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Accounting and Reporting of Financial Instruments

1. Introduction

During the last few years, a number of new financial instruments have assumed significance in the Indian economy. With rapid globalisation, this trend is likely to accelerate in future. Derivatives are a kind of financial instruments whose values change in response to the change in specified interest rates, security prices, commodity prices, index of prices or rates, or similar variables. Typical examples of derivatives are futures and forward contracts, swaps and option contracts. The Institute of Chartered Accountants of India came out with the Accounting Standards 30, 31, 32 for recognition, measurement, presentation and disclosures of financial instruments.

2. Classification of Financial Assets

Every financial asset that falls within the scope of AS 30 must be classified into one of the following four categories.

- (a) At fair value through profit or loss (FVTPL);
- (b) Available-for-sale (AFS);
- (c) Loans and receivables (LR); or
- (d) Held-to-maturity (HTM).

This classification is important as it drives the subsequent measurement of the asset (ie whether the asset is held at fair value or amortised cost). In the above list, assets in the first two categories are measured at fair value, whilst those in the last two categories are measured at amortised cost. The only exception to this rule is equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument, which are instead held at cost.

Financial assets at fair value through profit or loss (FVTPL): FVTPL has two sub-categories. The first includes any financial asset that is designated on initial recognition as one to be measured at fair value with fair value changes in the statement of profit and loss (except for investments in equity instruments and derivatives linked to and must be settled by delivery of equity instruments where the equity instrument does not have a quoted market price in an active market for which fair value is reliably determinable). This designation is irrevocable

The second category includes financial assets which should be classified as held for trading. All derivative assets are held for trading financial assets measured at fair value through profit or loss, except for derivatives that are designated and effective hedging instruments. If a derivative asset is a hedging instrument in a cash flow hedge or a hedge of a net investment in a foreign operation, part of the fair value gains/losses will be recognized initially in equity. Fair value gains/losses for a derivative asset that is a hedging instrument in a fair value hedge will always be recognized in the statement of profit and loss, the same treatment as if the instrument was not in a hedge relationship at all.

Held for trading: A financial asset or financial liability is classified as **held for trading** if it is:

- (i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term; or
- (ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking;
- (iii) a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity other than:

- (a) those that the entity upon initial recognition designates as at fair value through profit or loss;
- (b) those that meet the definition of loans and receivables; and
- (c) those that the entity designates as available for sale.

Held to maturity investments are measured at amortised cost using the effective interest rate method.

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than: (a) those that the entity intends to sell immediately or in the near term, which should be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss; (b) those that the entity upon initial recognition designates as available for sale; or (c) those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which should be classified as available for sale.

Loans and receivables are measured at amortised cost using the effective interest method.

The principal difference between loans and receivables and held-to-maturity investments is that loans and receivables are not subject to the tainting provisions that apply to held-to-maturity investments. Loans and receivables not held for trading can be classified as such even if an entity does not have the positive intention and ability to hold them until maturity. As a consequence, the ability to measure a financial asset at amortised cost without consideration of the entity's intention and ability to hold the asset until maturity is only appropriate when there is no active market for that asset.

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Available-for-sale financial assets are those non-derivative financial assets that are designated as available for sale or are not classified as

- (a) loans and receivables,
- (b) held-to-maturity investments, or
- (c) financial assets at fair value through profit or loss.

Available-for-sale financial assets are measured at fair value with fair value gains or losses recognized directly in an appropriate equity account, say Investment Revaluation Reserve Account and recycled into the statement of profit and loss on derecognition of the asset at which time the cumulative gain or loss previously recognized in equity is recognized in the statement of profit and loss for the period.

Dividends on an available-for-sale equity instrument are recognized in the statement of profit and loss when the entity's right to receive payment is established.

2.1 Derivatives : Derivatives are financial instruments that derive their value from changes in benchmark based on stock prices, interest rates, mortgage rates, currency rates, commodity prices or some other agreed upon base. The method of accounting for derivatives would depend on the standard issued by the ICAI and pronouncements of other regulatory bodies such as the Securities and Exchange Board of India. However, the main issues relating to its accounting are its recognition, classification, impairment and de-recognition.

AS 30 requires that all derivatives are accounted for on the balance sheet at fair value, irrespective of whether they are used as part of a hedging relationship. Changes in fair value are recognized in the statement of profit and loss unless the contract is part of an effective cash flow or net investment hedging relationship. As the definition of a derivative is so broad, many contracts are likely to be caught, and therefore will have to be accounted for at fair value. For example, certain contracts to buy or sell non-financial items fall within the scope of AS 30 and meet the definition of a derivative.

According to Para 8 of AS 30, A derivative is a financial instrument or other contract within the scope of this Standard with all three of the following characteristics:

- (a) 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, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying');
- (b) 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
- (c) it is settled at a future date.

An underlying is a variable that, along with either a notional amount or a payment provision, determines the settlement amount of a derivative.

