

## Financial Instruments during First-Time Adoption under Ind AS



*Accounting for financial instruments were earlier covered by Accounting Standards 30, 31 and 32, which were to become mandatory with effect from 1<sup>st</sup> April 2011. However, these standards were withdrawn as the corresponding accounting standards of International Accounting Standards Board, viz. IAS 32, IAS 39 and IFRS 7, were in the process of a major overhaul post-2008 financial crisis. Replacing IAS 39, IFRS 9 was issued in July 2014. Ind AS 109 is mandatory with effect from 1<sup>st</sup> April 2016 for listed companies with net worth exceeding ₹500 crore as on 31<sup>st</sup> March 2014. While the rest of the world, wherever IFRS is being implemented, would follow IFRS 9 effective from 1<sup>st</sup> January 2018, India implemented the same and made it effective from 1<sup>st</sup> April 2016. For the Phase 1 entities, this standard is already effective from the transition date of 1<sup>st</sup> April 2015. The author in this article discusses the financial instruments in the perspective of first-time adoption under the Indian Accounting Standards. Read on...*

Financial instruments are probably the most complex topic in the whole set of Ind AS. Accounting for Financial Instruments were earlier covered by AS 30,



**CA. R. Venkata Subramani**

(The author is a member of the Institute who may be contacted at [rsvbell@gmail.com](mailto:rsvbell@gmail.com).)

AS 31 and AS 32 issued by the Institute of Chartered Accountants of India (ICAI) in the year 2007 / 2008 (AS 32). These standards were to become mandatory with effect from April 1, 2011. But these standards were withdrawn by ICAI since the corresponding accounting standards of International Accounting Standards Board (IASB), viz., IAS 32, IAS 39 and IFRS 7 were in the process of a major overhaul after the financial crisis of the year 2008. IFRS 9 was subsequently issued replacing IAS 39 during July

2014, the mandatory effective date being 1st January 2018. Ind AS 109 is mandatory (along with 38 other standards notified by MCA) with effect from 1st April 2016 for listed companies with net worth exceeding ₹ 500 crore as on 31st March 2014.

While the rest of the world wherever IFRS is being implemented would follow IFRS 9 effective 1st January 2018, India has implemented the same with effect from 1st April 2016. For the Phase 1 entities, this standard is already effective from the transition date of 1st April 2015.

Accounting standards relating to financial instruments gains importance on account of the following reasons:

1. Accounting standards relating to financial instruments forms a substantial portion of the entire literature on accounting standards in terms of volume.
2. India would be implementing these complex accounting standards relating to financial instruments ahead of the rest of the world.
3. India never had any formal accounting standards on several aspects of financial instruments thus far. So it is quite new to almost all the entities.
4. The revised accounting standard IFRS 9 when compared with its erstwhile standard IAS 39 is significantly more complex, even more principle based and certain concepts are entirely new for all entities.
5. For the rest of the entities not covered by Ind AS, ICAI has issued a Guidance Note on accounting for derivative contracts (applicable with effect from 1st April 2016) which again is new for all the entities in India.

Financial Instruments is considered from an investor's perspective in Ind AS 109, the converged version of IFRS 9 and in Ind AS 32 (converged version of IAS 32) from an issuer's perspective. In this article it is proposed to cover the highlights of financial instruments when an entity adopts Ind AS for the first time.

Financial Instruments includes financial assets, financial liabilities and Equity. A financial asset that is a debt security should be classified based on certain criteria into any of the following categories viz., Amortised Cost (AC) or Fair value through Other Comprehensive Income (FVOCI) or Fair value Through Profit or Loss (FVTPL) on the basis of both:

- a) the entity's business model for managing the financial assets and

- b) the contractual cash flow characteristics of the financial asset.

#### Amortised Cost:

A financial asset shall be measured at amortised cost if both of the following conditions are met:

- a) the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and
- b) 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.

