

Financial Instruments - Quick Pointers for Answers / Revision / MCQs

SPPI & Business Model Tests

Situation	Conclusion / Treatment
Bond linked to an unleveraged inflation index , principal protected	SPPI met — inflation only resets time value of money ("real" interest)
Interest linked to debtor's net income or an equity index	SPPI fails — return inconsistent with basic lending
Convertible bond (holder)	Assessed in entirety ; return linked to issuer's equity → SPPI fails → FVTPL
Hold-to-collect; unplanned sale later due to liquidity crisis	Still hold-to-collect ; no retrospective reclassification
Interest-free loan to sub, repayable on demand	SPPI met (only principal)
Floating-rate loan with a cap (e.g. 10%)	SPPI met — fixed + floating combination still principal & interest
Trade receivables with early-payment discount / late-payment interest	SPPI met + hold-to-collect → Amortised cost
Lessee's refundable security deposit	FA at amortised cost
Holder of OCPS (convert or redeem at premium)	Cash flows not SPPI → FVTPL

Initial Measurement & Off-Market Terms

Core rule

- Initial measurement = **FV** (PV of cash flows at **market rate**) ± transaction cost (added to FA, deducted from FL, except FVTPL).
- Day-1 difference: first ask "**what else did the parties get?**" — classify it accordingly (see table). Only if nothing, apply the Level 1 → P&L / otherwise deferred rule.

Situation	Conclusion / Treatment
Interest-free security deposit (lessee)	FA = PV; difference = prepaid rent → ROU asset , depreciated SL.
Concessional employee loan	FA = PV @ market rate; difference = prepaid employee cost , expensed SL over loan term
Employee prepays part of loan	Reduce FA to PV of revised flows; excess cash received over FA reduction reduces prepaid cost



Situation	Conclusion / Treatment
Interest-free loan parent → sub , fixed term	Parent: FA (PV) + Investment in sub . Sub: FL (PV) + Equity contribution . Unwind interest both sides
Loan repayable on demand	FV = face value (demand feature, Ind AS 113); no interest accrued
Repayable " when funds are available "	Not on demand – estimate repayment date and discount
Shareholder loan repayable only from subsidiary dividends	Not on demand; FV from expected dividends; shortfall vs face = equity contribution (holder: part of investment)
Redeemable pref (near-zero dividend) issued to holding co.	Issuer: FL = PV of redemption; balance = equity (capital contribution)

FVOCI

- Interest under FVOCI = **same EIR income as amortised cost**; only the FV difference goes to OCI.
- FV gain/loss each year = FV – (Previous FV + Interest – Receipt).
- Year-end FV is **not reduced by costs to sell**
- Equity at FVOCI: bought 10,000 sh @ 50, FV 45 → **OCI loss 50,000**; never recycled.

Liability vs Equity

Situation	Conclusion / Treatment
Puttable shares + side contract giving holder 50% of profits (market 4–6%)	Fails PFI conditions → FL
CCPS converting at FV on conversion date (variable no.)	FL – own equity used "as currency"; FVTPL
CCPS with fixed conversion ratio	Equity ; carried at cost
Written put on own shares, gross physical settlement, obligation to deliver cash	FL = PV of exercise price , Dr Equity; premium Cr Equity; lapse → FL back to equity
Parent writes put to NCI of subsidiary	FL, Dr Equity
Conversion no. = based on FV at conversion	Variable → FL
Convertible into fixed shares	Equity component
Option: fixed shares @ fixed ₹50	Equity .
Exercise price ₹40 / ₹60 depending on share price	Variable cash → FL



Situation	Conclusion / Treatment
Share swap: fixed own shares vs variable value of target's shares	Not equity → derivative asset/liability
Ratio changes only with passage of time (1 → 1.5 → 2)	Time is certain → fixed → Equity
Anti-dilution adjustment for split/bonus	Preserves proportion → still Equity
Down-round protection (issue below ₹10 resets ratio)	Underwrites return → FL
Convert at FV, stake floor 15% / cap 40%	Variable within band → FL
Different ratios on independent events in different periods	separate contracts, each fixed → Equity
Different ratios on interdependent Enterprise valuation thresholds	Single contract, variable → FL