2.2 Hedge Accounting: Hedge accounting is a method of presentation that may be voluntarily applied to hedging transactions. The objective of hedge accounting is to ensure that the gain or loss on the hedging instrument is recognised in the statement of profit and loss in the same period when the item that is being hedged affects profit or loss. In other words, applying hedge accounting results in the 'matched' timing of recognition of gains and losses in the statement of profit and loss. Where an entity is perfectly hedged, the gains and losses on the hedging instrument and the hedged item perfectly offset in the statement of profit and loss in the same period.

AS 30 allows an entity to apply hedge accounting if an entity specifically designates the hedging instrument and the hedged item at inception of the hedge accounting relationship. Generally, there are two ways in which hedge accounting achieves the matching of gains and losses on the hedging instrument and the hedged item:

- Changes in the fair value of the hedging instrument are recognised in the statement of profit and loss at the same time that a recognised asset and liability that is being hedged is adjusted for movements in the hedged risk and that adjustment is also recognised in the statement of profit and loss in the same period. This is referred to as a fair value hedge because it is the exposure to changes in the fair value of the hedged item due to the designated risk that is being hedged; or
- Changes in the fair value of the hedging instrument are recognised initially in equity and 'recycled' into the statement of profit and loss when the hedged item affects profit or loss. This is known as a cash flow hedge because it is the exposure to the variability in future cash flow that is being hedged.

A third and final category of hedge accounting is hedging a net investment in a foreign operation. This is accounted for similarly to cash flow hedges.

There are specific rules within the Standard that limit which financial instruments can be considered a hedging instrument, and which items can be considered a hedged item. In summary, a hedging instrument can be a derivative financial instrument or a non-derivative financial instrument (for hedges of foreign exchange risk only). The hedged item must be an identified hedged item or group of items that could affect profit or loss.

When an entity wishes to apply hedge accounting, it must formally document in writing its intention to apply hedge accounting prospectively. Hedge accounting cannot be applied retrospectively. Additionally, hedge accounting must be consistent with the entity's established risk management strategy for that hedge relationship. The hedge documentation must identify the hedging instrument, the hedged item or transaction, the nature or the risk being hedged and specify how the 'effectiveness' of the hedge relationship will be assessed and ineffectiveness measured.

Hedge accounting is only permitted if the hedge relationship is expected to be highly effective and it is actually effective within a quantitative range. To the extent that the hedging instrument and hedged item are not perfectly effective at offsetting each other, this ineffectiveness is immediately recognised in the statement of profit and loss.

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AS 30 does not mandate the use of hedge accounting. Hedge accounting is voluntary. If an entity does not wish to use hedge accounting it does not need to designate and document its hedging relationships. Where an entity applies the normal recognition and measurement requirements of AS 30 it may find in some cases that the effect on the statement of profit and loss account of applying hedge accounting could be substantially the same as where hedge accounting is not applied. In such cases, an entity may well choose not to apply hedge accounting because there is very little benefit in doing so.

Definitions of hedge accounting

AS 30 recognises three types of hedge accounting depending on the nature of the risk exposure:

(a) Fair value hedge: Fair value hedge is a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss.

Fair value exposures arise from existing assets or liabilities, including firm commitments. Fixed-rate financial assets and liabilities, for example, have a fair value exposure to changes in market rates of interest and changes in credit quality. Non-financial assets have a fair value exposure to changes in their market price, eg a commodity price. Some assets and liabilities have fair value exposures arising from more than one type of risk, eg interest rate, credit, foreign currency risk.

The following assets and liabilities are commonly fair value hedged:

- Fixed rate liabilities like loans;
- Fixed rate assets like investments in bonds;
- Investments in equity securities; and
- Firm commitments to buy/sell non-financial items at a fixed price.

A firm commitment is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

(b) Cash flow hedge: Cash flow hedge is a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss.

Common assets and liabilities and forecast transactions that are cash flow hedged include:

- Variable rate liabilities like loans;
- Variable rate assets like investments in bonds;
- Highly probable future issuance of fixed rate debt;
- Forecast reinvestment of interest and principal received on fixed rate assets; and
- Highly probable forecast sales and purchases.

An example of a cash flow hedge is a hedge of variable rate debt with a floating to fixed interest rate swap. The cash flow hedge reduces future variability of interest cash flows on the debt. A hedging instrument that swaps one variable rate for another, eg LIBOR for MIBOR, would not qualify in a cash flow hedge relationship as it does not reduce cash flow variability, it merely swaps the existing cash flow variability of the debt for cash flow variability determined on a different basis.

Forecast transactions

A forecast transaction is an uncommitted but anticipated future transaction.

It is important to distinguish between forecast transactions and firm commitments as forecast transactions are always cash flow hedged, whereas firm commitments are generally fair value hedged.

(c) Hedge of a net investment in a foreign operation ('net investment hedge'): A hedging relationship qualifies for hedge accounting under AS 30 if, and only if, all of the following conditions are met.