#### Fair Value through Other Comprehensive Income (FVOCI)

A financial asset shall be measured at fair value through other comprehensive income if both the following conditions are met:

- a) the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling such financial assets and
- b) 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.

#### Fair Value through Profit or Loss (FVTPL)

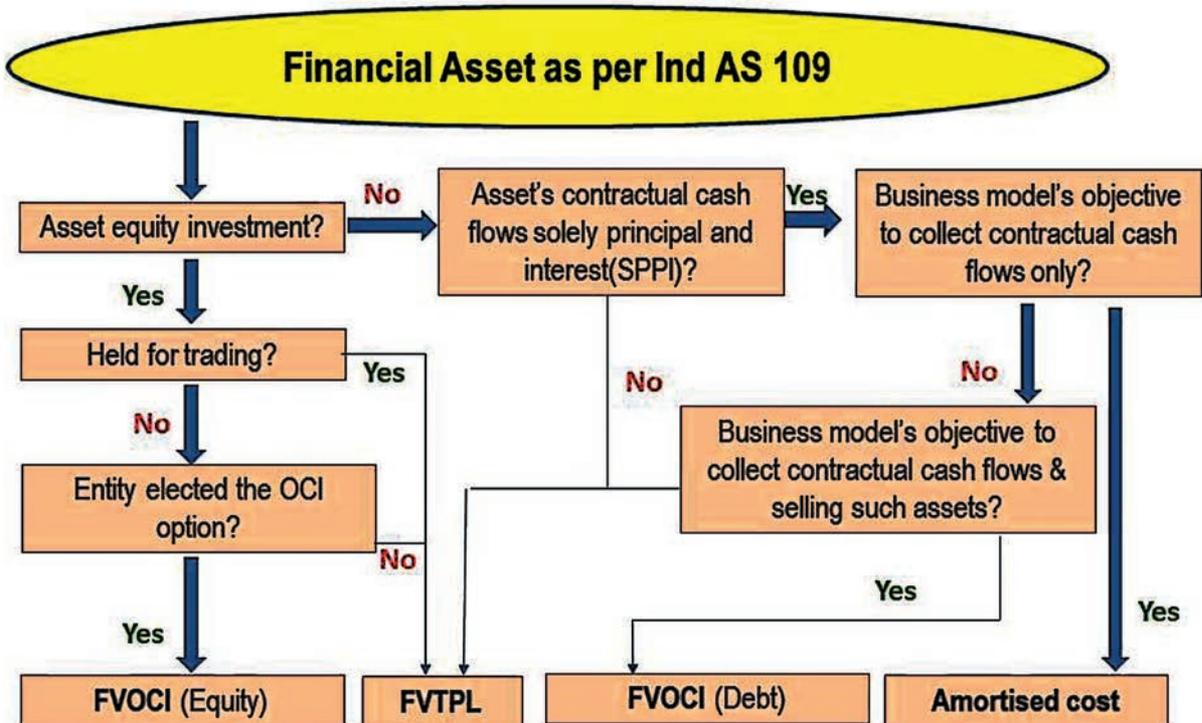
The financial asset shall be measured at fair value through profit or loss in all other cases. Basically FVTPL is a residuary class.

A financial asset that is an equity investment should be classified based on certain criteria into any of the following categories viz., Fair value through Other Comprehensive Income (FVOCI) or Fair value through Profit or Loss (FVTPL) on the basis of both:

- a) Whether the security is held for trading purposes and
- b) Whether the entity has elected the irrevocable FVOCI option in respect of those securities at inception.

