

## *Query No. 4*

**Subject:** *Classification of investments in units of debt mutual funds under Ind AS 109.*<sup>1</sup>

### **A. Facts of the Case**

1. X Ltd. is a company incorporated in India and its shares are listed on Bombay Stock Exchange and National Stock Exchange. It is engaged in software services and has made investments in financial assets which are essentially in the form of investments in Fixed Maturity Plans (FMPs), Liquid Mutual Funds, Equity Mutual Funds, Tax Free Bonds, and Preference Shares.

2. The classification and accounting treatment of the financial assets is dealt with in Indian Accounting Standard (Ind AS) 109, 'Financial Instruments'. A financial asset can fall into one of the following three categories (see Section 4.1 of Ind AS 109) based on the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial asset:

- Measured at amortised cost
- Measured at fair value through other comprehensive income
- Measured at fair value through profit or loss

An entity's business model for managing financial assets could be holding the financial assets in order to collect the contractual cash flows or selling the financial assets or both (see paragraph B4.1.2A of Ind AS 109).

*Measured at amortised Cost:*

Paragraph 4.1.2 of Ind AS 109 is reproduced below:

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

- (a) the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and**
- (b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.**

**Paragraphs B4.1.1-B4.1.26 provide guidance on how to apply these conditions.”**

Although the objective may be to hold financial assets to collect contractual cash flows, the entity need not hold all of those instruments until maturity. The business model may be to hold assets to collect contractual cash flows even if the entity sells financial assets when there is an increase in the asset's credit risk (see paragraphs B4.1.3 and B4.1.3A of Ind AS 109).

*Measured at fair value through other comprehensive income:*

Paragraph 4.1.2A of Ind AS 109 is reproduced below:

**“4.1.2A A financial asset shall be measured at fair value through other comprehensive income if both of the following conditions are met:**

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<sup>1</sup> Opinion finalised by the Committee on 4.1.2018.

- (a) **the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets and**
- (b) **the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.**

**Paragraphs B4.1.1-B4.1.26 provide guidance on how to apply these conditions.”**

*Measured at fair value through profit or loss:*

Paragraph 4.1.4 of Ind AS 109 is reproduced below:

**“4.1.4 A financial asset shall be measured at fair value through profit or loss unless it is measured at amortised cost in accordance with paragraph 4.1.2 or at fair value through other comprehensive income in accordance with paragraph 4.1.2A. However an entity may make an irrevocable election at initial recognition for particular investments in *equity instruments* that would otherwise be measured at fair value through profit or loss to present subsequent changes in fair value in other comprehensive income (see paragraphs 5.7.5-5.7.6).”**

As per paragraph 5.7.5 of Ind AS 109, the equity instrument should not be held for trading, if election is made to present fair value changes in other comprehensive income.

3. The scope of Ind AS 32, ‘Financial Instruments: Presentation’ includes financial instruments issued by an entity that meet the definition of an equity instrument. The following extracts from paragraph 11 of Ind AS 32 are relevant in this regard:

**“A *financial asset* is any asset that is:**

- (a) **cash;**
- (b) **an equity instrument of another entity;**
- (c) **a contractual right**
  - (i) **to receive cash or another financial asset from another entity; or**
  - (ii) **...**
- (d) **...”**

**“An *equity instrument* is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.”**

Examples of equity instruments include instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation. (See paragraph AG13 and paragraphs 16C and 16D of Ind AS 109).

4. X Ltd. has a portfolio of investments in debt mutual funds through FMP/Liquid/short-term/ultra short-term schemes. Essentially, the debt funds carry relatively low to moderate risks. FMPs are close-ended mutual funds, which are redeemable only on maturity. FMPs seek to generate income by investing in a portfolio of fixed income securities maturing on or before the maturity of the scheme and the cash flow which the Asset Management Company (hereinafter referred to as ‘the AMC’) gets is largely for principal and interest. The AMC invests in relatively safe debt instruments and generally one can infer the indicative return. The offer document to the scheme typically provides

the maturity period, the investment objective, investment strategy, the asset allocation pattern, investment associated risks and strategies to manage the risks. (Sample offer document for a close-ended debt fund has been furnished by the querist for the perusal of the Committee).

