

PwC Reporting *InBrief*

Ind AS 109, *Financial Instruments* for corporates



In brief

India has early adopted IFRS 9, *Financial Instruments* by notifying the corresponding Ind AS 109, *Financial Instruments*. Ind AS 109 is aligned with IFRS 9. The measurement principles contained in Ind AS 109 vary significantly as compared to accounting requirements prescribed under existing Indian GAAP. While Ind AS 109 is expected to majorly affect banks and financial institutions, the requirements also have a significant impact on reporting of financial instruments held by corporates.

This *InBrief* gives an overview and practical insights into the key classification, measurement and impairment requirements of Ind AS 109 for corporates.

Let's talk

Classification and measurement

Classification of financial assets:

Ind AS 109 has two measurement categories: amortised cost and fair value. Movements in fair value are presented in either profit or loss or other comprehensive income, subject to certain criteria being met, as described below. To determine which measurement category a financial asset falls into, management should first consider whether the financial asset is an investment in an equity instrument, as defined in Ind AS 32, *Financial Instruments: Presentation*, by considering the perspective of the issuer or a debt instrument.

A. Classification of equity instruments:

Investments in equity instruments (as defined in Ind AS 32, from the perspective of the issuer) are always measured at fair value. Equity instruments that are held for trading (including all equity derivative instruments, such as warrants and rights issues) are required to be classified at FVPL, with dividend income recognised in profit or loss.

For all other equities within the scope of Ind AS 109, management has the ability to make an irrevocable election on initial recognition, on an instrument-by-instrument basis, to present changes in fair value in OCI rather than profit or loss.

Dividends are recognised in profit or loss unless they clearly represent a recovery of part of the cost of an investment. There is no recycling of amounts from OCI to profit or loss – for example, on sale of an equity investment – nor are there any impairment requirements. But the entity can transfer the cumulative gain or loss within equity.

Cost option for unquoted instruments:

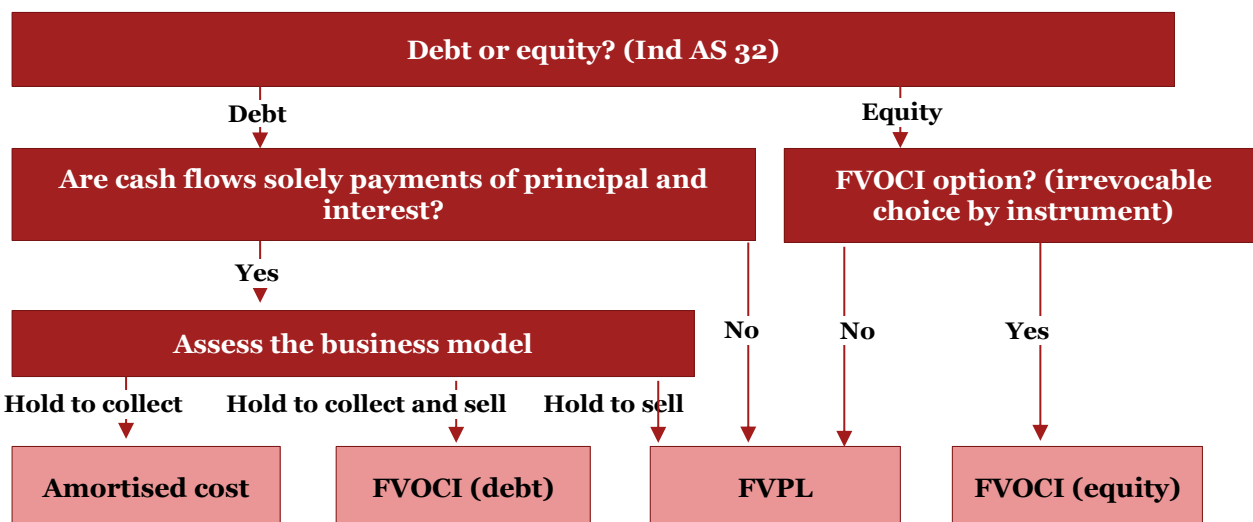
Ind AS 109 does not provide an option to measure unquoted equity investments at cost where fair value cannot be determined reliably. However, Ind AS 109 indicates that, in limited circumstances, cost might be used as an estimate of fair value – for example, where more recent available information is insufficient to determine fair value; or where there is a wide range of possible fair value measurements, and cost represents the best estimate of fair value within that range.

