Study :

Romeo has items of inventory whose selling price is based upon the fair value of their commodity content. Romeo is concerned that the fair value of the commodity will fall and so reduce the cash flow on the sale of inventory.

The company enters into a forward contract to sell the inventory at fixed price in the future. The future sale of inventory is the designated hedge item and the forward contracts is designated at the hedging instrument. The hedge is effective and qualifies as a cash flow hedge.

If the fair value of the commodity falls by $600 then the fair value of the forward contract will increase by $600, assuming a perfect hedge , and create a derivative assets.

a) What would be the entries if hedge accounting is not followed?

b) What would be the entries if hedge accounting is followed?

Solution

Accounting entries, if hedge accounting is not used

Particulars	Dr./Cr	Amount ($)
Derivative asset	Dr.	600
Profit or loss	Cr.	600

The sale proceed will be $600 lower (or more) when the inventory is sold, presumed to be in the following periods in this illustration. Therefore there is mismatch in profit.

Accounting entries, if hedge accounting is used :

Particulars	Dr./Cr	Amount ($)
Derivative asset	Dr.	600
Other comprehensive income	Cr.	600

The $600 gain, which was included as other comprehensive income, will be reclassified through profit and loss when the cash flow impact of the inventory affects profit or loss (i.e. when inventory is sold).

Hedge effectiveness assessment: overview

Hedge effectiveness test

1. Economic relationship

- Between hedged item and hedging instrument
- Systematic change (opposite direction) in response to same or economically related underlying.

2. Credit risk does not dominate

- Credit risk does not frustrate economic relationship
- Credit risk can arise from hedging instrument and hedged item

3. Hedge ratio

- Consistent with actual ratio used by entity
- Different ratio only if accounting outcome would be inconsistent with purpose of hedge accounting

Case study:

Entity C with a has forecast sales receipts of USD 5 million in six months' time. It does not wish to be exposed to changes in the LC/FC exchange rate so it enters into a foreign exchange forward contract to sell USD 5 million in return for LC in six months.

Assume that the credit risk of the derivative counterparty is not expected to deteriorate significantly (meaning that changes in the fair value of the derivative are not expected to be dominated by the effects of changes in credit risk).

How are the effectiveness testing criteria under IFRS 9 met?

Response:

Effectiveness testing is satisfied by the critical terms match test. The critical terms of the hedged item, being the forecast sales, match the critical terms of the derivative, i.e.:

1) Same quantity – FC5 million
2) Same underlying risk – FC/LC exchange rate
3) Same timing – settlement date of the contract matches the timing of the sales receipts in FC.

Thank you