5. As per the querist, on analysis of the sample offer document, the FMPs may meet the 'Hold to Collect contractual cash flows' test, since, the investments are largely held to maturity for collecting contractual cash flows rather than to realise benefits through fair value changes/sale. Though the payments made by the fund to the holder (in this case X Ltd.) represent principal and interest and even though there is no pre-agreed contractual cash flow, the redemption value is dependent on the performance of the underlying securities and any default in principal or interest could affect the fair value. The investments in liquid/ultra short-term/ short-term plans also have the same characteristics except that these are open-ended schemes. X Ltd. does not hold these investments to maturity but exits depending on the cash flow requirement and books the resultant profit or loss. Given that the investment in the debt funds carry similar low to moderate risks, X Ltd. would like to examine considering them as a single portfolio for the purpose of classification and application of Ind AS 109. If one were to consider the investment in debt funds as a single portfolio, cash flow would be generated both through holding securities until their maturity and trading. Further, the payments received by the AMC are primarily for the principal and interest, which finally get distributed to the unitholders (X Ltd. in this case). It is pertinent to note that the cash flow for the unitholders is primarily through the contractual cash flows received by the AMC consisting of principal and interest.

## **B. Query**

6. The querist has sought the opinion of the Expert Advisory Committee as to whether the investments in debt funds (FMPs and liquid/short-term) can be treated as a single portfolio for the purpose of characterisation and application of Ind AS 109 and whether in such a case the unrealised gains or losses on account of fair valuation can be routed through other comprehensive income.

## **C. Points considered by the Committee**

7. The Committee notes that the basic issue raised by the querist relates to classification and treatment of investments in *units* of certain debt mutual funds (hereinafter referred to as 'investments in debt funds') under Indian Accounting Standard (Ind AS) 109, 'Financial Instruments', notified under the Companies (Indian Accounting Standards) Rules, 2015 as amended till date (hereinafter referred to as 'the Rules'). Further, the Committee presumes that the querist's intention in Query in paragraph 6 above is to evaluate possibility of treating its investments in debt funds as a single portfolio for the purpose of classifying such investments as subsequently measured at fair value through other comprehensive income. The Committee has, therefore, considered only this issue and has not examined any other issue that may be contained in the Facts of the Case. The Committee notes that investments in units of mutual funds meet the definition of financial assets given in paragraph 11 of Ind AS 32, 'Financial Instruments: Presentation', notified under the Rules, (reproduced by the querist in paragraph 3 above). At the outset, the Committee wishes to point out that Asset Management Company (hereinafter referred to as 'the AMC') and the mutual funds managed by the AMC are distinct entities. Hereinafter, any reference to AMC should be understood in the context of relevant funds managed by the AMC. The Committee presumes that X Ltd. has not

designated any investment in the debt funds in a hedging relationship. Further, the Committee presumes that X Ltd. has not designated any investment as measured at fair value through profit or loss to eliminate or significantly reduce a measurement or recognition inconsistency, as permitted in paragraph 4.1.5 of Ind AS 109. From the sample offer document furnished by the querist, the Committee notes that investments in the close-ended debt fund (which is a Fixed Maturity Plan ('FMP')) can be redeemed only at the time of maturity or sold before that date through the relevant stock exchange on which the units of the Scheme are listed. 'Switch-out' (which, in substance, represents redemption and reinvestment of the redemption proceeds in another scheme) is possible only based on 'Net Asset Value' ('NAV') on the date of maturity. The Committee also notes that while the sample offer document for the close-ended debt fund states that the mutual fund or AMC and its empanelled brokers are prohibited from giving any indicative portfolio and indicative yield in any communication, as per the querist, *generally* one can infer the indicative return. However, the AMC shall, on its website, disclose portfolio of all Schemes on a monthly basis as on the last day of month, on or before tenth day of the succeeding month. Further, in the case of the close-ended debt fund, there are two options *viz.* cumulative option and dividend option. In the case of dividend option, half-yearly dividend frequency will be available, subject to the availability of distributable surplus, while the Trustee at its sole discretion may also declare interim dividend. For open-ended debt funds, no sample document has been furnished by the querist. However, it is obvious that in the case of open-ended debt funds, redemption is possible as and when opted for by the unitholder and dividend frequency (in case of dividend option) will be as specified in the scheme. Incidentally, as per the querist, the 'FMPs' may meet the 'Hold to Collect contractual cash flows' test, since, the investments are largely held to maturity for collecting contractual cash flows rather than to realise benefits through fair value changes/sale (see paragraph 5 above). Here, it appears that the term 'FMPs' should read as 'investments in FMPs'.

