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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

CL 02 – Financial Reporting and Governance

Corporate Level

(Financial Instruments – P 01)

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Financial Instruments

Topic No 08 – P01

Accounting for financial instruments is a complex area, with requirements coming from a number of accounting standards. Therefore, this topic financial instruments will consist of following accounting standards.

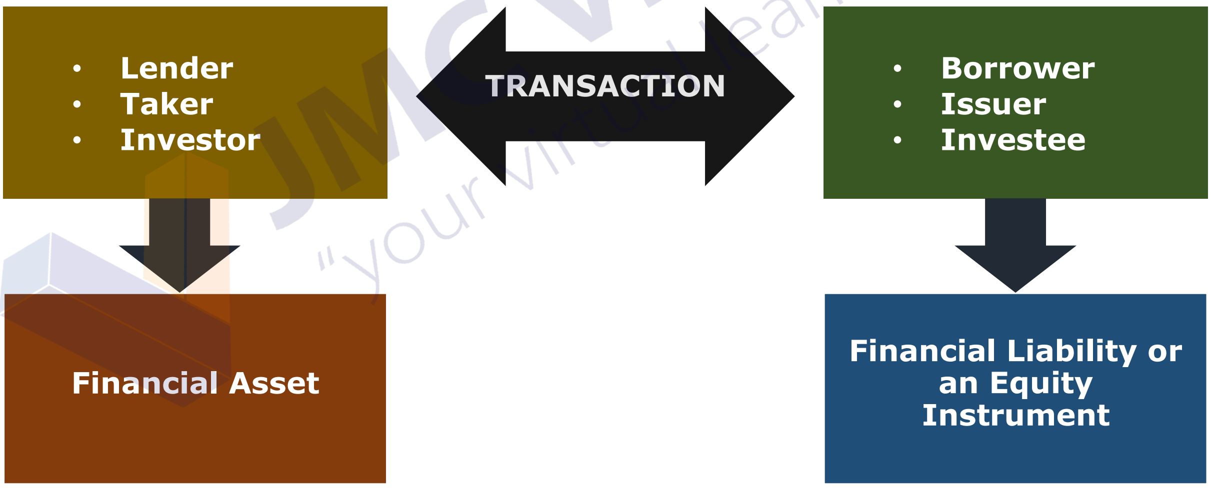
- LKAS 32 Financial Instruments: Presentation
- SLFRS 9 Financial Instruments
- SLFRS 7 Financial Instruments: Disclosure.

1. DEFINITIONS

1.1 Financial Instruments

A financial instrument is **any contract** that gives rise to a financial asset of one entity, and a financial liability or equity instrument of another entity.

This means that items that will be settled through the receipt or delivery of goods or services are not financial instruments, nor typically are tax assets and liabilities as these arise through legal rather than contractual requirements.



1.2 Financial Assets

A financial asset is defined as any asset that is:

- Cash;
- A contractual right;
  - To receive cash or another financial asset from another entity;
  - To exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity.
- An equity instrument of another entity;

- A contract that will or may be settled in the entity's own equity instruments and is:
  - A non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or

  - A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, the entity's own equity instruments do not include puttable equity instruments or instruments that include a contractual obligation for the entity to deliver a pro rata share of its net assets only on liquidation, that do not meet the definition of equity but are classified as such under LKAS 32 Financial Instruments: Presentation, nor do they include instruments that are contracts for the future receipt or delivery of an entity's own equity instruments.

1.3 Financial Liabilities

A financial liability is defined as any liability that is:

- A contractual obligation.
  - To deliver cash or another financial asset to another entity;
  - To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.
- A contract that will or may be settled in the entity's own equity instruments and is:
  - A non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
  - A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, the entity's own equity instruments do not include certain instruments as set out above in the equivalent part of the definition of financial assets.

1.4 Equity Instruments

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

1.5 Derivative

A financial instrument or other contract with all three of the following characteristics:

- Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the 'underlying');

– It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
– It is settled at a future date.

The **following are points to note** in relation to the **definition of a financial instrument above**:

- The **contract** giving rise to a financial asset and liability **need not be in writing**, but it **must comprise an agreement** that has **'clear economic consequences'** and which the parties to it cannot avoid, usually because the agreement is enforceable in law
- An **'entity'** involved in the contract could be an individual, partnership, company or government agency.

The definitions of financial assets and financial liabilities may seem rather circular, referring as they do to the terms financial asset and financial instrument. The point is that there may be a chain of contractual rights and obligations, but it will lead ultimately to the receipt or payment of cash or the acquisition or issue of an equity instrument.

Financial Assets	Financial Liabilities
• Trade receivables • Options • Shares (when used as an investment)	• Trade payables • Debenture loans payable • Redeemable preference (non-equity) shares • Forward contracts standing at a loss

LKAS 32 makes it clear that the **following items are not financial instruments**.

- **Physical assets**, eg inventories, property, plant and equipment, leased assets and intangible assets (patents, trademarks etc)
- Prepaid expenses, deferred revenue and most warranty obligations - Because these assets and liabilities will not make a cash (any other financial asset) inflow or outflow.
- Liabilities or assets that are **not contractual in nature** – For example, Legal obligations such as Tax Liabilities and Assets on court orders.
- Contractual rights/obligations that **do not involve transfer of a financial asset**, eg commodity futures contracts, operating leases for lessors.

2. LIABILITIES AND EQUITY

LKAS 32 requires that financial instruments issued by an entity are presented as financial liabilities or equity according to their substance, not merely their legal form. The **classification** of a financial instrument as a liability or as equity depends on the following.