B. Classification of debt instruments:

If the financial asset is a debt instrument (or does not meet the definition of an equity instrument in its entirety), management should consider the following assessments in determining its classification:

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

The below chart provides an overview of the classification requirements for financial assets



If the financial asset (debt) is measured at FVOCI, all movements in the fair value should be taken through OCI, except for the recognition of impairment gains or losses, interest revenue using the effective interest method and foreign exchange gains and losses, which are recognised in profit or loss.

1. Assessment of contractual cash flow characteristics of the financial asset:

Generally, when looking at the Ind AS 109 classification guidance, the business model is assessed first. However, for purposes of corporate entities, the business models are less defined as in a financial institution and it may be easier to first consider the cash flows from a financial assets and whether such payments represent solely principal plus interest (SPPI). If the cash flows do not meet the SPPI criterion, the financial asset would be measured at FVPL irrespective of the business model. If the cash flows meet the SPPI criterion, then it is necessary to assess the business model to determine whether the financial asset is to be measured at amortised cost or FVOCI. For assessing SPPI, Ind AS 109 defines principal and interest as follows:

- ‘Principal’ is defined as the fair value of the financial asset at initial recognition.
- ‘Interest’ consists of consideration for the time value of money, for the credit risk associated with the principal amount outstanding, and for other basic lending risks (for example, liquidity risk) and costs (for example, servicing or administrative costs) associated with holding a financial asset for a period of time, as well as a profit margin. These are consistent with features of a basic lending arrangement.

Contractual features that introduce exposure to risks or volatility in the contractual cash flows unrelated to a basic lending arrangement, such as exposure to changes in equity or commodity prices, do not give rise to contractual cash flows that are SPPI.

The classification approach in Ind AS 109 applies to all financial assets, including those with embedded derivatives. That is, if a hybrid contract contains a host that is a financial asset within the scope of Ind AS 109, an entity should apply the business model assessment and SPPI criterion to the entire hybrid contract, in order to determine its measurement category. There is no need to assess whether embedded derivatives in host contracts that are financial assets are closely related or not and should therefore be separated.

i. Assessment of SPPI for a convertible instrument:

An entity has an investment in a convertible bond that, from the issuer’s perspective, has both a liability and an equity component.

How should the holder account for the bond?

Answer:

Since the contract is a financial asset that is within the scope of Ind AS 109 in its entirety, the contract should be accounted for as a whole. From the holder's perspective, the cash flows on the convertible bond are not SPPI since the bond includes contractual features that introduce exposure to risks or volatility in the contractual cash flows unrelated to a basic lending arrangement, so the bond cannot be classified as a financial asset measured at amortised cost, and it will always be classified at FVPL by the holder. However, if a convertible bond were to be classified as equity in its entirety from the issuer's perspective (for example, if the bond had no interest payments and mandatorily converted into a fixed number of the issuer's equity instruments on a future date), the holder might choose to designate it at FVOCI.

ii. Assessment of SPPI for financial assets containing embedded derivatives:

Do embedded derivatives in financial assets prevent the SPPI criterion from being met?

Answer:

It depends. Many embedded derivatives introduce variability to cash flows, which is not consistent with the notion that the instrument's contractual cash flows represent SPPI. But the number of circumstances in which such instruments will qualify for amortised cost is limited. There are some embedded derivatives (such as caps and floors) that may pass the SPPI condition in Ind AS 109.

2. Business model assessment:

An entity's business model refers to how an entity manages its financial assets in order to generate cash flows. Ind AS 109 prescribes two business models: holding financial assets to collect contractual cash flows; and holding financial assets to collect contractual cash flows and selling. FVPL is the residual category which is used for financial assets that are held for trading or if a financial asset does not fall into one of the two prescribed business models.

An entity's business model is determined by the entity's key management personnel (as defined in Ind AS 24, Related Party Disclosures).