**Financial Instruments is considered from an investor's perspective in Ind AS 109, the converged version of IFRS 9 and in Ind AS 32 (converged version of IAS 32) from an issuer's perspective.**

Following diagram explains the aforementioned concepts:



## First-Time Adoption

When an entity adopts Ind AS for the first time, there are several requirements to be observed in respect of financial instruments. The entity may or may not be following AS 30/ AS 31 or may be just complying with AS 11 for the transactions in foreign exchange including the hedge of an existing asset or a liability. AS 11 does not allow hedging of a non-existing asset or a liability viz., a forecasted purchase or sale or an unrecognised firm commitment to buy or sell a non-financial asset. When an entity adopts Ind AS for the first time, there are certain mandatory exceptions and optional exemptions for financial instruments. There are two categories of adjustments to the principle that an entity's opening Ind AS Balance Sheet shall comply with each Ind AS:

- A. Prohibit retrospective application of some aspects of other Ind ASs [Mandatory exceptions]
- B. Grant exemptions from some requirements of other Ind ASs [Optional exemptions]

### A. Mandatory Exceptions

#### 1. Derecognition of Financial Assets/Financial Liabilities:

Derecognition requirements in Ind AS 109 should be

applied only prospectively for transactions occurring on or after the date of transition to Ind ASs. If a non-derivative financial assets or non-derivative financial liabilities is derecognised as per previous GAAP based on a transaction that occurred before the date of transition, it shall not recognise those assets and liabilities as per Ind ASs unless they qualify for recognition as a result of a later transaction or event.

As per Ind AS 109, an entity can derecognise a financial asset if and only if the risk and rewards as well as control are not retained by the entity. Control over a financial asset is determined based on identifying the risks and rewards of the asset and evaluating which party has exposure to the risks and which party has benefits from the financial asset. For example, an entity does not recognise assets transferred in a securitisation, transfer or other derecognition transaction that occurred before the date of transition to Ind ASs if those transactions qualified for derecognition as per previous GAAP.

When an entity transfers a financial asset it should evaluate the extent to which it retains risks and rewards of the ownership of the financial asset

- a) If risk and rewards are transferred – derecognised

- b) If not – continue to recognise the financial asset
- c) Irrespective of the above, if the entity retains the control of the financial asset – continue to recognise the financial asset
- d) Else derecognise the financial asset.

However, if the entity uses the same securitisation arrangement or other derecognition arrangement for further transfers after the date of transition to Ind ASs, those further transfers qualify for derecognition only if they meet the derecognition criteria of Ind AS 109. An entity does not recognise financial assets and financial liabilities that do not qualify for recognition as per Ind AS 109, or have already qualified for derecognition as per Ind AS 109.

**Exception to Exception of Retrospective Application:** An entity may apply the derecognition requirements in Ind AS 109 retrospectively from a date of the entity's choosing, provided that the information needed to apply Ind AS 109 to financial assets and financial liabilities derecognised as a result of past transactions was obtained at the time of initially accounting for those transactions.

## 2. Hedge Accounting:

Hedge accounting can be applied prospectively only from the date that the hedge relationship is fully designated and documented. The reason is that an entity is not allowed to benefit from the information available hindsight and selectively decide to apply hedge accounting whenever it is convenient. The designation and documentation of a hedge relationship must be completed on or before the date of transition to Ind ASs if the hedge relationship is to qualify for hedge accounting from that date.