8. The Committee notes that the classifications under Ind AS 109 determine their subsequent measurement. In this regard, paragraph 4.1.1 of Ind AS 109 is reproduced below:

**"4.1.1 Unless paragraph 4.1.5 applies, an entity shall classify financial assets as subsequently measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss on the basis of both:**

- (a) the entity's business model for managing the financial assets and**
- (b) the contractual cash flow characteristics of the financial asset."**

From the above, the Committee notes that there are two tests to be performed for classification of financial assets based on their subsequent measurement (i.e., measurement after initial recognition) *viz.* 'Business model test' and 'Contractual cash flow characteristics test'. The conditions for subsequent measurement of financial assets at amortised cost, fair value through other comprehensive income and fair value through profit or loss based on the assessment of the above two tests are prescribed in paragraphs of 4.1.2, 4.1.2A and 4.1.4 of Ind AS 109 respectively, reproduced by the querist in paragraph 2 above, while paragraph 4.1.3 of Ind AS 109 deals with meaning of 'principal' and 'interest' for the purposes of paragraphs 4.1.2 and 4.1.2A of Ind AS 109. Hereinafter, reference to these measurement bases should be understood in the context of subsequent measurement.

9. The Committee first examines whether the investments in debt funds meet the business model test prescribed in paragraph 4.1.2 or 4.1.2A of Ind AS 109. In this regard, the Committee notes the principles elaborated in paragraphs B4.1.1-B4.1.6 of Ind AS 109. The key aspects that emerge from the analysis of prescriptions in these paragraphs are summarised below:

- (a) An entity's business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective. The entity's business model does not depend on management's intentions for an individual instrument. Further, since an entity may have more than one business model for managing its financial instruments, the classification need not be determined at the reporting entity level. The business model is as determined by the entity's key management personnel (as defined in Ind AS 24 *Related Party Disclosures*).
- (b) In some circumstances, it may be appropriate to separate a portfolio of financial assets into subportfolios in order to reflect the level at which an entity manages those financial assets. For example, an entity may hold similar or identical financial assets and it may classify those assets into subportfolios, some of which may be portfolios with an objective to hold to collect contractual cash flows (see paragraph 4.1.2 of Ind AS 109) and others may be classified into portfolios whose business model objective is achieved both by holding those assets to collect contractual cash flows as well as by selling them (see paragraph 4.1.2A of Ind AS 109).
- (c) An entity's business model for managing financial assets is a matter of fact and not merely an assertion. It is typically observable through the activities that the entity undertakes to achieve the objective of the business model.
- (d) Although the objective of an entity's business model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those instruments until maturity. Therefore, some amount of sales before contractual maturity is permitted even in case of business model whose objective is to hold financial assets to collect contractual cash flows only. However, the frequency, value and timing of sales and the reasons for such sales before maturity are critical factors which require analysis and use of judgement by the entity's management.