7. Derivatives & Embedded Derivatives

Situation	Conclusion / Treatment
Debt with prepayment option	Closely related if exercise price ≈ amortised cost on each date; set a policy threshold (e.g. 2%) – beyond it, separate
USD contract for machinery between two INR entities	USD is neither party's FC, not routine for machinery, not common locally → separate FX forward
Separated forward – accounting	FV Nil at inception; FV changes → P&L; PPE recorded at inception forward rate , derivative balance settled against it
Commodity contract – 30% history of net settlement / short-term resale	Derivative (FVTPL); own use lost
Commodity contract – net settled only 1% , rest delivered & used	Own use → executory contract, outside Ind AS 109
Exchange-traded contract, must be cash settled	Derivative
Forward MTM:	Book only the change each quarter
USD sale contract with separated ED	Revenue at inception forward rate (55); derivative settled against receivable on collection
Issuer call with fixed premium	If Not ≈ Amortised cost → separate . Host = proceeds + option FV. Option FV → P&L;



8. Derecognition of Financial Assets

Situation	Conclusion / Treatment
Pro-rata 90% of loan cash flows passed through, no guarantee	Derecognise 90% cr ; retain 10%
Repo of same / substantially same / substitutable asset at fixed price or lender's return	Not derecognised — risks & rewards retained
Only a right of first refusal at FV	Derecognise
Transferor call option deep ITM	Not derecognised
Call deep OTM	Derecognise
Call neither ITM nor OTM, asset readily obtainable in market	Derecognise — control not retained
Amortising swap linked to transferred principal	Prepayment risk retained → recognise / continuing involvement
Swap not linked to principal outstanding	May derecognise
Securitisation with retained principal/interest strips & servicing asset	Split carrying amount on relative FV
Factoring with credit guarantee	Continuing involvement asset = lower of asset and guarantee amount ; associated liability = guarantee amount + FV of guarantee



FINANCIAL INSTRUMENTS

1. Financial Instruments — Definitions

Financial Instrument = any contract that gives rise to a **financial asset** of one entity and a **financial liability or equity instrument** of another entity.

Financial Asset (TR, advances, loans given)	Financial Liability (TP, loans taken, payables)
1. Cash / deposit with bank	1. Contractual obligation to deliver cash / another FA
2. Contractual right to receive cash / another FA	2. Obligation to exchange FA/FL under potentially unfavourable conditions (e.g. written options)
3. Equity instrument of another entity	3. Contract settled in own equity :
4. Right to exchange FA/FL under potentially favourable conditions (e.g. purchased ITM option)	(a) Non-derivative — obliged to deliver a variable no. of own shares
5. Contract settled in own equity :	(b) Derivative — other than fixed-for-fixed
(a) Non-derivative — will receive a variable no. of own shares	
(b) Derivative — other than fixed-for-fixed	

Equity Instrument

- Residual interest in assets after deducting all liabilities.
- Passes the equity test only if it is **not** a FL as defined above, i.e. if settled in own equity:
 - Non-derivative → **no obligation to deliver a variable** number of own shares (fixed number)
 - Derivative → **fixed amount of cash for fixed number of shares (fixed-for-fixed)**

Item	Classification
Derivative with gain (favourable)	Financial asset
Derivative with loss (unfavourable)	Financial liability
Redeemable preference shares (mandatory / holder option)	Financial liability



Item	Classification
Irredeemable preference shares	Equity — only if dividends are discretionary ; mandatory/cumulative dividends create a liability component. Not permitted in India (Sec 55, Companies Act 2013)

Exception — Puttable Financial Instruments (PFI)

A PFI gives the holder the right to put the instrument back to the issuer for cash/FA, **or** is automatically put back on occurrence of an uncertain future event (or death/retirement of the holder). Normally a FL — but classified as **equity** if ALL conditions are met:

1. Holder entitled to a **pro-rata share of net assets** on liquidation.
2. Instrument is in the **most subordinate class**.
3. All instruments in that class have **identical features**.
4. Apart from the put, **no other contractual obligation** to deliver cash/FA.
5. Total expected cash flows based **substantially on P&L, change in net assets, or change in FV of net assets**.
6. Issuer has **no other instrument** with cash flows as in (5) that substantially restricts or fixes the residual return to PFI holders.