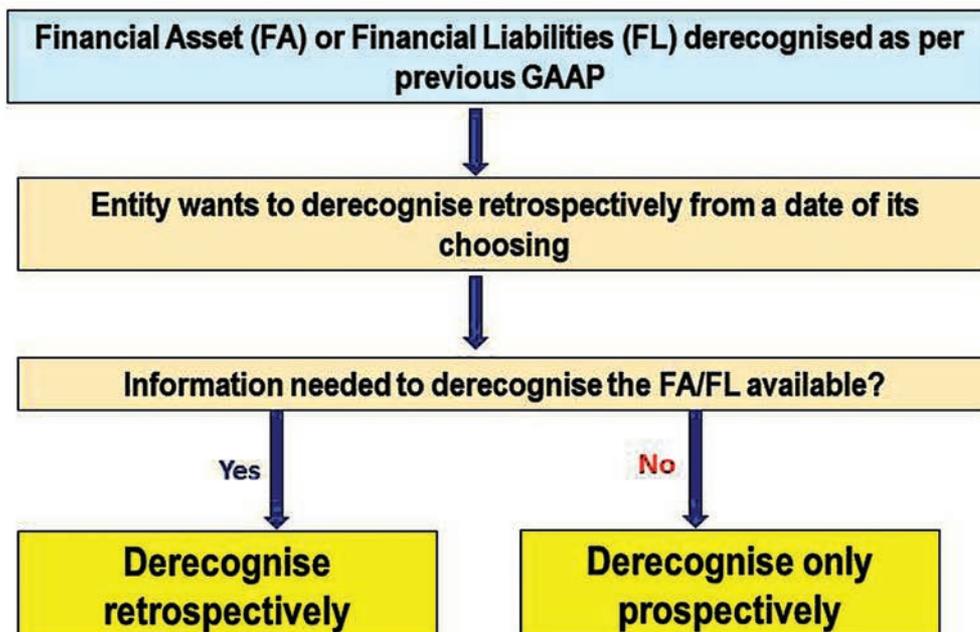
At the date of transition to Ind ASs an entity shall:

- measure all derivatives at fair value and
- eliminate all deferred losses and gains arising on derivatives that were reported as per previous GAAP as if they were assets or liabilities.

## Fair Value Hedge:

As per previous GAAP, an entity may have deferred or not recognised gains and losses on a fair value hedge of a hedged item that is not measured at fair value. For such a fair value hedge, an entity adjusts the carrying amount of the hedged item at the date of transition to Ind ASs.

## Derecognition of financial assets/financial liabilities



The adjustment is the lower of:

- that portion of the cumulative change in the fair value of the hedged item that was not recognised as per previous GAAP
- that portion of the cumulative change in the fair value of the hedging instrument and, as per previous GAAP, was either (i) not recognised or (ii) deferred in the Balance Sheet as an asset or liability.

Let us assume that the fair value of the hedged item at inception was ₹1,000 and on the date of transition, the fair values of the hedged item and hedging item are ₹1,060 and ₹50 respectively. As per previous gap, the debt would be shown in the balance sheet at ₹1,000 being the cost and the hedging instrument would not be recognised.

## Hedge accounting – fair value hedge

Fair value hedge		
	Hedged Item	Hedging Item
Inception	Debt: Rs.1,000	IRS: Rs.0
Year end	Debt: Rs.1,060	IRS: Rs.50
Adjustment to Carrying Value	Lower of Rs.60 and Rs.50 added to the carrying value of the debt	
Measured at	Debt: Rs.1,050	IRS: Rs.50

On first time adoption, the derivative *viz.*, the hedging instrument would be recognised at fair value of ₹50 and the carrying value of the hedged item would be adjusted with the lower of the fair value changes of hedged item *viz.*, ₹60 and the fair value of the hedging instrument *i.e.*, ₹50. So the hedged item would be shown at ₹1,050. The effect of this would be that both the debt and the derivative (asset) would be increased by ₹50 each.

### Cash Flow Hedge:

Deferred gains and losses on a cash flow hedge of a forecast transaction is not highly probable, but is expected to occur, the entire deferred gain or loss is recognised in the cash flow hedge reserve within equity. Any net cumulative gain or loss that has been

**When an entity adopts Ind AS for the first time, there are several requirements to be observed in respect of financial instruments. The entity may or may not be following AS 30/ AS 31 or may be just complying with AS 11 for the transactions in foreign exchange including the hedge of an existing asset or a liability.**

reclassified to the cash flow hedge reserve on initial application of Ind AS 109 remains there until

- the forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability,
- the forecast transaction affects profit or loss or subsequently circumstances change and the forecast transaction is no longer expected to occur, in which case any related net cumulative gain or loss is reclassified from the cash flow hedge reserve to profit or loss.