- The **substance** of the contractual arrangement on initial recognition
- The definitions of a financial liability and an equity instrument

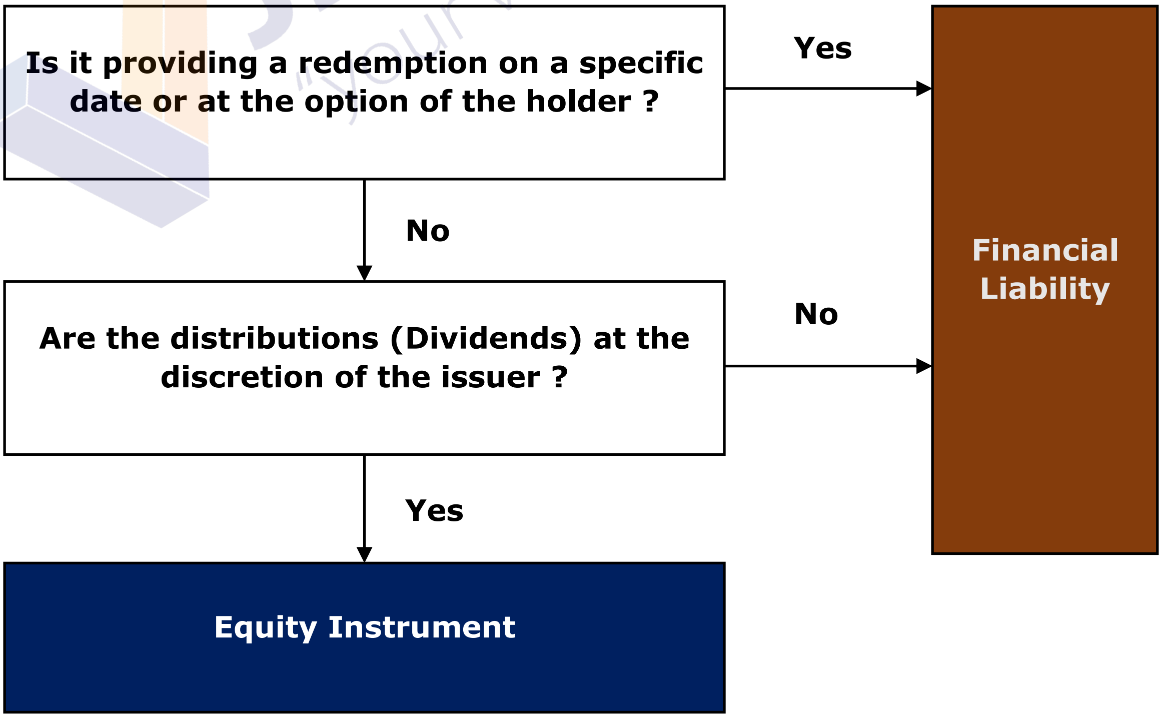
The critical feature of a liability is an obligation to transfer economic benefit. Therefore, a financial instrument is a financial liability if there is a contractual equity, but in substance it is in fact a liability. Other instruments may combine features of both equity instruments and financial liabilities.

If **there is no contractual obligation** to deliver cash or another financial asset to the holder, the financial instrument **is an equity instrument** *(eg ordinary shares are an equity instrument as the issuer has no obligation to pay a dividend).*

2.1 Preference Shares

For preference shares an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability **(Para AG25)**. When evaluating below two characteristics will be mainly evaluated.

- Availability of a guaranteed redemption
- How the distribution are made



- Most preference shares are redeemable and are therefore classified as a financial liability.
- Most irredeemable preference shares do not oblige the issuer to deliver cash and are therefore equity. If, however, an irredeemable preference share carries a non-discretionary dividend this creates an obligation on the issuer to deliver cash and so the shares are classified as liability.

Question 01 – Debt or Equity

Explain with reasons whether following instruments are financial liabilities or equity instruments.

1. Ford issued 40 million non-redeemable USD 1 preference shares at par value. Under the terms attaching to the preference shares, a dividend is payable on the preference shares only if Ford also pays a dividend on its ordinary shares relating to the same period.

2. Ford entered into a contract with a supplier to buy a significant item of equipment. Under the terms of the agreement, the supplier will receive ordinary shares with an equivalent value of USD 5 million one year after the equipment is delivered.

3. The directors of Ford, on becoming directors, are required to invest a fixed agreed sum of money in a special class of USD 1 ordinary shares that only directors hold. Dividend payments on the shares are discretionary and are ratified at the annual general meeting (AGM) of the company. When a director’s service contract expires, Ford is required to repurchase the shares at their nominal value.

4. Ford issued 2 million preference shares for USD 2.80 each. No dividends are payable. The preference shares will be redeemed in two years' time by issuing 3 million ordinary shares.

2.2 Compound financial instruments

Some financial instruments contain both a liability and an equity element. In such cases, LKAS 32 requires the component parts of the instrument to be classified separately, according to the substance of the contractual arrangement and the definitions of a financial liability and an equity instrument.

2.2.1 Convertible Debt

One of the most common types of compound instrument is **convertible debt** where **conversion is at the holder's option**. This creates a primary financial liability of the issuer and grants an option to the holder of the instrument to convert it into an equity instrument (usually ordinary shares) of the issuer. This is the economic equivalent of the issue of conventional debt plus a warrant to acquire shares in the future.

Although in theory there are several possible ways of calculating the split, the following method is recommended ***(Para 28)***.

(a) Calculate the value for the liability component as the future cash flows associated with the instrument (assuming redemption) discounted at a market interest rate for similar bonds having no conversion rights.

(b) Deduct this from the instrument as a whole to leave a residual value for the equity component.