Own-Use Exemption (Contracts to Buy/Sell Non-Financial Items)

Contracts to buy/sell a non-financial item (e.g. commodity) that can be **settled net** are within Ind AS 109 as if they were FIs — **except** contracts entered into and held for receipt/delivery as per the entity's **expected purchase, sale or usage requirements** (own use).

Outside Ind AS 109

Gross settlement / delivery taken for own use

Covered by Ind AS 109

Practice of **net settling** similar contracts, or taking delivery and **selling within a short period** for dealer's margin

Terms permit net settlement / item is **readily convertible to cash**

Designated at **FVTPL** to eliminate accounting mismatch (Irrevocable)

Example: Forward to buy 1,000 tons of oil @ \$100/ton.

- Expects to take delivery in the normal course of business → **Not a FI** (own use).
- Net settles / designates at FVTPL → **FI**, Ind AS 109 applies (derivative at FVTPL).

2. Classification & Measurement of Financial Assets



Two tests decide classification of a **debt** instrument:

- **SPPI test** – contractual cash flows are **solely payments of principal and interest?**
- **Business model test** – held to **collect**, to **collect and sell**, or other?

Category	When	Initial recognition	Subsequent
Amortised Cost (ACM)	Debt; SPPI met; hold to collect	FV + transaction cost	EIR method. CA = Opening + Interest – Receipts. Impairment applies
FVOCI – Debt	Debt; SPPI met; collect and sell	FV + transaction cost	Interest (EIR), ECL, FX → P&L. FV change → OCI; recycled to P&L on derecognition
FVOCI – Equity (election)	Equity not HFT; irrevocable election at initial recognition	FV + transaction cost	FV change → OCI, never recycled (may transfer within equity). Dividends → P&L. No impairment
FVTPL (residual)	Everything else: derivatives, HFT, SPPI fail, designated	FV; transaction cost → P&L	All FV changes, interest/dividend → P&L

FV = PV of future cash flows at the **market rate of interest**.

Irrevocable Designation Options

- FA otherwise at ACM/FVOCI → designate at **FVTPL** only if it **eliminates/significantly reduces an accounting mismatch**.
- Equity investment **not held for trading** (and not contingent consideration in a business combination) → designate at **FVOCI**.

Amortised Cost – Illustration (Lender)

Data	Amount
Loan amount (face)	₹10,00,000
Tenure	5 years
Coupon @ 5%	₹50,000 p.a.
Upfront fee charged to borrower	₹1,20,000
Net amount disbursed (initial carrying amount)	₹8,80,000
EIR (rate equating ₹8,80,000 with future cash flows)	≈ 8%



Proof of EIR $\approx 8\%$

Particulars	Amount (₹)	Factor @ 8%	PV (₹)
Coupon ₹50,000 $\times$ 5 years	50,000	PVAF 3.9927	1,99,635
Principal at end of Year 5	10,00,000	PVF 0.6806	6,80,600
Present value			8,80,235
Rounded			$\approx 8,80,000$

Year	Opening (₹)	Interest @ 8% (₹)	Receipts (₹)	Closing (₹)
1	8,80,000	70,400	(50,000)	9,00,400
2	9,00,400	72,032	(50,000)	9,22,432
3	9,22,432	73,795	(50,000)	9,46,227
4	9,46,227	75,698	(50,000)	9,71,925
5	9,71,925	78,075*	(10,50,000)	Nil

*Year 5 interest at 8% = ₹77,754; ₹321 is a rounding plug because exact EIR is marginally above 8%.

Journal Entries (Lender) — Borrower passes mirror entries

Initial recognition	Year-end interest (Y1)	Coupon received (Y1)
Dr Financial Asset 8,80,000 Cr Bank 8,80,000	Dr Financial Asset 70,400 Cr Interest income 70,400	Dr Bank 50,000 Cr Financial Asset 50,000

Off-Market Terms (Day-1 Difference)

At initial recognition, FA/FL is measured at **FV**. If transaction price $\neq$ FV (e.g. interest-free loan, below-market deposit):

1. First check whether the difference represents **another asset/liability/equity** element $\rightarrow$ recognise accordingly (table below).
2. If not — FV evidenced by **Level 1 / observable inputs** $\rightarrow$ Day-1 gain/loss in **P&L**.
3. Otherwise $\rightarrow$ **defer** the difference and recognise over life as a factor market participants would consider.