The business model is typically observable through the activities that the entity undertakes to achieve the objective of the business model. The business model for managing financial assets is not determined by a single factor or activity. Instead, management has to consider all relevant evidence that is available at the date of the assessment. Such relevant evidence includes, but is not limited to:

- how the performance of the business model (and the financial assets held within) is evaluated and reported to the entity's key management personnel;
- the risks that affect the performance of the business model (and the financial assets held within) and, in particular, the way that those risks are managed; and
- how managers of the business are compensated (for example, whether the compensation is based on the fair value of the assets managed or the contractual cash flows collected).

Management will need to apply judgement to determine the level at which the business model condition is applied. That determination is made on the basis of how an entity manages its business; it is not made at the level of an individual asset, rather it is performed at a higher level of aggregation.

i. Impact of factoring on business model assessment:**Scenario 1:**

Corporate A sets up a master trade receivables factoring agreement with a bank. At the inception of a trade receivable, it is often unknown whether it will be subject to factoring. The decision rests typically with the company's management and is made later in the process, depending on a number of factors. The terms of the factoring agreement are such that all receivables that are factored meet the financial asset de-recognition criteria, resulting in the original receivables being de-recognised from the balance sheet.

What would be the applicable Ind AS 109 business model for the trade receivables, potentially subject to factoring?

Answer:

The business model is a matter of fact, and it should be observable. When evaluating the business model, the relevant activities should be considered. In this scenario, one of two business models might be appropriate, depending on the facts and circumstances:

- A. 'Hold to collect and sell' business model – this would apply where relevant activities are represented through both the collection of contractual cash flows (for those receivables that are not factored) and regularly selling receivables (via selling receivables into the master factoring agreement on a regular basis, even if the exact extent and the specific receivables impacted cannot be identified at inception). Therefore, the whole portfolio of trade receivables should be classified as 'hold to collect and sell'.
- B. Selling business model – Where entity A's objective is to realise the cash flows primarily through selling, the business model is not held to collect and sell, and so the receivables should be measured at FVPL.

The business model assessment should be supported by an analysis of past sales (both their frequency and value). Judgement must be applied, since Ind AS 109 does not provide any bright line thresholds for sales.

Given that, in the above case, entity A cannot specify which receivables it plans to factor, and provided that it both factors and holds significant amounts of receivables, the 'hold to collect and sell' business model might be more appropriate.

Scenario 2:

Corporate A enters into a factoring arrangement for its trade receivables which involves the transfer of the contractual rights to receive the cash flows from its receivables in return for an upfront cash payment from the factor. However, Corporate A retains substantially all risks and rewards of ownership via a guarantee of the credit risk of the receivables such that the transfer does not result in full or partial derecognition.

Do the receivables continue to qualify as held to collect in Corporate A's Ind AS 109 business model assessment?

Answer:

Corporate A has an accounting policy choice depending on how it interprets the 'held to collect' notion in Ind AS 109.

Corporate A may look to the accounting treatment of the receivables and their continued recognition on the balance sheet and conclude that the held to collect business model is appropriate. Additionally, as the entity retains substantially all risks and rewards, it is economically in a similar position as if it had not transferred the contractual rights to the cash flows of the receivables.

Alternatively, Corporate A may look to the transfer of the contractual rights to the cash flows of the receivables in return for the upfront cash payment and conclude that the held to collect business model is not appropriate. Under this view, Corporate A has already collected cash up front and will thus not collect the contractual cash flows from the underlying receivables in the future, such that its objective is not to collect the contractual cash flows over the receivables' life.

This accounting policy choice may not apply in other circumstances, for example, when the entity enters into a pass through arrangement and thus retains (and will collect) the contractual rights to receive the cash flows from the financial asset, or in a repo transaction.

C. Classification of financial liabilities:

There are two measurement categories for financial liabilities, fair value, and amortised cost. Financial liabilities are measured at amortised cost, unless they are required to be measured at FVPL or an entity has opted to measure a liability at FVPL.

Certain liabilities are required to be measured at FVPL. These include all derivatives (such as foreign currency forwards or interest rate swaps, excluding those designated as qualifying hedging instruments) and an entity's liabilities that it classifies as 'held for trading'.

Option to designate a financial liability at FVPL:

Under Ind AS 109, an entity can, at initial recognition, irrevocably designate a financial liability as measured at FVPL where doing so results in more relevant information, because either:

- 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; or
- 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.