The Committee observes from the above analysis that the classification of financial assets into different portfolios for business model test is based on the objective of the business model i.e., whether to hold the financial assets to collect contractual cash flows or to hold the financial assets to collect contractual cash flows as well as to sell the financial assets or to hold financial assets for other purposes, for example, to realise cash flows through the sale of the financial assets. It is not in accordance with the principles of Ind AS 109 to create single portfolio or a particular subportfolio comprising financial assets which are managed under different business models. As stated by the querist, investments in FMPs are largely held to maturity to collect contractual cash flows rather than to realise benefits through fair value changes/sale. These investments would meet the criteria for inclusion in a portfolio whose business model objective is achieved by collecting contractual cash flows only. Thus, these investments meet the business model test prescribed in paragraph 4.1.2(a) of Ind AS 109. The investments in liquid/ultra short-term/ short-term plans are not held to maturity but the entity exits depending on the cash flow requirement and books

the resultant profit or loss. The Committee notes that paragraph B4.1.4A of Ind AS 109 specifically cites the example of objective of the business model to manage everyday liquidity needs or to match the duration of the financial assets to the duration of the liabilities that those assets are funding and states that to achieve such an objective, the entity will both collect contractual cash flows and sell financial assets. Hence, the investments in liquid/ultra short-term/ short-term plans would meet the criteria for inclusion in a portfolio whose business model objective is achieved by both collecting contractual cash flows and selling financial assets. Thus, these investments meet the business model test prescribed in paragraph 4.1.2A(a) of Ind AS 109. In reaching this conclusion, the Committee presumes that such investments do not constitute a portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis, since, as specifically stated in paragraph B4.1.6 of Ind AS 109, such a portfolio is neither held to collect contractual cash flows nor held both to collect contractual cash flows and to sell financial assets and consequently, such a portfolio must be measured at fair value through profit or loss.

Based on the above, the Committee concludes that the objective of business model of investments in FMPs is different from the objective of business model of investments in liquid/ultra short-term/ short-term plans. Consequently, all these investments cannot be grouped into a single portfolio and classified as subsequently measured at fair value through other comprehensive income.

10. In the extant case, though it is not necessary to evaluate compliance with cash flow characteristics test, the Committee considered it appropriate to elaborate this as it has relevance for classification these two portfolio separately. Thus, Committee now examines application of cash flow characteristics test to investments in close-ended debt funds (FMP). For this purpose, the Committee is of the view that the company has to 'look through' the instruments in which the close-ended debt funds have invested. From the sample offer document furnished by the querist, the Committee notes that the investment objective of the scheme is to seek to generate income by investing in a portfolio of fixed income securities/debt instruments maturing on or before the maturity of the scheme and that the investments will be in debt instruments including government securities and money market instruments. The allocation may vary during the tenure of the scheme depending on some instances like coupon inflow, calling of or buy-back of the instrument by the issuer and anticipation of any adverse credit event. In case of downgrade of a particular instrument, the Fund manager will endeavour to rebalance the portfolio on a best effort basis. There will be no exposure to derivatives. While the contractual cash flows from such instruments are expected to include payments of principal and interest on principal outstanding, it has to be examined as to whether such cash flows consist of *solely* payments of principal and interest on principal outstanding (hereinafter referred to as 'SPPI'), having regard to the provisions of paragraph 4.1.3 and paragraphs B4.1.7-B4.1.26 of Ind AS 109. Some of the key requirements in this regard are outlined below:

- (a) Contractual cash flows that are SPPI are consistent with a basic lending arrangement. Hence, elements of interest can include consideration for time value of money, credit risk, other basic lending risks, for example, liquidity risk, costs associated with holding the financial asset for a particular period of time and profit margin that is consistent with a basic lending arrangement.
- (b) Principal is the fair value of the financial asset at initial recognition. This may change subsequently if there are repayments of principal.

- (c) An entity should assess whether contractual cash flows are SPPI for the currency in which the financial asset is denominated.
- (d) Financial assets with leverage features do not meet the SPPI test since leverage increases the variability of the contractual cash flows with the result that they do not have the economic characteristic of interest.
- (e) Contractual terms that change the timing or amount of contractual cash flows should be analysed to determine whether they meet the SPPI test. For making this determination, the entity should assess the contractual cash flows that could arise both before, and after, the change in contractual cash flows and nature of contingent event that would change the timing or amount of contractual cash flows. For example, in case of prepayment features, the SPPI test is met, if the prepayment amount substantially represents unpaid amount of principal and interest on principal outstanding, which may include reasonable additional compensation for the early termination of the contract.