- (a) At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation should include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.
- (b) The hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.
- (c) For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.
- (d) The effectiveness of the hedge can be reliably measured, i.e., the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured.
- (e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

Mechanics of hedge accounting

Fair Value Hedges

If a fair value hedge meets the conditions in paragraph 98 during the period, it should be accounted for as follows:

- (a) the gain or loss from remeasuring the hedging instrument at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount measured in accordance with AS 11 (for a non-derivative hedging instrument) should be recognised in the statement of profit and loss; and

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- (b) the gain or loss on the hedged item attributable to the hedged risk should adjust the carrying amount of the hedged item and be recognised in the statement of profit and loss. This applies if the hedged item is otherwise measured at cost. Recognition of the gain or loss attributable to the hedged risk in the statement of profit and loss applies even if the hedged item is an available-for-sale financial asset.

Cash Flow Hedges

If a cash flow hedge meets the conditions in paragraph 98 during the period, it should be accounted for as follows:

- (a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (see paragraph 98) should be recognised directly in an appropriate equity account, say, Hedging Reserve Account; and
- (b) the portion of the gain or loss on the hedging instrument that is determined to be an ineffective hedge should be recognised in the statement of profit and loss.

More specifically, a cash flow hedge is accounted for as follows:

- (a) the appropriate equity account (Hedging Reserve Account) associated with the hedged item is adjusted to the lesser of the following (in absolute amounts):
 - (i) the cumulative gain or loss on the hedging instrument from inception of the hedge; and
 - (ii) the cumulative change in fair value (present value) of the expected future cash flows on the hedged item from inception of the hedge;
- (b) any remaining gain or loss on the hedging instrument or designated component of it (that is not an effective hedge) is recognised in the statement of profit and loss; and
- (c) if an entity's documented risk management strategy for a particular hedging relationship excludes from the assessment of hedge effectiveness a specific component of the gain or loss or related cash flows on the hedging instrument (see paragraphs 83, 84 and 98(a)), that excluded component of gain or loss is recognised in accordance with paragraph 61.

If a hedge of a forecast transaction subsequently results in the recognition of a financial asset or a financial liability, the associated gains or losses that were recognised directly in the appropriate equity account in accordance with paragraph 106 of the Standard should be reclassified into, i.e., recognised in, the statement of profit and loss in the same period or periods during which the asset acquired or liability assumed affects profit or loss (such as in the periods that interest income or interest expense is recognised). However, if an entity expects that all or a portion of a loss recognised directly in the equity account will not be recovered in one or more future periods, it should reclassify into, i.e., recognise in, the statement of profit and loss the amount that is not expected to be recovered.

Hedges of a Net Investment

Hedges of a net investment in a foreign operation (see AS 11), including a hedge of a monetary item that is accounted for as part of the net investment (see AS 11), should be accounted for similarly to cash flow hedges:

- (a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (see paragraph 98) should be recognised directly in the appropriate equity account; and
- (b) the portion of the gain or loss on the hedging instrument that is determined to be an ineffective hedge should be recognised in the statement of profit and loss.

The gain or loss on the hedging instrument relating to the effective portion of the hedge that has been recognised directly in the equity account should be recognised in the statement of profit and loss on disposal of the foreign operation.

2.3. Forwards and Options: A forward contract is basically a contractual arrangement in which one party buys and other party sells designated currency at a forward rate mutually agreed upon on the date of contract for delivery at designated future date. Accordingly, 'An enterprise may enter into a forward contract or other financial instrument that is in substance a forward exchange contract to establish the amount of reporting currency required or available at settlement date of a transaction. The difference between the forward rate and the exchange rate at the date of transaction should be recognised as income or expense over the life of the contract, except in respect of liabilities incurred for acquiring fixed assets, in which case, such difference should be adjusted in carrying amount of the respective fixed assets.

For example, suppose XYZ Ltd. needs \$3,00,000 on May 1, 2011 for repayment of loan installment and interest. As on December 1, 2010, it appears to the company that the dollar may be dearer as compared to the exchange rate prevailing on that date, say \$1 = ₹ 43.50. Accordingly, XYZ Ltd. may enter into a forward contract with a banker for \$3,00,000. The forward rate may be higher or lower than the spot rate prevailing on the date of the forward contract. Let us assume forward rate as on December 1, 2010 was \$ 1 = ₹ 44 as against the spot rate of ₹ 43.50. As on the future date, i.e., May 1, 2011, the banker will pay XYZ Ltd. \$ 3,00,000 at ₹ 44 irrespective of the spot rate as on that date. Let us assume that the Spot rate as on that date is \$ 1 = ₹ 44.80.

In the given example XYZ Ltd. gained ₹ 2,40,000 by entering into the forward contract.