Transaction	Debit the difference to
Interest-free / concessional loan to employee	Prepaid employee benefit (expensed over period)
Security deposit paid under lease	Lessee: add to ROU asset (Ind AS 116) · Lessor: advance lease rent (income over term)
Interest-free loan parent $\rightarrow$ subsidiary	Parent: Investment in sub (deemed capital contribution) · Sub: Equity



Transaction	Debit the difference to
Interest-free loan subsidiary → parent	Sub: Equity (deemed distribution/dividend) · Parent: Income (dividend)

3. Classification & Subsequent Measurement — FL & Equity

- **Amortised cost (EIR)** — default for most FLs.
- **FVTPL** — HFT, derivatives, contingent consideration (acquirer), or designated (accounting mismatch / managed on FV basis / hybrid with ED).
 - Designated FVTPL FLs: change in FV due to **own credit risk** → **OCI** (never recycled);
 - Rest → P&L.
 - HFT and derivative FLs: **entire** FV change → P&L.
- **Equity** — recorded at proceeds less transaction costs (net of tax); **not remeasured**. Distributions debited to equity.

4. Compound Financial Instruments (CFI)

An instrument with both a **liability** and an **equity** component (e.g. convertible debenture with fixed-for-fixed conversion). Split on initial recognition (**issuer** only):

Component	Measurement
FV of CFI	Usually the transaction price (issue proceeds)
Liability component (first)	PV of contractual cash outflows at market rate for a similar non-convertible instrument
Equity component (residual)	FV of CFI – Liability component

- Transaction costs allocated to FL and equity **in proportion to the allocated proceeds**; FL portion → recompute EIR.
- **No gain/loss** on initial recognition.
- Equity component is **never remeasured**.

Early Redemption / Repurchase

Step	Treatment
Allocate redemption price	Liability part = PV of remaining cash flows at current market rate on redemption date; Equity part = Redemption price – Liability part
Liability portion	Dr FL, Cr Bank → difference to P&L
Equity portion	Dr Equity component, Cr Bank → difference to other equity/RE (no P&L)



At Maturity

Redeemed in cash	Converted into shares
Dr FL / Cr Bank	Dr FL
Dr Equity component / Cr Other equity (RE)	Dr Equity component Cr Equity share capital Cr Securities premium

Preference Shares – Classification Map

Type	Feature	Classification
Irredeemable (not allowed in India)	Discretionary dividend	Equity
Redeemable	Mandatory redemption	FL
	Redemption at issuer's option	Equity*
	Redemption at holder's option	FL
Convertible	Compulsory, fixed no. of shares	Equity*
	Compulsory, variable no. of shares	FL
	Optional at issuer's option	Equity*
	Optional at holder's option (else redeemed)	Compound: FL + Equity (if fixed-for-fixed)

*Subject to dividends being discretionary. Mandatory/cumulative dividends create a **liability component** (PV of dividends).

5. Modification of FL (Debt Restructuring)

Step	Action
1	Carrying amount of existing FL (A)
2	PV of revised cash flows (incl. fees paid net of fees received) discounted at the original EIR (B)
3	10% test: $ B - A \div A$



$\geq 10\%$ (or qualitatively substantial, e.g. change of currency) → EXTINGUISHMENT	$< 10\%$ → MODIFICATION
Derecognise old FL Recognise new FL at FV (new cash flows at current market rate) Difference + costs/fees → P&L	Restate FL to B (revised PV of cash flows at original EIR) Difference (modification gain/loss) → P&L Costs/fees adjust FL carrying amount → amortised over remaining term (revised EIR)

6. Financial Guarantee Contracts (FGC) — Guarantor

Step 1 — Initial Recognition at FV

- FV (if not given) = PV of **interest saving** to borrower = PV of (interest @ market rate – interest @ concessional rate).

Situation	Entry
Premium received at arm's length	Dr Bank / Cr FG Liability
Parent guarantees sub's loan, no fee	Dr Investment in sub / Cr FG Liability
Guarantee for others, no fee (no other benefit)	Dr P&L / Cr FG Liability

Step 2 — Subsequent Measurement: **HIGHER** of

- Loss allowance (ECL)** = Exposure $\times$ PD $\times$ LGD
- Amount initially recognised – cumulative income** recognised as per Ind AS 115 principles.

