Unit – 4 Financial Instruments (Ind AS 109)

Introduction, Classification of financial assets, Classification of financial liabilities, Recognition of Financial Instruments, De-recognition of financial assets, Embedded derivatives

Introduction:

Financial instruments are a critical part of corporate balance sheets, especially for companies that deal with investments, loans, receivables, derivatives or complex financial arrangements. It is one of the most significant and technically complex standards under the Indian Accounting Standards framework.

This standard has replaced earlier guidance and introduced a more principle-based approach to classification, measurement, impairment and hedge accounting for financial instruments. It has a significant impact on how companies recognize credit losses, measure investments and manage financial risks.

ICAI identifies Ind AS 109 as the Indian Accounting Standard corresponding to IFRS 9, although Ind AS contains certain India-specific modifications/carve-outs and carve-ins.

Ind AS 109 is broadly divided into four major areas:

1. **Recognition and derecognition**
2. **Classification and measurement**
3. **Impairment**
4. **Hedge accounting**

Objectives:

1. To prescribe principles for recognition and measurement of financial assets and financial liabilities.
2. To provide a consistent accounting framework for financial instruments.
3. To improve the presentation of financial instruments in the financial statements.
4. To establish rules for classification of financial assets based on their nature and the entity's business model.
5. To prescribe measurement methods such as:
   - Amortised Cost
   - Fair Value Through Other Comprehensive Income (FVOCI)
   - Fair Value Through Profit or Loss (FVTPL)
6. To provide guidance for impairment of financial assets using the Expected Credit Loss (ECL) model.
7. To prescribe principles for hedge accounting, so that the accounting treatment reflects an entity's risk-management activities.
8. To ensure timely recognition of credit losses, rather than recognising losses only after a default or credit event occurs.

9. To improve comparability and transparency of financial information relating to financial instruments.
10. To provide useful information to users of financial statements regarding the amount, timing and uncertainty of future cash flows arising from financial instruments.

Scope:

A. Financial Assets:

The standard applies to financial assets such as:

1. Cash and cash equivalents
2. Trade receivables
3. Loans and advances
4. Investments in debt instruments
5. Investments in equity instruments
6. Derivatives, such as:
    - Futures
    - Options
    - Forward contracts
    - Swaps

B. Financial Liabilities:

It applies to financial liabilities such as:

1. Trade payables
2. Loans and borrowings
3. Debentures and bonds payable
4. Derivative liabilities
5. Certain contractual obligations to deliver cash or another financial asset

C. Other areas

1. Recognition and derecognition of financial assets and liabilities.
2. Classification and measurement of financial assets.
3. Classification and measurement of financial liabilities.
4. Impairment of financial assets.
5. Hedge accounting.
6. Embedded derivatives in specified circumstances.

Important Terms:

Financial Instrument: A financial instrument is essential a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

Examples of financial instruments are

(i) **Financial Assets:** Cash, bank balance, trade receivables, loans receivables, debentures/bonds/shares held, derivatives having favourable value and investments in certain debt instruments.
(ii) **Financial Liabilities:** Trade payables, bank loans, debentures/bond issued, loans payables, derivatives liabilities and certain redeemable preference shares.

Classification of Financial Assets:

1. Financial Assets at Amortised Cost

A financial asset is measured at amortised cost when both conditions are satisfied:

- Business Model Test: The asset is held to collect contractual cash flows.
- SPPI Test: Contractual cash flows represent solely payments of principal and interest on the principal amount outstanding.

Examples:

- Trade receivables
- Loans given
- Certain debt investments
- Fixed deposits, subject to the applicable conditions

Example:
A company gives a ₹10 lakh loan carrying a fixed interest rate and intends to collect the principal and interest according to the loan agreement.

→ Amortised Cost

2. Financial Assets at FVOCI

FVOCI means Fair Value Through Other Comprehensive Income.

A debt instrument is measured at FVOCI when both conditions are satisfied:

- Business Model Test: The asset is held both to collect contractual cash flows and to sell.
- SPPI Test: Contractual cash flows are solely payments of principal and interest.

Example:
A company invests in government bonds and may either collect interest/principal or sell the bonds when appropriate.
→ Debt instrument at FVOCI

3. Financial Assets at FVTPL

FVTPL means Fair Value Through Profit or Loss.

A financial asset is measured at FVTPL when it does not qualify for amortised cost or FVOCI, or when it is designated at FVTPL in accordance with Ind AS 109 to eliminate or significantly reduce an accounting mismatch.

Examples:

- Derivatives
- Certain equity investments
- Debt instruments that fail the SPPI test
- Financial assets held for trading

Changes in fair value are generally recognised in the Statement of Profit and Loss.

Classification of Financial Liabilities:

1. Financial Liabilities at Amortised Cost

Most financial liabilities are subsequently measured at amortised cost using the Effective Interest Rate (EIR) method.

Examples:

- Trade payables
- Bank loans
- Borrowings
- Debentures
- Bonds payable
- Other contractual financial obligations

Example:
A company takes a bank loan of ₹10 lakh at an agreed interest rate.

→ The loan will generally be measured at amortised cost after initial recognition.

2. Financial Liabilities at FVTPL

FVTPL = Fair Value Through Profit or Loss

A financial liability is measured at FVTPL when it falls within specified categories, particularly:

- Financial liabilities held for trading
- Derivative liabilities, unless they are designated as effective hedging instruments
- Liabilities designated at FVTPL by the entity at initial recognition, subject to the requirements of Ind AS 109.