Ind AS 109 requires that for financial liabilities for which an entity chooses to account at FVPL, changes in fair value of such liabilities related to changes in own credit risk are presented separately in OCI, whilst all other fair value changes are presented in the statement of profit and loss. Amounts in OCI relating to changes in own credit risk are not recycled to the statement of profit and loss, even when the liability is de-recognised and the amounts are realised. However, the standard allows transfers within equity, and so entities that wish to transfer realised balances to retained earnings, for example, could do so.

Financial liabilities that are required to be measured at FVPL (as distinct from those that the entity has chosen to measure at FVPL) continue to have all fair value movements, including those related to changes in the credit risk of the liability, recognised in profit or loss.

Impairment of financial assets

Ind AS 109 outlines a ‘three-stage’ model (‘general model’) for impairment based on changes in credit quality since initial recognition:

Stage 1 (Initial recognition)	Stage 2 (significant increase in credit risk)	Stage 3 (Credit impaired)
Interest recognition		
Interest on gross carrying amount	Interest on gross carrying amount	Interest on net carrying amount
12 month ECL	Lifetime ECL	Lifetime ECL

- Stage 1 includes financial instruments that have not had a significant increase in credit risk since initial recognition or that (at the option of the entity) have low credit risk at the reporting date. For these assets, 12-month expected credit losses (‘ECL’) are recognised and interest revenue is calculated on the gross carrying amount of the asset (that is, without deduction for credit allowance).

12-month ECL are the ECL that result from default events that are possible within 12 months after the reporting date, whereas lifetime ECL are the ECL that result from all possible default events over the maximum contractual period during which the entity is exposed to credit risk.

- Stage 2 includes financial instruments that have had a significant increase in credit risk since initial recognition (unless they have low credit risk at the reporting date and this option is taken by the entity) but that do not have objective evidence of impairment. For these assets, lifetime ECL are recognised, but interest revenue is still calculated on the gross carrying amount of the asset.
- Stage 3 includes financial assets that have objective evidence of impairment at the reporting date. For these assets, lifetime ECL are recognised and interest revenue is calculated on the net carrying amount (that is, net of credit allowance).

The model should be applied to:

- investments in debt instruments measured at amortised cost;
- investments in debt instruments measured at FVOCI;
- all loan commitments not measured at FVPL;

- financial guarantee contracts to which Ind AS 109 is applied and that are not accounted for at FVPL; and
- lease receivables that are within the scope of Ind AS 17, *Leases*.

The model does not apply to investments in equity instruments. Further, for trade receivables within the scope of Ind AS 11, *Construction Contracts* and Ind AS 18, *Revenue*, entities are required to apply the simplified approach (discussed below).

The table below gives an overview of the impairment requirements and approach applicable to corporate investments:

Asset category	Whether Ind AS 109 impairment model applies	Approach to be followed
Investment in subsidiary, associate and joint venture in separate financial statements	No	Impairment is determined in accordance with Ind AS 36, <i>Impairment of Assets</i> .
Inter-company loans	Yes	General model
Trade receivables	Yes	Simplified approach. Refer illustration below for how this is applied.
Lease receivables	Yes	Accounting policy choice i.e. Simplified approach or general model
Investment in equity instruments	No	NA
Debt instruments measured at amortised cost	Yes	General model
Debt instruments measured at FVOCI	Yes	General model
Inter-company financial guarantees (issuer)	Yes	General model
Derivatives	No	NA

A. Simplified approach for trade and lease receivables:

The model includes some operational simplifications for trade receivables and lease receivables, because they are often held by entities that do not have sophisticated credit risk management systems. These simplifications eliminate the need to calculate 12-month ECL and to assess when a significant increase in credit risk has occurred.

An entity has an accounting policy choice for lease receivables. It can either apply the simplified approach (that is, to measure the loss allowance at an amount equal to lifetime ECL at initial recognition and throughout its life) or it can apply the general model.

For trade receivables, the loss allowance should be measured at initial recognition and throughout its life at an amount equal to lifetime ECL. As a practical expedient, a provision matrix can be used to estimate ECL for these financial instruments.