Hedging relationship of a type that does not qualify for hedge accounting as per Ind AS 109 should not be reflected in its opening Ind AS Balance Sheet. If, before the date of transition to Ind ASs, an entity had designated a transaction as a hedge but the hedge does not meet the conditions for hedge accounting in Ind AS 109, the entity shall discontinue hedge accounting. Transactions entered into before the date of transition to Ind ASs shall not be retrospectively designated as

hedges.

## 3. Classification and Measurement of Financial Assets

A financial asset should meet the conditions for classification and measurement on the basis of the facts and circumstances that exist **at the date of transition** to Ind ASs. If it is impracticable to assess the impact of the following features, then an entity shall assess the financial asset on the basis of the facts and circumstances that existed on the date of transition to Ind ASs without taking into account the impact of such features:

- Modified time value of money element
  - Fair value of the prepayment feature
- Effective Interest Rate:** If it is impracticable

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 shall be the new gross carrying amount of that financial asset or the new amortised cost of that financial liability on the date of transition to Ind ASs.

**Impairment Requirements:** This should be applied retrospectively. On the date of transition, an entity should use information that is available without undue cost or effort to determine the credit risk on the date that financial instruments were *initially recognised*. To determine if there has been a significant increase in credit risk since initial recognition, an entity shall use the change in the risk of a default occurring over the expected life of the financial instrument instead of the change in the amount of expected credit losses. If an entity is unable to make this determination without undue cost or effort, a loss allowance shall be recognised at an amount equal to lifetime expected credit losses at each reporting date until that financial instrument is derecognised. If the cost and effort of determining whether there has been substantial increase in credit risk since the initial recognition, an entity shall recognise a loss allowance at an amount equal to *lifetime expected credit losses* at each reporting date until that financial instrument is derecognised unless that financial instrument is a low credit risk at a reporting date.

#### 4. Embedded Derivatives

A first-time adopter shall 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 i.e., when there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract.

### B. Optional Exemptions

#### 1. Compound Financial Instruments

A first-time adopter need not separate the equity and liability portions if the liability component is no longer outstanding at the date of transition.

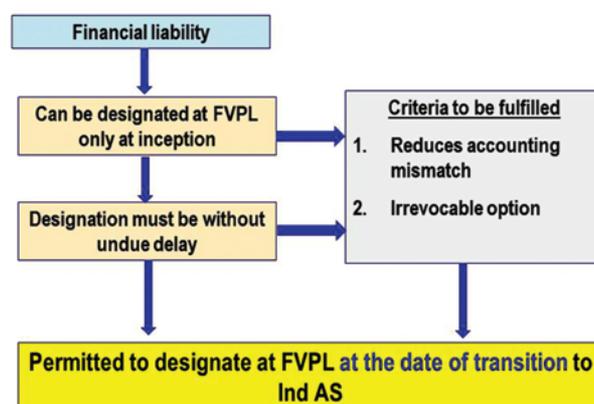
Ind AS 32 requires an entity to split a compound financial instrument at inception into liability and

equity components. If the liability component is no longer outstanding, retrospective application of Ind AS 32 involves separating two portions of equity. The first portion is in retained earnings and represents the cumulative interest accreted on the liability component. The other portion represents the original equity component.

#### 2. Designation of Previously Recognised Financial Instruments

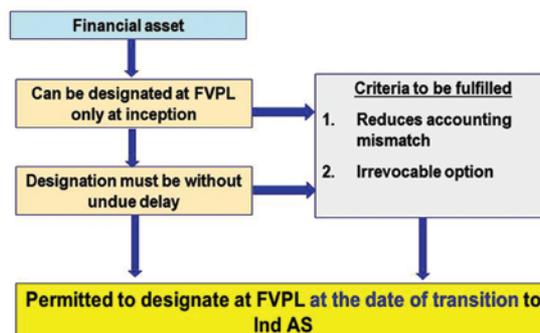
A financial liability can be designated as a financial liability at fair value through profit or loss provided it meets certain criteria. Despite this requirement, an entity is permitted to designate, *at the date of transition*, any financial liability as at fair value through profit or loss provided the liability meets certain criteria.