Payment to be made as per forward contract

(US \$3,00,000 × ₹ 44)	₹ 1,32,00,000
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Amount payable had the forward contract not been in place

(US \$3,00,000 × ₹ 44.80)	₹ 1,34,40,000
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Gain arising out of the forward exchange contract	₹ 2,40,000
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Currency options provide the corporate treasurer another tool for hedging foreign exchange risk arising out of the firm's operations. Unlike forward contract options allowing the hedger to

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gain from favourable exchange rate movements, Currency options are frequently suggested as an appropriate hedging tool because one can remove downside risk without limiting the upside potential. Options can be put option or a call option. A put option is a contract that specifies the currency that the holder has the right to sell. A call option is a contract that specifies the currency that the holder has the right to sell. This can better be explained with the help of an illustration.

In late February, an American Importer anticipates a Yen payment of JPY 100 million to a Japanese supplier sometime in late May. The current USD/JPY spot rate is 0.007739 (which implies that JPY/USD rate of 129.22). A June Yen call option on the Philadelphia Exchange with the strike price of \$0.0078 per yen is available for a premium of 0.0108 cents per yen or \$ 0.000108 per yen. A contract is for JPY 6.25 million. Premium per contract is therefore: \$ 0.000108 × 6250000 = \$ 675. The firm decides to purchase 16 calls for a total premium of \$ 10800. In addition, there is a brokerage fee of \$ 20 per contract. Thus, total expenses in buying the options is \$ 11120. The firm has, in effect, ensured that its buying rate for yen will not exceed - \$ 0.0078 + \$ (11120/100000000) = \$ 0.0079112 per yen. The yen depreciates to \$ 0.0075 per yen in late May when the payment becomes due. The firm will not exercise the option. It can sell 16 calls in the market, provided the resale value exceeds the brokerage commission it will have to pay. Therefore, price per yen is \$ 0.075 + 0.0001125 \$. If Yen appreciates, then the firm will exercise option.

2.4 Stock Index Futures: Stock index futures are instruments where the underlying variable is a stock index future. Both the Bombay Stock Exchange and the National Stock Exchange have introduced index futures in June, 2000 and permit trading on the Sensex Futures and the Nifty Futures respectively. AS 13 on Accounting for Investments deals with accounting of shares, debenture and other securities. Accounting Standard (AS) 13, Accounting for Investments, stands withdrawn from the date AS 30 becomes applicable, except to the extent it relates to accounting for investment properties.

2.5 Embedded Derivatives: AS 30 describes embedded derivative as a component of a hybrid (combined) instrument that also includes a non-derivative host contract—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to 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, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

The hybrid contract is the entire contract, within which there may be an embedded derivative. The host contract is the main body of the contract, excluding the embedded derivative.

Company X holds a bond which is convertible into the equity shares of company Y. The hybrid contract is the convertible bond; the host contract is the bond asset, and the embedded derivative is the conversion option.

A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.

An embedded derivative should be separated from the host contract and accounted for as a derivative under this Standard if, and only if:

- (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract (see Appendix A paragraphs A50 and A53 of AS 30);
- (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- (c) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in the statement of profit and loss (i.e., a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).

If an embedded derivative is separated, the host contract should be accounted for under this Standard if it is a financial instrument, and in accordance with other appropriate Standards if it is not a financial instrument. This Standard does not address whether an embedded derivative should be presented separately on the face of the financial statements.

Notwithstanding paragraph 10 of AS 30, if a contract contains one or more embedded derivatives, an entity may designate the entire hybrid (combined) contract as a financial asset or financial liability at fair value through profit or loss unless:

- (a) the embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract; or
- (b) it is clear with little or no analysis when a similar hybrid (combined) instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.

If an entity is required by this Standard to separate an embedded derivative from its host contract, but is unable to measure embedded derivative separately either at acquisition or at a subsequent financial reporting date, it should designate the entire hybrid (combined) contract as at fair value through profit or loss.

If an entity is unable to determine reliably the fair value of an embedded derivative on the basis of its terms and conditions (for example, because the embedded derivative is based on an unquoted equity instrument), the fair value of the embedded derivative is the difference between the fair value of the hybrid (combined) instrument and the fair value of the host contract, if those can be determined under this Standard. If the entity is unable to determine the fair value of the embedded derivative using this method, paragraph 12 of AS 30 applies and the hybrid (combined) instrument is designated as at fair value through profit or loss.

An entity that applies this Standard for the first time should assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative

on the basis of the conditions that existed on the date it first became a party to the contract or on the date on which a reassessment is required by Appendix A paragraph A56 of AS 30, whichever is the later date.

3. Initial Recognition of Financial Instruments

An entity should recognise a financial asset or a financial liability on its balance sheet when, and only when, the entity becomes a party to the contractual provisions of the instrument. (See paragraphs 38-42 of AS 30 with respect to regular way purchases of financial assets.)

4. De-recognition of Financial Assets and Liabilities

A financial asset is derecognised, ie removed from the balance sheet, when, and only when, either the contractual rights to the asset's cash flows expire, or the asset is transferred and the transfer qualifies for derecognition.

The decision whether a transfer qualifies for derecognition is made by applying a combination of risks and rewards and control tests. The risks and rewards tests seek to establish whether, having transferred a financial asset, the entity continues to be exposed to the risks of ownership of that asset and/or continues to enjoy the benefits that it generates. The control tests are designed with a view to understand which entity controls the asset, ie which entity can direct how the benefits of that asset are realised.