Income amortisation — common exam schedule:

Opening | Unwinding @ market rate | Benefit released | Closing (closing = PV of remaining interest savings).

7. Derivative Financial Instruments

A derivative has ALL three:	NOT a derivative if:
1. Value changes with an underlying (rate, price, index, FX, credit rating)	Underlying is a non-financial variable specific to a party to the contract (e.g. insurance on own asset).
2. No / small initial net investment	
3. Settled at a future date	

- Measured at **FVTPL** (unless designated as hedging instrument → hedge accounting).
- Favourable → **FA**; unfavourable → **FL**.



- Option holder exercises only if **in the money**.

Instrument	Nature	Initial FV
Forward	Buy/sell underlying at agreed rate on future date (OTC)	Nil
Future	Like forward; exchange-traded, standard lot/expiry, margin	Nil (margin is a deposit)
Option	Right, not obligation, to buy/sell at strike	Premium paid/received

Position	Meaning	Expectation
Long	Buy	Price up
Short	Sell	Price down
Buy call	Right to buy	Price up
Sell call	Obligation to sell if exercised	Price not up
Buy put	Right to sell	Price down
Sell put	Obligation to buy if exercised	Price not down

Accounting Entries

Event	Forwards / Futures	Options
Inception	Nil (FV = 0) Margin: Dr Deposit / Cr Bank	Buyer: Dr Derivative asset / Cr Bank Writer: Dr Bank / Cr Derivative liability
Gain	Dr Derivative FA / Cr P&L	Dr Derivative / Cr P&L
Loss	Dr P&L / Cr Derivative FL	Dr P&L / Cr Derivative

Interest Rate Swaps — Prepaid Legs

- Exchange of fixed and floating interest on a **notional principal**.
- Fixed leg prepaid**, variable received in future → still a **derivative** (value depends on future rates).
- Variable leg prepaid**, fixed received in future → **not a derivative** (economically a fixed-rate debt investment).

8. Embedded Derivatives (ED)

A component of a **hybrid contract** that also includes a **non-derivative host**, causing some cash flows to vary like a stand-alone derivative. E.g **₹10 lakh bond with interest linked to USD/INR exchange rate** → Forex-linked interest = **Embedded derivative**.



Separation Rule

Host	Treatment
Financial asset (Ind AS 109 scope)	Never separate – classify the whole hybrid (usually fails SPPI → FVTPL)
Others (FL, non-financial host)	Separate ED only if ALL three : (1) ED not closely related to host; (2) a separate instrument with same terms would be a derivative; (3) hybrid not measured at FVTPL

If separated	Measurement
ED	FVTPL (initial and subsequent)
Host	As per its own standard (e.g. ACM for FL)
FV of ED not reliably measurable	ED = FV of hybrid – FV of host
Neither measurable	Designate entire hybrid at FVTPL

Prepayment option in a debt host – closely related (not separated) if exercise price ≈ **amortised cost** on each exercise date, **or** it reimburses the lender ≈ PV of lost interest for the remaining term.

Foreign Currency ED (in non-financial host contracts)

Closely related (**not separated**) if **no leverage**, **no option feature**, and payments are denominated in:

- Functional currency of **any substantial party** to the contract; or
- Currency in which the item is **routinely denominated in international commerce** (e.g. USD for crude oil, aircraft); or
- Currency **commonly used** in the economic environment where the transaction takes place.

Steps for Solving FX ED Questions

1. Decide whether separation is required.
2. At inception: forward ED → FV **Nil**; option ED → value given in question.
3. Each reporting date: FV change → P&L (gain ↑ derivative asset; loss ↓ asset / create liability).
4. Settlement: remeasure, recognise final gain/loss, adjust derivative.
5. Record the purchase/sale of the non-financial item at cash paid/received; the derivative balance is **adjusted against** that item.

9. Hedge Accounting

Hedged item: recognised asset/liability, unrecognised firm commitment, highly probable forecast transaction, or net investment in a foreign operation (NIFO).