The **reasoning** behind this approach is that an entity's equity is its residual interest in its assets amount after deducting all its liabilities. The sum of the carrying amounts assigned to liability and equity will always be equal to the carrying amount that would be ascribed to the instrument as a whole.

Question 02 – Compound Instruments

Explain how should the entity account for the instruments according to LKAS 32?

1. An entity issues a convertible bond for Rs.1,000. The bond is convertible into equity shares of the issuer at the discretion of the holder at any time in the next 10 years. The bond converts into a variable number of shares equal to the value of the liability.

2. The entity also issues Rs. 7,000 of 8% convertible redeemable preference shares. In five years' time, the preference shares will either be redeemed or converted into 5,000 equity shares of the issuer, at the option of either the holder or issuer.

Question 03 – Compound Instruments

An entity issued 5,000 8% convertible bonds at par value of Rs.10 on 1 January 2015. Each bond is convertible into three ordinary shares on 31 December 2016. Interest is payable annually in arrears. The entity incurred transaction costs of Rs.1,000. On the date of issue, the market interest rate for similar debt without the conversion option was 10%.

Calculate the liability and equity component of the convertible bond on issue.

2.3 Treasury shares (Para 33 – 34)

If an entity reacquires its own equity instruments, those instruments ('treasury shares') shall be deducted from equity. No gain or loss shall be recognized in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments.

Such treasury shares may be acquired and held by the entity or by other members of the consolidated group. Consideration paid or received shall be recognised directly in equity.

2.4 Interest, dividends, losses and gains (Para 35)

As well as dealing with the presentation of financial instruments in the statement of financial position, LKAS 32 considers how financial instruments affect the statement of profit or loss and other comprehensive income (and changes in equity). The treatment varies according to whether interest, dividends, losses or gains relate to a financial liability or an equity instrument.

(a) Interest, dividends, losses and gains relating to a financial instrument classified as a financial liability are recognized as income or expense in profit or loss.

(b) Dividends to equity shareholders are charged directly to equity by the issuer. These will appear in the statement of changes in equity.

(c) Transaction costs of an equity transaction are accounted for as a deduction from equity.

2.5 Offsetting a financial asset and a financial liability (Para 42)

A financial asset and financial liability should only be offset, with the net amount reported in the statement of financial position, when an entity:

(a) Has a legally enforceable right of set off, and

(b) Intends to settle on a net basis, or to realize the asset and settle the liability simultaneously, ie at the same moment.

This will reflect the expected future cash flows of the entity in these specific circumstances. In all other cases, financial assets and financial liabilities are presented separately.

3. RECOGNITION OF FINANCIAL INSTRUMENTS

SLFRS 9 provides guidance on the classification and recognition of financial assets and financial liabilities; it also deals with the measurement of financial instruments, including the impairment of financial assets.

3.1 Recognition

A financial asset or financial liability is recognized in the statement of financial position **when the reporting entity becomes a party to the contractual provisions of the instrument** ***(Para 3.1.1)***.

For example, if one entity sells goods to another entity, promising to pay at a later date, both entities are party to the sales contract and one recognizes a receivable whilst the other recognizes a payable.

Notice that this is different from the recognition criteria in the Conceptual Framework and in most other standards.

3.2 De-Recognition

Derecognition is the removal of a previously recognized financial instrument from an entity's statement of financial position.

3.2.1 Financial Assets

An entity should **derecognize** a financial asset when:

(a) The contractual rights to the cash flows from the financial asset **expire**, or

(b) It transfers substantially all the risks and rewards of **ownership** of the financial asset **to another party**

For example, a trade receivable is derecognized when payment is collected. In this case, the rights to the cash flow associated with the asset expire (because the cash has been collected) and there is no further exposure to risks and rewards for the entity collecting the cash. *Some more complex transactions may not be so clear-cut; however these are not examinable at Corporate Level*.

3.2.2 Financial Liabilities

An entity should derecognize a financial liability when it is extinguished – ie when the obligation specified in the contract is discharged or cancelled or expires.

3.2.3 Partial Derecognition

It is possible for only part of a financial asset or liability to be derecognized. This is allowed if the part comprises:

(a) Only specifically identified cash flows; or
(b) Only a fully proportionate (pro-rata) share of the total cash flows.

For example, if an entity holds a bond it has the right to two separate sets of cash inflows: those relating to the principal and those relating to the interest. It could sell the right to receive the interest to another party while retaining the right to receive the principal.

3.2.4 Gain or loss on derecognition

On derecognition, the amount to be included in net profit or loss for the period is the difference between the carrying amount of the financial instrument derecognized and the proceeds paid (for a liability) or received (for an asset).

Any accumulated gains or losses that have been recognized in other comprehensive income in respect of debt instruments classified as fair value through other comprehensive income (FVTOCI) (see Section 4) are also reclassified to profit or loss on derecognition of the asset.

Where only part of a financial asset is derecognized, the carrying amount of the asset should be allocated between the part retained and the part transferred based on their relative fair values on the date of transfer. A gain or loss should be recognized based on the proceeds for the portion transferred.

Question 04 – Derecognition

Discuss whether the following financial instruments should be derecognized:

(a) Co enters into a stock lending agreement where an investment is lent to a third party for a finite period of time in exchange for payment of a fee.
(b) Co sells title to some of its receivables to a debt factor in exchange for an immediate cash payment of 92% of their value. The terms of the agreement are that B Co has to compensate the factor for any amounts not recovered after 6 months.
(c) Co sells an investment in shares but retains a call option to repurchase those shares at any time at a price equal to their current market value at the date of repurchase.