#### Designation of previously recognised financial liability



An entity may designate a financial asset as measured at fair value through profit or loss in accordance on the basis of the facts and circumstances that exist at the date of transition to Ind ASs.

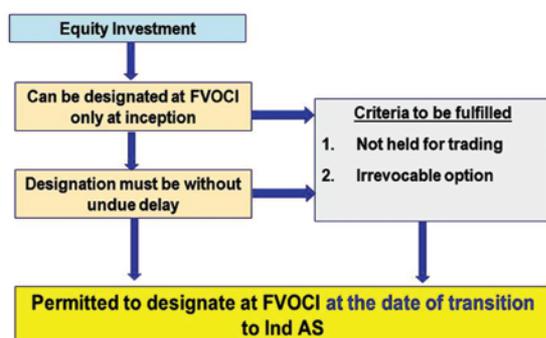
#### Designation of previously recognised financial asset



**As per previous GAAP, an entity may have deferred or not recognised gains and losses on a fair value hedge of a hedged item that is not measured at fair value. For such a fair value hedge, an entity adjusts the carrying amount of the hedged item at the date of transition to Ind ASs.**

An entity may designate an investment in an equity instrument as at fair value through other comprehensive income on the basis of the facts and circumstances that exist at the date of transition to Ind ASs.

#### Designation of previously recognised equity investment



### 3. FV of Financial Assets/Financial Liabilities at Initial Recognition

If there is a difference between the fair value at initial recognition and the transaction price should be deferred. After initial recognition, the entity shall recognise that deferred difference as a 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. However as per Ind AS 101, an entity is permitted to apply the above requirements relating to fair value of financial assets and financial liabilities at initial recognition prospectively to transactions entered into on or after the date of transition to Ind ASs.

**Ind AS 32 requires an entity to split a compound financial instrument at inception into liability and equity components. If the liability component is no longer outstanding, retrospective application of Ind AS 32 involves separating two portions of equity.**

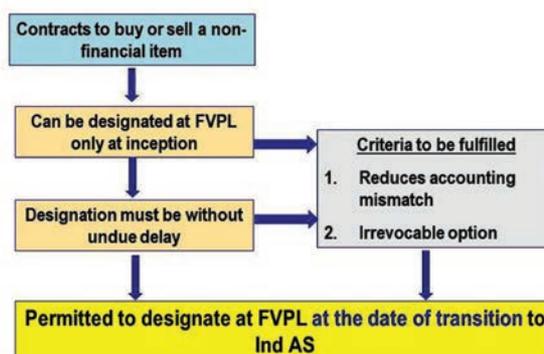
### 4. Extinguishing Financial Liabilities with Equity Instruments

A debtor and creditor might renegotiate the terms of a financial liability with the result that the debtor extinguishes the liability fully or partially by issuing equity instruments to the creditor. These transactions are sometimes referred to as 'debt for equity swaps'. A first-time adopter may apply the Appendix D of Ind AS 109 Extinguishing Financial Liabilities with Equity Instruments *from the date of transition* to Ind ASs prospectively.

### 5. Designation of Contracts to Buy or Sell a Non-Financial Item

Certain contracts to buy or sell a non-financial item can be designated at inception as measured at fair value through profit or loss, even though it is meant for own use, provided it reduces an accounting mismatch and such designation is irrevocable.

#### Designation of contracts to buy or sell a non-financial item



Despite this requirement, an entity is permitted to designate on the date of transition to Ind ASs, contracts that already exist on that date as measured at fair value through profit or loss but only if they meet the other requirements for doing so and the entity designates all similar contracts.

#### Conclusion:

In accordance with Ind AS 101, while engaged in first time adoption, the entity should carefully study the implications of selecting the available options wherever the standard grants exemptions from some requirements. Wherever the standard prohibits retrospective application, the entity should find out if there is any exception for such retrospective application, and if so, the entity may avail such exception, if the circumstances so warrant. ■