Use of a standard default rate to provision matrix for trade receivables

Trade receivables	Current	31-60 days	61-90 days	More than 90 days	Total
Gross carrying amount (A)	2,500	650	580	400	4,130
Default rate (B)	3%	3%	3%	3%	
Expected credit loss (A)x(B)	75	20	17	12	124

Question: Is the above provision matrix appropriate?

Answer:

No. The above provision matrix is not appropriate. A standard default rate (e.g. 3%) applied to all time buckets is not an acceptable method of preparing a provision matrix. Provision matrices also need to incorporate forward-looking information, not just historical. The default rates cannot be the same for each period - the longer debtors remain unpaid the more likely this will default.

Steps in building a provision matrix

Ind AS 109 does not specify how such matrices should be developed. There are multiple ways in which corporates may establish a provision matrix and identify appropriate default rates by incorporating forward-looking information. The method illustrated below is one of the possible ways to build a provision matrix for trade receivables. Selecting data for a sufficient period of time, and determining payment profiles, is critical.

Step 1: Define the period of sales and bad debts related to those sales

- Calculate the total amount of sales on credit made during the time period (e.g. INR 10,000)
- Calculate the total amount of bad debts incurred related to sales (i.e. debts written-off with respect to the sales (e.g. INR 300))

Step 2: Calculate the payment profile of the debtors

	Total sales of INR 10,000	Total paid (cumulative)	Ageing profile of sales (Total sales – Total paid)
Paid in 30 days	2,000	2,000	8,000
Paid between 31-60 days	3,500	5,500	4,500
Paid between 61-90 days	3,000	8,500	1,500
Paid after 90 days	1,200	9,700	300 (written-off)

Step 3: Calculate the historical default rate as follows:

	Current sales	Sales payments outstanding after 30 days	Sales payments outstanding after 60 days	Sales payments outstanding after 90 days
Ageing profile of sales (as per step 2) (A)	10,000	8,000	4,500	1,500
Loss (B)	300	300	300	300
Historical default rate (B)/(A)	3.00%*	3.75%#	6.67%	20.00%

* Since all the receivables relating to the sales made and those written off were current at some stage, we can derive that for all current amounts, we could incur an eventual loss of INR 300. The default rate would therefore be INR 300 / INR 10,000 = 3% for all current amounts.

If we then consider the next time bucket, since only INR 2,000 was paid in the current period, an amount of INR 8,000 was not paid within 30 days. We also know that from this amount of INR 8,000 payable, an eventual loss of INR 300 resulted. Therefore, the default rate for amounts 30 days outstanding would be 3.75%. The same calculation is performed for the remaining buckets.

Step 4: Adjust the loss percentage for forward-looking information

While incorporating forward-looking information, an entity may consider macro-economic information such as economic outlook, regulatory environment, technological changes, industry outlook, employment rates and political environment etc.

Basis above, the entity adjusts the historical loss from INR 300 to INR 400 as forward-looking information indicates that there will be a higher level of default. The default rates are then recalculated for the various time buckets based on the expected future losses of INR 400.

	Current sales	Sales payments outstanding after 30 days	Sales payments outstanding after 60 days	Sales payments outstanding after 90 days
Ageing profile of sales (as per step 2) (A)	10,000	8,000	4,500	1,500
Loss (B)	400	400	400	400
Adjusted default rate (B)/(A)	4.0%	5.0%	8.9%	26.7%

Step 5: Use the above adjusted default rates to determine the expected credit losses for trade receivables

Trade receivables	Current	31-60 days	61-90 days	More than 90 days	Total
Gross carrying amount (A)	2,500	650	580	400	4,130
Default rate (B)	4.0%	5.0%	8.9%	26.7%	
Expected credit loss (A)x(B)	100	33	52	107	292

Conclusion: The total expected credit loss of INR 292 is significantly different from the impairment calculated using standard 3% applied to all balances. It is also important to note how different the total ECL is as a percentage of the total book balance at the reporting date compared to the 4% expectation in the default rate calculation. The reason for this is that the ultimate ECL amount is dependent on the ageing profile of the trade receivables at the calculation date and not merely the average of the total bad debts written off in the past.