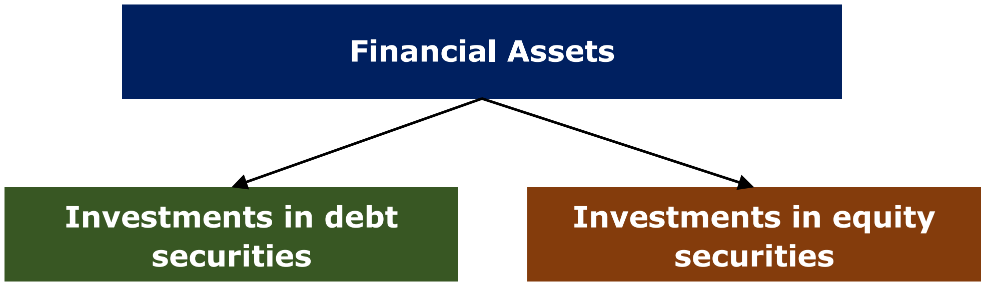
Question 05 – Derecognition

Pacific Plants (Pvt) Ltd purchased loan stock in a listed company for Rs. 30m on 20 February 2016, classifying it as measured at FVTOCI. At 31 December 2016 the loan stock was remeasured to a fair value of Rs. 35m, with an Rs. 5m gain recognized in other comprehensive income. Pacific Plants sold half of the loan stock in August 2017 for Rs. 20m.

Required to **Prepare** extracts from the statement of profit or loss and other comprehensive income for the year ended 31 December 2017 in respect of the disposal.

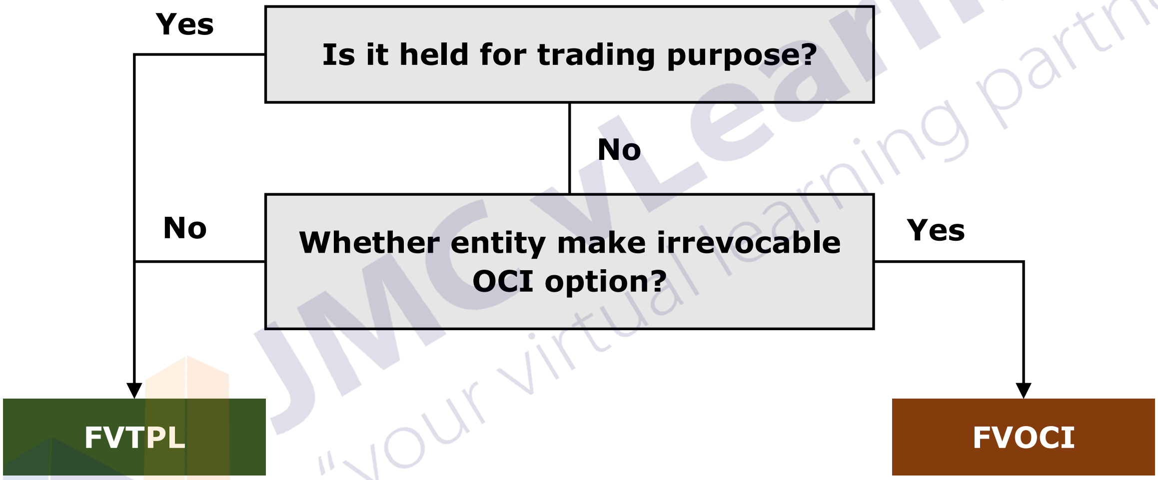
4. CLASSIFICATION OF FINANCIAL INSTRUMENTS

4.1 Financial assets classification



4.1.1 Financial assets on equity securities

To identify correct classification below flowchart can be used.



4.1.1.1 Equity investments at FVOCI

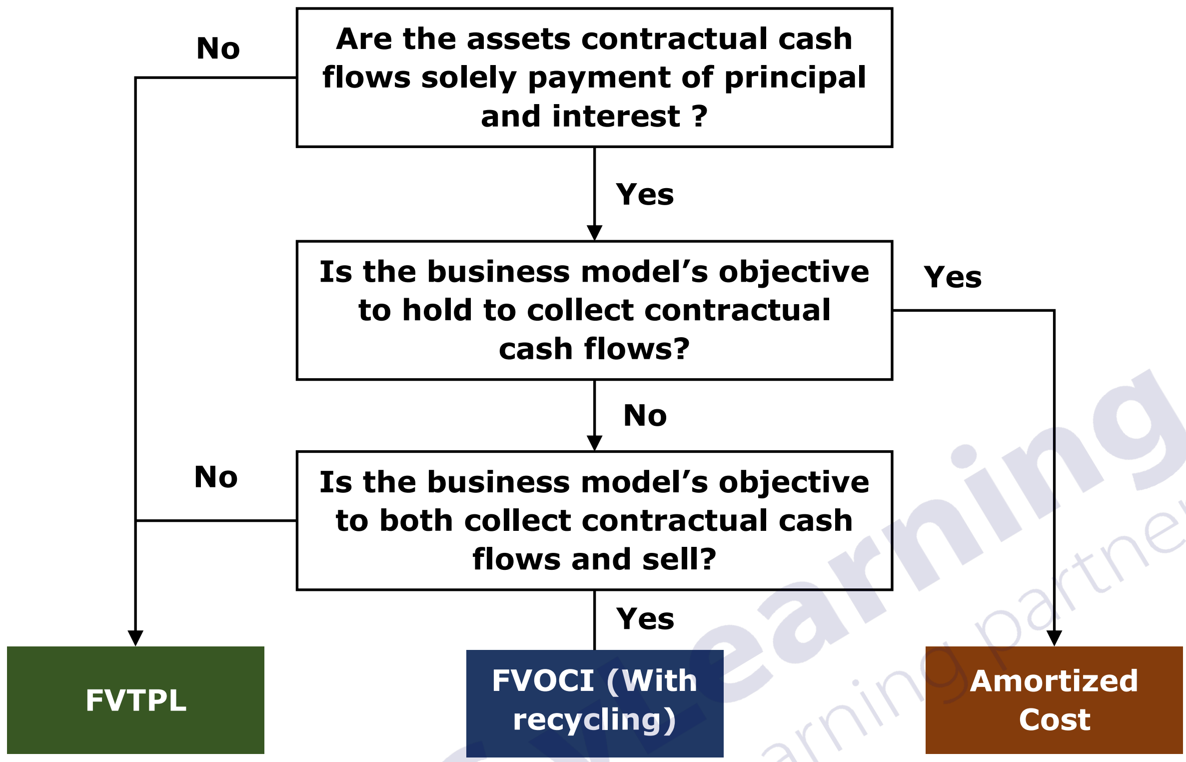
Equity instruments and derivatives are **normally measured at FVTPL**. However, on initial recognition, an entity may make an **irrevocable election** (on an instrument-by-instrument basis) to present in OCI the subsequent changes in the fair value of an investment in an equity instrument within the scope of IFRS 9. This option only applies to instruments that are not held for trading.