This approach of using two types of tests is often criticised for being a mix of two accounting models that can create confusion in application. AS 30 addresses this criticism by providing a clear hierarchy of application of the two sets of tests: risks and rewards tests are applied first, with the control tests used only when the entity has neither transferred substantially all risks and rewards of the asset nor retained them.

Inherent in the AS 30 derecognition model is the notion of 'stickiness', ie it is more difficult to remove an asset from an entity's balance sheet than it is to recognise that asset in the first place. Derecognition cannot be achieved by merely transferring the legal title to a financial asset to another party. The substance of the arrangement must be assessed in order to determine whether an entity has transferred the economic exposure associated with the rights inherent in the asset, ie its risks and rewards, and control of those rights.

Before evaluating whether, and to what extent, derecognition is appropriate, an entity determines whether those paragraphs should be applied to a part of a financial asset (or a part of a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety, as follows.

- (a) Paragraphs 16-22 of AS 30 are applied to a part of a financial asset (or a part of a group of similar financial assets) if, and only if, the part being considered for derecognition meets one of the following three conditions.
 - (i) The part comprises only specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash

flows, but not the principal cash flows from a debt instrument, paragraphs 16-22 are applied to the interest cash flows.

- (ii) The part comprises only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of all cash flows of a debt instrument, paragraphs 16-22 are applied to 90 per cent of those cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the cash flows provided that the transferring entity has a fully proportionate share.
 - (iii) The part comprises only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of interest cash flows from a financial asset, paragraphs 16-22 are applied to 90 per cent of those interest cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the specifically identified cash flows provided that the transferring entity has a fully proportionate share.
- (b) In all other cases, paragraphs 16-22 are applied to the financial asset in its entirety (or to the group of similar financial assets in their entirety). For example, when an entity transfers (i) the rights to the first or the last 90 per cent of cash collections from a financial asset (or a group of financial assets), or (ii) the rights to 90 per cent of the cash flows from a group of receivables, but provides a guarantee to compensate the buyer for any credit losses up to 8 per cent of the principal amount of the receivables, paragraphs 16-22 are applied to the financial asset (or a group of similar financial assets) in its entirety.

In paragraphs 16-26, the term 'financial asset' refers to either a part of a financial asset (or a part of a group of similar financial assets) as identified in (a) above or, otherwise, a financial asset (or a group of similar financial assets) in its entirety.

An entity should derecognise a financial asset when, and only when:

- (a) the contractual rights to the cash flows from the financial asset expire; or
- (b) it transfers the financial asset as set out in paragraphs 17 and 18 and the transfer qualifies for derecognition in accordance with paragraph 19. (See paragraphs 38-42 for regular way sales of financial assets.)

An entity transfers a financial asset if, and only if, it either:

- (a) transfers the contractual rights to receive the cash flows of the financial asset; or
- (b) retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement that meets the conditions in paragraph 18.

An entity should remove a financial liability (or a part of a financial liability) from its balance sheet when, and only when, it is extinguished—i.e., when the obligation specified in the contract is discharged or cancelled or expires.

An exchange between an existing borrower and lender of debt instruments with substantially different terms should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, should be recognised in the statement of profit and loss. If an entity repurchases a part of a financial liability, the entity allocates the previous carrying amount of the financial liability between the part that continues to be recognised and the part that is derecognised based on the relative fair values of those parts on the date of the repurchase. The difference between (a) the carrying amount allocated to the part derecognised and (b) the consideration paid, including any non-cash assets transferred or liabilities assumed, for the part derecognised is recognised in the statement of profit and loss.

5. Measurement

Initial Measurement of Financial Assets and Financial Liabilities

When a financial asset or financial liability is recognised initially, an entity should measure it as follows:

- (a) A financial asset or financial liability at fair value through profit or loss should be measured at fair value on the date of acquisition or issue.
- (b) Short-term receivables and payables with no stated interest rate should be measured at original invoice amount if the effect of discounting is immaterial.
- (c) Other financial assets or financial liabilities should be measured at fair value plus/ minus transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

When an entity uses settlement date accounting for an asset that is subsequently measured at cost or amortised cost, the asset is recognised initially at its fair value on the trade date (see paragraphs 38–42 of AS 30). Often it will be obvious whether the effect of discounting of short-term receivables and payables would be material or immaterial and there would be no need to make detailed calculations. In other cases, it will be necessary to make detailed calculations.

Subsequent Measurement of Financial Assets

For the purpose of measuring a financial asset after initial recognition, this Standard classifies financial assets into the following four Categories defined in paragraphs 8.2 to 8.5 of AS 30:

- (a) financial assets at fair value through profit or loss;
- (b) held-to-maturity investments;

- (c) loans and receivables; and
- (d) available-for-sale financial assets.