Hedge type	Hedged exposure	Hedging instrument G/L	Hedged item
Fair value hedge e.g. Inventory of Copper, \$ Loan	FV changes of recognised asset/liability or firm commitment	P&L (OCI if hedging FVOCI equity)	Gain/loss adjusts carrying amount → P&L (firm commitment: recognise asset/liability)
Cash flow hedge e.g. Hedging interest payouts of \$ loan	Variability in cash flows of recognised item or forecast transaction	Effective → OCI (CFHR); ineffective → P&L	No adjustment until CF occurs. CFHR: transfer to NFA/NFL. Else reclassify to P&L when hedged CF hits P&L
NIFO hedge	FX risk of net investment in foreign operation	Effective → OCI (FCTR); ineffective → P&L	OCI reclassified to P&L on disposal of foreign operation

Key principle: both legs must hit the **same** place — if the hedged item affects P&L, so does the hedging instrument.

Qualifying criteria:

- (1) eligible instrument & item;
- (2) formal designation and documentation at inception;
- (3) economic relationship;
- (4) credit risk does not dominate;
- (5) hedge ratio consistent with risk management.

FX risk of a **firm commitment** may be designated as either a FV hedge or a CF hedge.

10. Impairment of Financial Assets (ECL Model)

Measured at	Impairment?	Reason / Presentation
Amortised cost	Applicable	Loss allowance reduces carrying amount
FVOCI — Debt	Applicable	Allowance recognised in OCI (does not reduce FV carrying amount)



Measured at	Impairment?	Reason / Presentation
FVOCI – Equity	Not applicable	No contractual cash flows
FVTPL	Not applicable	Already at FV through P&L

Also in scope: lease receivables, contract assets, loan commitments, FGCs.

Expected Credit Loss

- ECL = PV (at **original EIR**) of cash shortfalls (contractual – expected), **probability-weighted**.
- Practical formula: **EAD (Exposure/Amt) × PD × LGD**.
- 12-month ECL** – lifetime cash shortfalls from defaults possible within the next 12 months.
- Lifetime ECL** – from all possible defaults over the life.

General (3-Stage) Approach

Stage	Condition	Loss allowance	Interest on
1	No significant increase in credit risk (SICR)	12-month ECL	Gross carrying amount
2	SICR, not credit-impaired	Lifetime ECL	Gross carrying amount
3	Credit-impaired (objective evidence)	Lifetime ECL	Net (amortised cost)

MCQ / EXAM POINT

Rebuttable presumptions: > 30 days past due → SICR (Stage 2); > 90 days past due → default (Stage 3).

Simplified Approach

- Always lifetime ECL** – mandatory for trade receivables/contract assets without a significant financing component; policy choice for those with one and for lease receivables.
- Typically applied using a **provision matrix** (ageing × historical loss rates, adjusted for forward-looking info).

Purchased or Originated Credit-Impaired (POCI)

- Interest at **credit-adjusted EIR** (based on FV and expected, not contractual, cash flows).
- Allowance = **cumulative changes in lifetime ECL** since initial recognition only (can be a gain).

11. Derecognition of Financial Assets



1. Have contractual rights to cash flows **expired** or been **transferred**? If no → continue to recognise.
2. Transferred **substantially all** risks & rewards → **derecognise**.
3. Retained substantially all risks & rewards → **continue to recognise** (proceeds = FL / collateralised borrowing).
4. Neither → has the entity retained **control**? No → derecognise; Yes → recognise to the extent of **continuing involvement**.
 - Partial transfer: split carrying amount on **relative FV** between transferred and retained parts.
 - Gain/loss on derecognition = Consideration received – Carrying amount derecognised → P&L.
 - FVOCI **debt**: cumulative OCI **recycled** to P&L. FVOCI **equity**: **not recycled** (transfer within equity).

12. Reclassification of Financial Assets

Only when the **business model changes** (rare). **Prospective** from the **reclassification date** (first day of the next reporting period). **FLs and equity designations are never reclassified**.

To ↓ / From →	From ACM	From FVOCI	From FVTPL
To ACM	—	At FV; cumulative OCI removed and adjusted against FV (as if always at AC). EIR & ECL unchanged	FV = new gross carrying amount; new EIR
To FVOCI	At FV; difference → OCI . EIR & ECL unchanged	—	At FV; new EIR
To FVTPL	At FV; difference → P&L	At FV; cumulative OCI reclassified to P&L	—