Changes in fair value are generally recognised in the Statement of Profit and Loss, subject to special rules for liabilities designated at FVTPL.

Examples:

- Derivative liabilities
- Trading liabilities
- Certain liabilities voluntarily designated at FVTPL

Recognition of Financial Instruments:

Recognition means recording a financial asset or financial liability in the books of accounts when the entity becomes a party to the contractual provisions of the financial instrument.

In simple words:

A financial instrument is recognised when the entity enters into a contractual agreement that gives rise to a financial asset, financial liability, or equity instrument.

1. Recognition of Financial Asset

An entity recognises a **financial asset** when it becomes a party to the contractual provisions of the instrument.

Examples:

- When a company sells goods on credit → **Trade receivable** is recognised.
- When a company purchases shares/bonds → **Investment** is recognised.
- When money is deposited with a bank → **Bank balance** is recognised.
- When a loan is given to another party → **Loan receivable** is recognised.

2. Recognition of Financial Liability

A **financial liability** is recognised when the entity becomes a party to the contractual provisions and has a contractual obligation to pay cash or another financial asset.

Examples:

- Taking a bank loan → **Loan liability** is recognised.
- Purchasing goods on credit → **Trade payable** is recognised.
- Issuing bonds/debentures → **Financial liability** is recognised, subject to the instrument's classification.

3. Recognition of Equity Instrument

An **equity instrument** is recognised when the instrument represents a residual interest in the assets of the entity after deducting all its liabilities.

Example:
A company issues ordinary equity shares for ₹10 lakh.

→ The company receives cash and recognises **equity share capital**.

De-recognition of Financial Assets:

De-recognition means removing a financial asset from the balance sheet when the entity no longer has the asset or the rights associated with it.

In simple words:

When a financial asset is no longer recognised as an asset in the books, it is called de-recognition.

As per Ind AS 109, a financial asset is de-recognised when:

1. The contractual rights to cash flows expire

If the entity's contractual right to receive cash flows from the financial asset expires, the asset is removed from the books.

Example:
A company has a loan receivable of ₹5,00,000. The borrower repays the entire amount according to the agreement.

➡️ The company's right to receive further cash flows ends.
➡️ The loan receivable is de-recognised.

2. The financial asset is transferred

A financial asset is also de-recognised when the entity transfers the asset and the transfer qualifies for de-recognition under Ind AS 109.

Examples include:

- Sale of a receivable
- Transfer of a loan
- Securitisation of financial assets
- Assignment of contractual rights to receive cash flows

However, simply transferring an asset does not automatically mean de-recognition. The entity must assess whether it has transferred substantially all the risks and rewards and/or control as prescribed by Ind AS 109.

Embedded Derivatives

An embedded derivative is a derivative component that is included within a non-derivative financial instrument (the host contract).

In simple words:

A normal contract contains a hidden derivative whose cash flows change based on an underlying variable.

Think of it as “a derivative hidden inside another contract.”

The **host contract** is the main/basic contract.

For example:

- Loan agreement → host contract
- Bond → host contract
- Insurance or other commercial contract → may be a host contract

A derivative feature may be included inside that contract.

Simple example

Suppose a company issues a bond:

“The bond will pay ₹1,00,000 after 5 years, but the repayment amount will change depending on the price of gold.”

Here:

- **Bond** = host contract
- **Gold-price-linked feature** = embedded derivative

The gold-linked feature causes the cash flows to vary according to an underlying variable.

The purpose is to prevent an entity from **hiding a derivative inside another contract** and accounting for the entire contract in an inappropriate manner.

For example, suppose:

Contract A: Ordinary loan
Contract B: Loan + foreign currency-linked feature

The second contract may have significantly different risks because of the currency-linked feature.

Ind AS 109 therefore requires the entity to assess the derivative component appropriately.

Common Examples

Example 1 – Foreign currency clause

A company enters into a loan agreement where repayment depends on the exchange rate of USD/INR.

Host: Loan
Embedded derivative: Foreign exchange-linked feature

Example 2 – Commodity-linked payment

A contract requires payment based on the future price of gold, crude oil or another commodity.

Host: Main purchase/sale contract
Embedded derivative: Commodity-price-linked feature

Example 3 – Equity-linked bond

A bond provides interest or repayment based on the price of shares.

Host: Bond
Embedded derivative: Equity-price-linked feature

A. Embedded derivative in a financial asset

For a **financial asset**, Ind AS 109 generally does **not** separate the embedded derivative from the host.

Instead, the **entire hybrid contract is assessed as a whole** for classification under Ind AS 109.

It is classified based on the applicable requirements, including:

- **Business model**, and
- **Contractual cash-flow characteristics (SPPI test)**.

So, remember:

Financial asset → Do not separate embedded derivative; assess the hybrid contract as a whole.

B. Embedded derivative in a financial liability or non-financial host

For a **financial liability** or a **non-financial host contract**, the embedded derivative may need to be **separated and accounted for separately** if the required conditions are satisfied.

Generally, separation is required when:

1. The economic characteristics and risks of the embedded derivative are **not closely related** to those of the host contract.
2. A separate instrument with the same terms would meet the definition of a **derivative**.
3. The hybrid contract is **not already measured at fair value through profit or loss (FVTPL)**.

If these conditions are met:

Host contract → accounted for under the applicable standard

Embedded derivative → accounted for as a derivative at FVTPL