Financial assets at fair value through profit or loss

Assets falling within this category, which includes those classified as held for trading and derivative assets that are not designated as effective hedging instruments, are measured at fair value. Gains and losses that arise on changes in fair value are recognized in the statement of profit and loss.

Gains and losses that arise between the last balance sheet date and the date an instrument is derecognized do not constitute a separate 'profit/loss on disposal'. Such gains and losses will have arisen prior to disposal, while the item is still being held as at fair value through profit or loss, and should be recognized in the statement of profit and loss as they occur.

Transaction costs that might be incurred upon future disposal are not deducted from fair value in determining the carrying amount. Some argue that this is inconsistent with the use of exit prices (ie fair value) for measurement purposes, but the Standard is clear that such costs are viewed as being related to the act of disposal and, therefore, are recognized only in the period of disposal itself.

Held-to-maturity investments

Held-to-maturity investments are measured at amortised cost using the 'effective interest method'. This method is discussed in detail below.

Loans and receivables

Loans and receivables are also measured at amortised cost using the effective interest method, as discussed below.

Available-for-sale financial assets

Assets classified as available-for-sale are measured at fair value. As with financial assets at fair value through profit or loss, no deduction is made for transaction costs that might be incurred upon future disposal. Section 7.5 below contains guidance on the appropriate determination of fair value.

Gains and losses that arise on changes in fair value are recognized in equity, with three exceptions:

- (i) Interest, calculated using the effective interest method, is recognized in the statement of profit and loss
- (ii) Impairment losses are recognized in the statement of profit and loss; and
- (iii) Foreign exchange gains and losses on monetary financial assets

Subsequent Measurement of Financial Liabilities

After initial recognition, an entity should measure all financial liabilities at amortised cost using the effective interest method, except for:

- (a) financial liabilities at fair value through profit or loss. Such liabilities, including derivatives that are liabilities, should be measured at fair value other than a derivative liability that is

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linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured, which should be measured at cost.

- (b) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies. Paragraphs 29 and 31 of AS 30 apply to the measurement of such financial liabilities.
- (c) short-term payables with no stated interest rate should be measured at the original invoice amount if the effect of discounting is immaterial.
- (d) financial guarantee contracts as defined in paragraph 8.6. After initial recognition, an issuer of such a contract should (unless paragraph 52(a) or (b) applies) measure it at the higher of:
 - (i) the amount determined in accordance with AS 29; and
 - (ii) the amount initially recognised (see paragraphs 47-49) less, when appropriate, cumulative amortisation recognised, if any.
- (e) commitments to provide a loan at a below-market interest rate. After initial recognition, an issuer of such a commitment should (unless paragraph 52(a) applies) measure it at the higher of:
 - (i) the amount determined in accordance with AS 29; and
 - (ii) the amount initially recognised (see paragraphs 47-49 of AS 30) less, when appropriate, cumulative amortisation recognised, if any.

Financial liabilities that are designated as hedged items are subject to the hedge accounting requirements in paragraphs 99-113 of AS 30.

6. Reclassifications

An entity should not reclassify a financial instrument into or out of the fair value through profit or loss category while it is held or issued. If, as a result of a change in intention or ability, it is no longer appropriate to classify an investment as held to maturity, it should be reclassified as available for sale and remeasured at fair value, and the difference between its carrying amount and fair value should be accounted for in accordance with paragraph 61(b) of AS 30.

7. Impairment and Uncollectibility of Financial Assets

AS 30 requires all financial assets, with the exception of those measured at fair value through profit or loss, to be reviewed for impairment. The approach specified in the Standard is explained in the remainder of this chapter.

The two most notable characteristics of the AS 30 impairment model are:

- (i) Impairment losses should be recognised when they are incurred, rather than as expected;
- (ii) An impairment loss should be regarded as incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after initial recognition (a 'loss event')

An entity should assess at each balance sheet date whether there is any objective evidence that a financial asset or group of financial assets is impaired. If any such evidence exists, the entity should apply paragraph 69 (for financial assets carried at amortised cost), paragraph 72-74 of AS 30 (for short-term receivables with no stated interest rate carried at original invoice amount), paragraph 75 of AS 30 (for financial assets carried at cost) or paragraph 76 of AS 30 (for available-for-sale financial assets) to determine the amount of any impairment loss.

8. Gains and Losses

A gain or loss arising from a change in the fair value of a financial asset or financial liability that is not part of a hedging relationship, should be recognised, as follows.

- (a) A gain or loss on a financial asset or financial liability classified as at fair value through profit or loss should be recognised in the statement of profit and loss.
- (b) A gain or loss on an available-for-sale financial asset should be recognised directly in an appropriate equity account, say, Investment Revaluation Reserve Account, except for impairment losses and foreign exchange gains and losses, until the financial asset is derecognised, at which time the cumulative gain or loss previously recognised in the appropriate equity account should be recognised in the statement of profit and loss. However, interest calculated using the effective interest method is recognised in the statement of profit and loss. Dividends on an available-for-sale equity instrument are recognised in the statement of profit and loss when the entity's right to receive payment is established.