Although most gains and losses on investments in equity instruments designated at FVOCI will be recognized in OCI, dividends will normally be recognized in profit or loss.

Meanwhile, gains or losses recognized in OCI are never reclassified from equity to profit or loss. Consequently, there is no need to review such investments for possible impairment.

4.1.2 Financial assets on debt securities

The classification is based on both the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial asset.



Below summarizes the outcome of the thought process depicted above:

		Contractual cash flow characteristics test (SPPI)	
		Fail	Pass
Business Model	Held within a business model whose objective is to hold financial assets in order to collect contractual cash flows	Amortized Cost	FVTPL
	Held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets	FVOCI (with recycling)	FVTPL
	Financial assets which are neither held at amortized cost nor at FVOCI	FVTPL	FVTPL

4.1.2.1 Amortized Cost Financial Assets *(Para 4.1.1)*

A financial asset is classified as subsequently measured at amortized cost under SLFRS 9 if it meets both of the following criteria:

- **'Hold-to-collect' business model** – The asset is held within a business model whose objective is to hold the financial asset in order to collect contractual cash flows; and
- **'SPPI' contractual cash flow characteristics**– The contractual terms of the financial asset give rise to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding on a specified date.

Examples of financial instruments that are likely to be classified and accounted for at amortized cost under SLFRS 9 include:

- Trade receivables
- Loan receivables with 'basic' features
- Investments in government bonds that are not held for trading
- Investments in term deposits at standard interest rates.

4.1.2.2 FVOCI Financial Assets on Debt *(Para 4.1.2)*

A financial asset is measured at fair value through other comprehensive income (FVOCI) under SLFRS 9 if it meets both of the following criteria:

- **'Hold-to-collect and sell'** business model: The asset is held within a business model whose objective is achieved by both holding the financial asset in order to collect contractual cash flows and selling the financial asset, and

- **'SPPI' contractual cash flow characteristics**: 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.

Examples of financial instruments that may be classified and accounted for at FVOCI under IFRS 9 include:

- 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.

It is unlikely that intercompany loans or trade receivables would be classified in the FVOCI category.

The **accounting requirements** for debt instruments classified as FVOCI are:

- Interest income is recognized in profit or loss using the effective interest rate method that is applied to financial assets measured at amortized cost;
- Foreign exchange gains and losses on the amortized cost are recognized in profit or loss;
- Credit impairment losses/reversals are recognized in profit or loss using the same credit impairment methodology as for financial assets measured at amortized cost;

- Other changes in the carrying amount on remeasurement to fair value are recognized in OCI;
- The cumulative fair value gain or loss recognized in OCI is recycled from OCI to profit or loss when the related financial asset is derecognized.

4.1.2.3 FVTPL Financial Assets on both Debt and Equity

Fair value through profit or loss (FVTPL) is the **residual category** in SLFRS 9. A financial asset is classified and measured at

FVTPL if the financial asset is:

- A held-for-trading financial asset;
- A debt instrument that does not qualify to be measured at amortized cost or FVOCI;
- An equity investment which the entity has not elected to classify as at FVOCI.

Examples of financial assets that are likely to fall into the FVTPL category include:

- Investments in shares of listed companies that the entity has not elected to account for as at FVOCI;
- 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 convertible notes, commodity linked bonds;
- Contingent consideration receivable from the sale of a business;
- Any other financial assets that fail SPPI.

4.2 Financial liabilities classification

Financial liabilities are classified as either:

- Financial liabilities at amortised cost; or
- Financial liabilities as at fair value through profit or loss (FVTPL).

Financial liabilities are measured at amortised cost unless either:

- The financial liability is held for trading and is therefore required to be measured at FVTPL (e.g. derivatives not designated in a hedging relationship); or
- The entity elects to measure the financial liability at FVTPL (using the fair value option). If it *eliminates or significantly reduces an accounting mismatch* and/or group of *liabilities is managed, and its performance evaluated on a fair value basis* this option can be used.

In contrast to financial assets, the existing requirements in IAS 39 for the separation of embedded derivatives have been continued for financial liabilities, meaning that financial liabilities to be measured at amortised cost would still need to be analysed to determine whether they contain any embedded derivatives that are required to be accounted for separately at FVTPL.

Examples of financial liabilities that are likely to be classified and measured either at amortised cost or at FVTPL include.