B. ECL measurement approach – general model:

i. Assessing significant increases in credit risk:

All information available without undue cost or effort should be taken into account to perform the assessment of changes in credit risk. Ind AS 109 provides a non-exhaustive list of information that might be relevant in assessing changes in credit risk. Both forward-looking and historical information are used in order to determine whether a significant increase in credit risk has occurred. Lifetime ECL are generally expected to be recognised before a financial instrument becomes past due. Typically, credit risk increases significantly before a financial instrument becomes past due or other lagging borrower-specific factors (for example, a modification or restructuring) are observed. Reasonable and supportable information that is more forward-looking than past due information, and that is available without undue cost or effort, must be used to assess changes in credit risk

There is a rebuttable presumption that credit risk has increased significantly since initial recognition when the contractual payments are more than 30 days past due. This presumption can be rebutted if there is reasonable and supportable evidence that there has been no significant increase in the credit risk (for example, where non-payment is an administrative oversight, instead of resulting from financial difficulty of the borrower).

ii. Measuring expected credit losses:

ECL are a probability-weighted estimate of credit losses. A credit loss is the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive discounted at the original effective interest rate.

ECL considers the amount and timing of payments, thus a credit loss arises even if the entity expects to be paid in full but later than when contractually due.

ECL are measured over the remaining life of a financial instrument in a way that reflects:

- an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;
- the time value of money; and
- reasonable and supportable information about past events and current conditions, and reasonable and supportable forecasts of future events and economic conditions at the reporting date.

iii. What information to consider:

An entity can use various sources of data, both internal and external, to measure ECL. Possible data sources include historical credit loss experience, internal ratings, credit loss experience of other entities, and external ratings, reports and statistics. However, an entity should consider observable market information about the credit risk of the particular financial instrument or similar financial instruments.

Historical data could be used as a base from which to measure ECL. Such data should be adjusted to reflect current conditions and its forecasts of future conditions that did not affect the period on which the historical data is based, and to remove the effects of the conditions in the historical period that are not relevant to the future contractual cash flows. An entity should regularly review the methodology and assumptions used for estimating ECL, to reduce any differences between estimates and actual credit loss experience.

Entities should also take into account forecast information available, such as that included in business plans ('internal information') or that provided by the market – for example, changes in prices that indicate expected changes in credit ratings ('external information').

iv. Consideration of time value of money:

The time value of money must be taken into account when calculating the ECL (regardless of whether it is the 12-month or the lifetime ECL). The entity should discount the cash flows that it expects to receive at the effective interest rate determined at initial recognition, or an approximation thereto, in order to calculate ECL. If a financial instrument has a variable interest rate, ECL should be discounted using the current effective interest rate.

C. Write-off of financial assets:

Ind AS 109 requires an entity to reduce the gross carrying amount of a financial asset when the entity has 'no reasonable expectations of recovering' a financial asset. Write-offs can relate to a financial asset in its entirety or to a portion of it.

D. Presentation requirements:

Interest revenue and impairment losses, including reversals of impairment losses or impairment gains, are presented as a separate line item in the statement of profit and loss. For financial assets that are mandatorily measured at FVOCI, the accumulated impairment amount is not separately presented in the balance sheet. However, an entity should disclose the loss allowance in the notes to the financial statements.

The takeaway

The classification, measurement and the impairment provisions of Ind AS 109 have significant implications on reporting of financial assets and liabilities by corporates. Ind AS 109 requires increased use of fair value for measuring financial assets (for example, unquoted instruments) and the use of forward-looking information for impairment provisions under the new expected credit loss model – estimating such information can often pose implementation challenges. Further, though entities may use a provision matrix for its ECL calculations, the estimation of default rates for such matrix could involve complexity while building such matrix. Finally, Ind AS 109 introduces extensive disclosures for which management may require significant amount of data to comply.

In light of the above, entities should continue to carefully consider the classification and measurement requirements to its transactions involving financial instruments while reporting its Ind AS financial information.

Appendix: Abbreviations

Abbreviations used in this publication are set out below.

FVPL	(Financial assets/liabilities at) fair value through profit or loss
FVOCI	(Financial assets/liabilities at) fair value through other comprehensive income
ECL	Expected credit losses
IFRS	International Financial Reporting Standards
Ind AS	Indian Accounting Standards
OCI	Other comprehensive income
SPPI	Solely payments of principal and interest


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