For financial assets and financial liabilities carried at amortised cost, a gain or loss is recognised in the statement of profit and loss when the financial asset or financial liability is derecognised or impaired, and through the amortisation process. However, for financial assets or financial liabilities that are hedged items the accounting for the gain or loss should follow paragraphs 99-113 of AS 30.

If an entity recognises financial assets using settlement date accounting, any change in the fair value of the asset to be received during the period between the trade date and the settlement date is not recognised for assets carried at cost or amortised cost (other than impairment losses). For assets carried at fair value, however, the change in fair value should be recognised in the statement of profit and loss or in the appropriate equity account.

Illustration 1

Aakshaya Ltd. has given a 12.50% fixed rate loan to its subsidiary Shaya Ltd. Aakshaya Ltd. measures this loan at an amortised cost of ₹ 2,50,000. Aakshaya Ltd. has plans to hive off the receivable at a later stage and as a measure to safeguard against fall in value of its dues enters into a pay-fixed, receive floating interest rate swap to convert the fixed interest receipts into floating interest receipts. Aakshaya Ltd. designates the swap as a Hedging instrument in a fair value hedge of the Loan Asset.

Over the following months, market interest rates increase and Aakshaya Ltd. earns interest income of ₹ 25,000 on the loan and ₹ 1,000 as net interest payments on the swap. The Fair

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value of the Loan Asset decreases by ₹ 5,000 while that of the interest rate swap increases by 5,000. You are informed that all conditions required for the Hedge Accounting are satisfied. You are required to pass Journal Entries, with suitable narrations, in the books of Aakshaya Ltd. to record the above transactions.

Solution

In the books of Aakshaya Ltd. Journal Entries

		₹	₹
Cash account	Dr.	25,000	
To Interest account			25,000
(Being the receipt of interest income on the loan asset)			
Derivative account	Dr.	5,000	
To Hedging gain account			5,000
(Being increase in the fair value of the interest rate swap)			
Hedging loss account	Dr.	5,000	
To Loan to Shaya Ltd. account			5,000
(Being decrease in the fair value of loan to Shaya Ltd attributable to the hedged risk recorded)			
Cash Account	Dr.	1,000	
To Interest account			1,000
(Being the entry to record the interest settlement of the swap as increase in interest income)			

Illustration 2

Friendly Ltd granted ₹ 100 lakhs as loan to its employees on 1st January, 2011 at a concessional rate of interest of 4 per cent per annum on the condition that the loan is to be repaid in five equal annual instalments along with interest thereon. You are informed that the prevailing lending rate for such risk profiles is 10% p.a. You are required to find out at what value the loan should be recognized initially and the amount of annual amortization till closure thereof. Show Journal Entries with appropriate narrations that will be recorded in the company's Books in the year 2011.

[Present value of an Indian Rupee at a discount rate of 10 per cent per annum will be .9090, .8263, .7512, .6829 and .6208 which is to be adopted for purposes of calculation].

Solution

(i) Calculation of initial recognition amount of loan to employees

Year end	Cash Inflow		Total ₹	P.V. factor @10%	Present value ₹
	Principal ₹	Interest @ 4% ₹			
2011	20,00,000	4,00,000	24,00,000	0.9090	21,81,600
2012	20,00,000	3,20,000	23,20,000	0.8263	19,17,016

2013	20,00,000	2,40,000	22,40,000	0.7512	16,82,688
2014	20,00,000	1,60,000	21,60,000	0.6829	14,75,064
2015	20,00,000	80,000	20,80,000	0.6208	12,91,264
Present value or Fair value					85,47,632

(ii) Calculation of amortised cost of loan to employees

Year	Amortised cost (Opening balance) [1] ₹	Interest to be recognised@10% [2] ₹	Repayment (including interest) [3] ₹	Amortised Cost (Closing balance) [4]=[1]+ [2] – [3] ₹
2011	85,47,632	8,54,763	24,00,000	70,02,395
2012	70,02,395	7,00,240	23,20,000	53,82,635
2013	53,82,635	5,38,264	22,40,000	36,80,899
2014	36,80,899	3,68,090	21,60,000	18,88,989
2015	18,88,989	1,91,011*	20,80,000	Nil

(iii) Journal Entries in the books of Friendly Ltd.

for the year ended 31st December, 2011 (regarding loan to employees)

	Dr. Amount (₹)	Cr. Amount (₹)
Staff loan A/c To Bank A/c (Being the disbursement of loans to staff)	Dr. 1,00,00,000	1,00,00,000
Staff cost A/c ₹ (1,00,00,000 – 85,47,632) [Refer part (ii)] To Staff loan A/c* (Being the write off of excess of loan balance over present value thereof in order to reflect the loan at its present value of ₹ 85,47,632)	Dr. 14,52,368	14,52,368
Staff loan A/c To Interest on staff loan A/c (Being the charge of interest @ market rate of 10% on the loan)	Dr. 8,54,763	8,54,763
Bank A/c To Staff loan A/c (Being the repayment of first instalment with interest for the year)	Dr. 24,00,000	24,00,000

* The difference of ₹ 2,112 (₹ 1,91,011 – ₹ 1,88,899) is due to approximation in computations.