Amortised cost	FVTPL
– Trade payables; – Loan payables with standard interest rates (such as a benchmark rate plus a margin) or the host contract arising from a loan agreement which contains separable embedded derivatives; – Bank borrowings.	– Interest rate swaps (not designated in a hedging relationship); – Commodity futures/option contracts (not designated in a hedging relationship); – Foreign exchange future/option contracts (not designated in a hedging relationship); – Convertible note liabilities designated at FVTPL; – Contingent consideration payable that arises from one or more business combinations.

5. MEASUREMENT OF FINANCIAL INSTRUMENTS

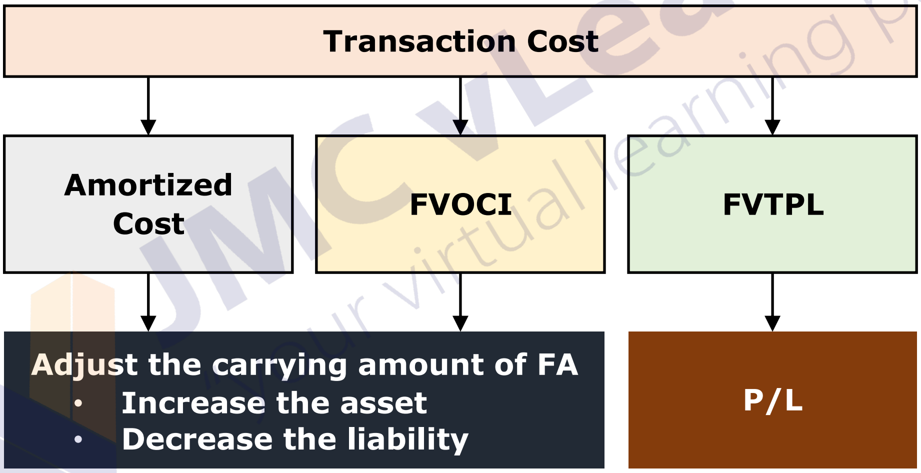
This section explains the initial and subsequent measurement of financial assets and financial liabilities. Subsequent measurement is dependent upon classification, discussed in the previous section.

5.1 Initial measurement

Financial instruments are **initially measured** at the transaction price, that is the **fair value** of the consideration given. An exception is where part of the consideration given (or received) is for something other than the financial asset (or financial liability). In this case the financial instrument is initially measured at fair value evidenced by a quoted price in an active market for an identical asset (an SLFRS 13 level 1 input) or based on a valuation technique that uses only data from observable markets.

The difference between the fair value at initial recognition and the transaction price is recognized as a gain or loss.

5.1.1 Transaction Costs



Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial instrument. ***Examples of transaction costs are***: fees and commissions paid to agents, advisers, brokers and dealers; levies by regulatory agencies and securities exchanges; transfer taxes and duties; credit assessment fees; registration charges and similar costs.

5.1.2 Day one gains and losses

The best evidence of fair value at initial recognition is usually the transaction price, represented by the fair value of the consideration given or received in exchange for the financial instrument. Any **difference between** the **fair value** measured by the entity and **the transaction price** is recognized:

- In profit or loss, if the estimate is measured by a quoted price in an active market or based on a valuation technique that uses only data from observable markets (Level 1 Inputs); and
- Deferred as an adjustment to the carrying amount of the financial instrument in all other cases (Level 2 or 3).

5.2 Subsequent measurement of financial assets

SLFRS 9 requires that financial assets are measured subsequent to recognition in accordance with their classification at:

- Amortised cost, using the effective interest method
- Fair value through other comprehensive income
- Fair value through profit or loss

5.2.1 Financial assets measured at amortised cost (Debt investments)

Amortised cost of a financial asset or financial liability is the amount at which the financial asset or liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the **effective interest method** of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance.

Effective Interest Method

The effective interest method is a method of calculating the amortised cost of a financial instrument and of allocating the interest income or interest expense over the relevant period. That means this has main 02 purposes.

1. It transforms the initial FV into the final maturity value.
2. It amortizes the total finance charge/income over maturity period

Effective Interest Rate

The **effective interest rate** is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument to the net carrying amount of the financial asset or liability.

For the **calculation of the effective interest rate**, an entity estimates the expected cash flows **considering** all contractual terms including any fees, **transaction costs**, and other premiums or discounts. Debt premiums or discounts, financing costs or internal administrative or holding costs **are not eligible transaction costs**. Because transaction costs are included as part of the initial carrying amount of the financial instrument, the recognition of these costs in profit or loss is spread over the term of the instrument through the application of the effective interest method.

The determination of the effective interest rate is based on the estimated cash flows arising from the asset. Expected credit losses are not included as part of the cash flows for the calculation of the effective interest rate method. This is because the gross carrying amount of a financial asset is adjusted for a loss allowance, which is not part of the effective interest rate calculation.

Changes in the expected cash flows will result in a recalculation of the gross carrying amount of an asset and the amortised cost of a financial liability. **The revised expected cash flows are discounted using the original effective interest rate of the instrument.** Any **difference** from the previous amount is recognised in **profit or loss**.

Question 06 – FA at Amortized Cost

On 1 January 2021, Purijjala Power PLC purchases a debt instrument for its fair value of Rs. 1,000m. The debt instrument is due to mature on 31 December 2025 and Purijjala Power intends to hold it to maturity. The instrument has a principal amount of Rs. 1,250m and the instrument carries fixed interest at 4.72% that is paid annually. The effective rate of interest is 10%.

Required to **demonstrate** how Purijjala Power should account for the debt instrument over its five-year term.

5.2.2 Financial assets measured at FVOCI (Debt Investments)

Where a financial asset on debt instrument is classified at fair value through other comprehensive income, fair value is determined at each reporting date in accordance with SLFRS 13 Fair Value Measurement.