If the contractual cash flows of the instruments in which the close-ended debt funds invest meet the 'SPPI' test, then, the cash flow characteristics test prescribed in paragraph 4.1.2(b) of Ind AS 109 is met for *investments* in close-ended debt funds. This is because the cash flows from investments in close-ended debt funds originate from the cash flows of the debt instruments held by such funds. In this situation, since business model test prescribed in paragraph 4.1.2(a) of Ind AS 109 is also met (see paragraph 9 above), investments in close-ended debt funds should be measured at amortised cost in accordance paragraph 4.1.2 of Ind AS 109. If the cash flow characteristics test prescribed in paragraph 4.1.2(b) of Ind AS 109 is not met for the investments in close-ended debt funds in the manner explained above, then, even though the business model test prescribed in paragraph 4.1.2(a) of Ind AS 109 is met, such investments should be measured at fair value through profit or loss in accordance with paragraph 4.1.4 of Ind AS 109. While making the analysis of cash flow characteristics test, the fact that the units may be traded on a recognised stock exchange (if the scheme provides for the facility) should be disregarded. This is because in the case of close-ended debt funds, redemption and switch-out can occur only on maturity of the scheme. Hence, contractual cash flows of the instruments held by such funds and, consequently investments in such funds, are not affected by the quoted prices for the units in the relevant fund on the recognised stock exchange.

In respect of investments in open-ended debt funds (liquid/ultra short-term/ short-term plans), the cash flow characteristics test mentioned in paragraph 4.1.2A(b) is not met. The reason is that its redemption value is based on NAV which is in turn based on future value of the underlying investments which is not consistent with the basic lending arrangement. Secondly, fund managers normally have discretion to buy and sell the underlying instruments to generate better yield/return for unit holders. Therefore, the NAV/redemption value is likely to include gain or loss on sale of underlying instruments which is not consistent with the basic lending arrangements. Consequently, the contractual cash flow characteristics test prescribed in paragraph 4.1.2A(b) of Ind AS 109 is not met for investments in open-ended debt funds, even though the business model test prescribed in paragraph 4.1.2A(a) of Ind AS 109 is met for such investments (see paragraph 9 above). Hence, the Committee is of the view that such investments should be measured at fair value through profit or loss in accordance paragraph 4.1.4 of Ind AS 109.

11. The Committee wishes to point out that investments in units of mutual funds are not investments in equity instruments as defined in Ind AS 32, simply because they may represent residual interest in the funds. This is because irrespective of classification of units by the mutual fund, there is contractual obligation on the part of the Fund to deliver cash on redemption of the units or to deliver units of another scheme on ‘switch-out’, which involves an obligation to deliver cash on behalf of the unitholder to the management of the other scheme. The units are, therefore, financial liabilities, having regard to the definition of the term ‘Financial liability’ given in paragraph 11 of Ind AS 32, which reads as below:

**“A financial liability is any liability that is:**

- (a) a contractual obligation:**
  - (i) to deliver cash or another financial asset to another entity; or**
  - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or**
- (b) ...**

**As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D.**

**...”**

The Committee is of the view that the exception requiring *classification* of certain financial instruments meeting the definition of a financial liability as equity by the *issuer* in accordance with paragraphs 16A-16D of Ind AS 32 cannot be applied by the *holder* of such instruments while applying Ind AS 109. This is because Ind AS 109 does not provide for an exception similar to the exception contained in Ind AS 32. In reaching this conclusion, the Committee relies on the views of the IFRS Interpretations Committee published in ‘IFRIC Update’, September 2017, duly supported by paragraph BC5.21 of International Financial Reporting Standard 9, ‘Financial Instruments’.

Consequently, the election to recognise fair value changes of particular investments in equity instruments permitted in paragraph 4.1.4 of Ind AS 109 read with paragraph 5.7.5 of Ind AS 109 is not available for investments in debt funds.

**D. Opinion**

12. On the basis of the above, the Committee is of the following opinion that all investments in (units of) debt funds (FMPs and liquid/short-term) cannot be treated as a single portfolio for the purposes of assessment of business model test and consequent classification as fair value through other comprehensive income under Ind AS 109. They should be measured as explained in paragraph 10 above.

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