- **Interest** (calculated at the effective interest rate same like in an amortized cost financial assets) is recognised in profit or loss.
- **Changes in fair value** is recognised in other comprehensive income (OCI).
- At the disposal the amounts recognised in OCI are **reclassified (Recycled)** to profit or loss.

Question 07 – FA at FVOCI – Debt Investments

At 1 January 2018 Jaffna Trading Co acquired Rs. 40m 5% loan stock at a cost of Rs. 38m. Interest is payable annually in arrears and the stock will be redeemed at a 5% premium in 3 years' time. The effective interest rate of the stock is 8.49% and its fair value is Rs. 39.1million at 31 December 2018 and Rs. 40.9million at 31 December 2019. The loan stock is classified as measured at FVTOCI.

Required to **Calculate** amounts to be recognised in the financial statements of Jaffna Trading Co for the years ended 31 December 2018 and 2019.

Question 08 – FA at FVOCI – Debt Investments

On 1 July 2021 Kalutara Ltd acquired Rs. 40 million 5% debt instruments at a cost of Rs. 38 million. Further information is as follows:

- Interest is payable annually in arrears.
- The debt will be redeemed at a 5% premium on 30 June 20X4.
- The effective interest rate attached to the debt is 8.49%.

The fair value of the debt is Rs. 38.8 million at 30 June 2022 and Rs. 40.8 million at 30 June 2023. The debt is classified as measured at fair value through other comprehensive income.

Required to Calculate amounts to be recognised in the statement of profit or loss and other comprehensive income of Kalutara Ltd in the years ended 30 June 2022 and 2023.

5.2.3 Financial assets measured at FVOCI (Equity Investments)

An entity may acquire an investment in an equity instrument that is not held for trading. At initial recognition, the entity may make an **irrevocable election** (on an instrument-by-instrument basis) to present in OCI subsequent changes in the fair value of such an investment.

- **Dividends** from such investments should be recognised in **profit or loss** when the right to receive payment is probable and can be measured reliably, unless the dividend clearly represents a recovery of part of the cost of the investment.
- **Fair value gains and losses** (including any related foreign exchange component) are recognised in **OCI**.
- Amounts presented in OCI are **not subsequently transferred** to profit or loss, even on derecognition. But the cumulative gain or loss may be transferred within equity.

Question 09 – FA at FVOCI – Equity Investments

On 8 February 2018 Horana Ltd acquires a quoted investment in the shares of another company with the intention of holding it in the long term. The investment cost Rs. 8.5 million and Horana Ltd paid Rs. 200,000 legal costs at acquisition. At Horana Ltd's year end of 31 March 2018, the market price of an identical investment is Rs. 9 million. Horana Ltd has elected to recognise changes in the fair value of the equity investment in other comprehensive income.

Explain how is the financial asset initially and subsequently measured as per SLFRS 9?

5.2.4 Financial assets measured at FVTPL (Debt Investments)

Financial assets on debt instruments classified as FVTPL are remeasured to fair value at each reporting date. All interest amounts and changes in fair value are recognised in profit or loss.

5.2.5 Financial assets measured at FVTPL (Equity Investments)

Financial assets on equity instruments classified as FVTPL are remeasured to fair value at each reporting date. All dividend amounts and changes in fair value are recognised in profit or loss.

Question 10 – FA at FVTPL

Lanka Linens (Pvt) Ltd acquires the following financial assets in 2015.

1. Five million equity shares in a quoted company, to be held in the medium to long term. The cost of the investment was Rs. 360m and transaction costs amounted to Rs. 2m. Lanka Linens made the irrevocable election to classify the shares at FVTOCI At 31 December 2015 the closing bid price of one of the equity shares was Rs. 76.
2. Equity shares in another quoted company to be held as a short-term investment with the intention of realising a profit on sale. The cost of the investment was Rs. 120m, and transaction costs were Rs. 1.5m. The fair value of the investment at 31 December 2015 was Rs. 115m.

Required to **Prepare** extracts of the financial statements of Lanka Linens for the year ended 31 December 2015 in respect of the two financial asset investments.

5.3 Subsequent measurement of financial liabilities

After initial recognition, financial liabilities are measured in accordance with their classification at amortised cost or fair value through profit or loss.

5.3.1 Financial liabilities measured at Amortized Cost

The definitions of amortised cost, effective interest method and effective interest rate given above are also applicable to financial liabilities.

Question 11 – FL at Amortized Cost

Monara Ltd issues a bond for Rs. 5,037,780 on 1 January 2012. No interest is payable on the bond, but it will be redeemed on 31 December 2014 for Rs. 6 million. The effective interest rate of the bond is 6%.

Required to **calculate** the charge to profit or loss of Monara Ltd for the year ended 31 December 2012 and the balance outstanding at 31 December 2012.

Question 12 – FL at Amortized Cost

On 1 January 2013 Wattala Ltd issued Rs. 6 million loan notes. Issue costs were Rs. 2,000. The loan notes do not carry interest but are redeemable at a premium of Rs. 1,523,890 on 31 December 2014. The effective finance cost of the loan notes is 12%.

Required: What is the finance cost in respect of the loan notes for the year ended 31 December 2014?

Question 13 – FL at Amortized Cost

On 1 January 2021, an entity issued a debt instrument with a coupon rate of 3.5% at a par value of Rs. 60 million. The directly attributable costs of issue were Rs. 1.2 million. The debt instrument is repayable on 31 December 2027 at a premium of Rs. 11 million.

Required: What is the total amount of the finance cost associated with the debt instrument?

5.3.2 Financial liabilities measured at FVTPL

Financial liabilities which are held for trading are re-measured to fair value each year in accordance with SLFRS 13 Fair Value Measurement with any gain or loss recognised in profit or loss unless it is part of a hedging arrangement.

- Specific rules apply to financial liabilities that are designated as measured at fair value through profit or loss. In this case the gain or loss in a period must be classified into:
  - Gain or loss resulting from credit risk (because of changes in the borrower's creditworthiness)
  - Other gain or loss

- The **gain or loss** as a result of **credit risk** is recognised in **other comprehensive income**, unless it creates or enlarges an accounting mismatch in which case it is recognised in profit or loss. The **other gain or loss** (not the result of credit risk) is **recognised in profit or loss**.

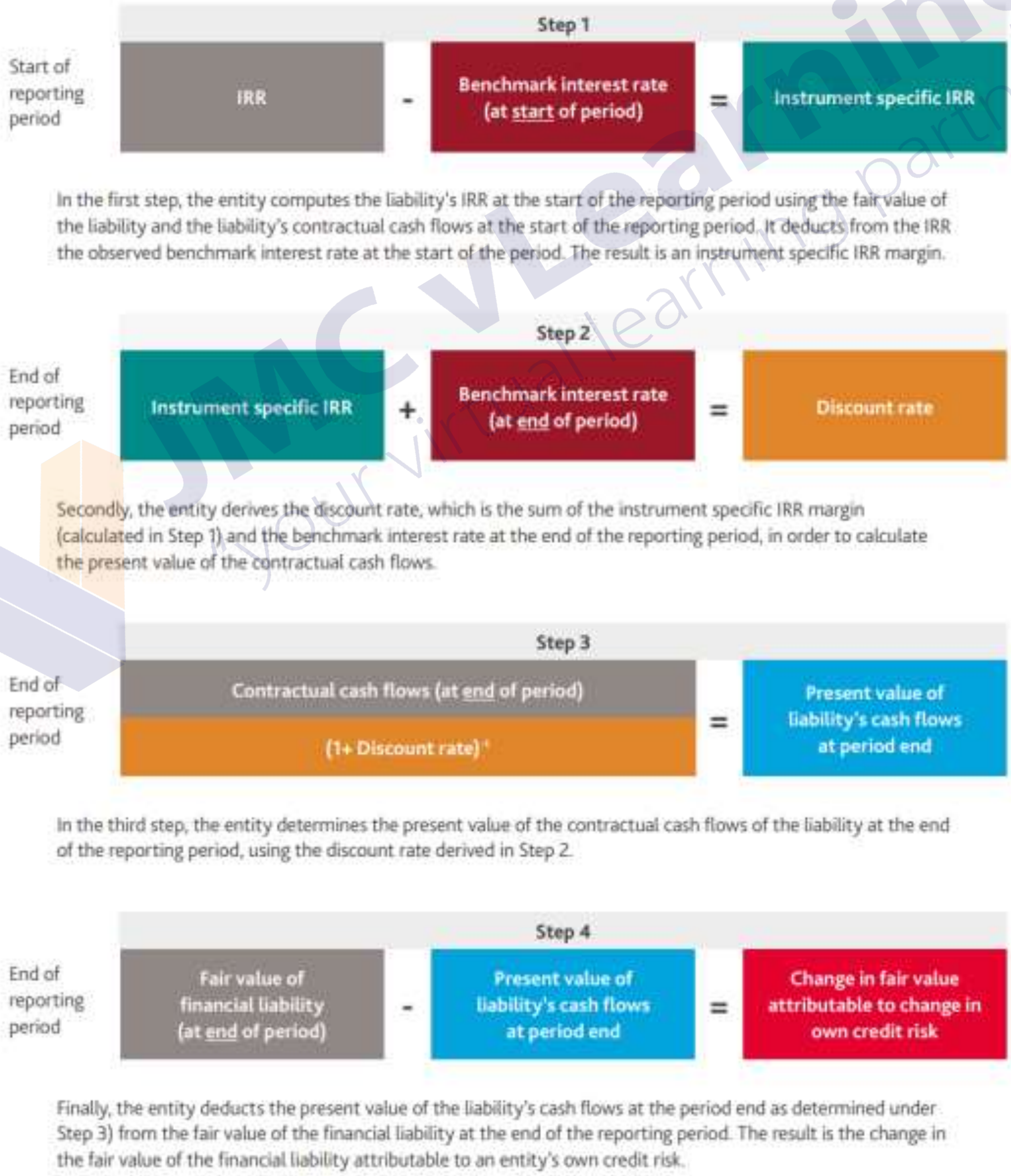
- On derecognition any gains or losses recognised in other comprehensive income are not transferred to profit or loss, although the cumulative gain or loss may be transferred within equity.

An entity determines the amount of the fair value change attributable to changes in its own credit risk either:

(i) As the amount of the change in the fair value that is not attributable to changes in market conditions that give rise to market risk, which includes changes in:
   - Benchmark interest rates;
   - Prices of other financial instruments;
   - Commodity prices;
   - Foreign exchange rates;
   - Index of prices and rates.

(ii) Using another method if that method more faithfully represents the related portion of the change in fair value.

If the only significant relevant changes in market conditions are due to changes in an observed benchmark interest rate, the amount attributable to changes in an entity's own credit risk can be estimated using the default method, which is based on the calculation of the financial instrument's internal rate of return (IRR)



Question 14 – FL at FVTPL

Entity A issued a bond under conditions that qualify for the fair value option in IFRS 9, and decided to designate the liability to be accounted for at fair value through profit or loss (FVTPL). At the end of the financial reporting period, Entity A determines that $ 2 of the change in the fair value of the bond of $ 10 is due to a change in Entity A’s credit risk.

Question: How should Entity A account for the fair value change?