* Loans and receivables should be measured at amortized cost using the effective interest method as per AS 30 'Financial Instruments: Recognition and Measurement'.

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Interest on staff loan A/c To Profit and loss A/c (Being transfer of balance of staff loan Interest account to profit and loss account)	Dr.	8,54,763	8,54,763
Profit and loss A/c To Staff cost A/c (Being transfer of balance of staff cost account to profit and loss account)	Dr.	14,52,368	14,52,368

Illustration 3

On 1st April, 2012 Sigma Ltd. issued 6% Convertible debentures of face value of ₹ 100 per debenture at par. The debentures are redeemable at a premium of 10% on 31-03-2016 or these may be converted into ordinary shares at the option of the holder, the interest rate for equivalent debentures without conversion rights would have been 10%. Being a compound financial instrument, you are required to separate equity and debt portions as on 01-04-2012. Equity portion is ₹ 1,85,400. Find out the debt portion (Debenture amount). The present value of ₹ 1 receivable at the end of each year based on discount rates of 6% and 10% can be taken as:

End of year	6%	10%
1	0.94	0.91
2	0.89	0.83
3	0.84	0.75
4	0.79	0.68

Solution

Assume that total proceeds of the issue is = ₹ M

Hence, interest payable every year = 6% on ₹ M = 0.06M

Present value of interest (at 10% discount) = 0.06M x cumulative discount factor of 4 years
= 0.06M x 3.17 = 0.1902M.

Amount refundable (as amount have to be redeemed at 10% premium) = 1.10 x M

Present value of 1.10M at 4th year = 1.10M x 0.68 = 0.748M.

Therefore, total present value of debentures = 0.1902M + 0.748M = 0.9382M

Hence, amount of equity = M - 0.9382M = ₹ 1,85,400

$$0.0618M = ₹ 1,85,400$$

$$M = 1,85,400 / 0.0618 = ₹ 30,00,000$$

Therefore, total proceeds of the issue is ₹ 30,00,000

Debt portion = ₹ 30,00,000 - ₹ 1,85,400 = ₹ 28,14,600.

Illustration 4

At the beginning of year 1, an enterprise issued 20,000 convertible debentures with face value ₹ 100 per debenture, at par. The debentures have six-year term. The interest at annual rate of 9% is paid half-yearly. The bondholders have an option to convert half of the face value of debentures into 2 ordinary shares at the end of year 3. The bondholders not exercising the conversion option will be repaid at par to the extent of ₹ 50 per debenture at the end of year 3. The non-convertible portion will be repaid at 10% premium at the end of year 6. At the time of issue, the prevailing market interest rate for similar debt without conversion option was 10%. Compute value of embedded derivative.

Solution

Half-year	Cash Flow ₹ 000	DF (5%)	PV ₹ 000
1 – 6	90	5.076	456.84
7 – 12	45	3.787	170.41
12	1,100	0.557	<u>612.70</u>
Value of host (Liability component)			1,239.95
Value of embedded derivative (Equity component)			<u>760.05</u>
Issue proceeds			<u>2,000.00</u>

Illustration 5

Certain callable convertible debentures are issued at ₹ 60. The value of similar debentures without call or equity conversion option is ₹ 57. The value of call as determined using Black and Scholes model for option pricing is ₹ 2.

Determine values of liability and equity component.

Solution

A callable bond is one that gives the issuer a right to buy the bond from the bondholders at a specified price. This feature in effect is a call option written by the bondholder. The option premium (value of call) is payable by the issuer.

Liability component (disregarding the call) = ₹ 57

Value of call payable by issuer = ₹ 2

Liability component = ₹ 57 – ₹ 2 = ₹ 55

Equity component = ₹ 60 – ₹ 55 = ₹ 5

Illustration 6

On February 1, 2011, Future Ltd. entered into a contract with Son Ltd. to receive the fair value of 1000 Future Ltd.'s own equity shares outstanding as on 31-01-2012 in exchange for payment of ₹ 1,04,000 in cash i.e., ₹ 104 per share. The contract will be settled in net cash as on 31.01.2012.

The fair value of this forward contract on the different dates were:

(i) Fair value of forward on 01-02-2011 Nil

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(ii) Fair value of forward on 31-12-2011 ₹ 6,300

(iii) Fair value of forward on 31-01-2012 ₹ 2,000

Presuming that Future Ltd. closes its books on 31st December each year, pass entries:

(i) If net settled is in cash

(ii) If net is settled by Son Ltd. by delivering shares of Future Ltd.

Solution

(i) If net is settled in cash

1.2.2011	No entry is required because fair value of derivative is zero and no cash is paid or received			
31.12.2011	Forward Asset A/c	Dr.	6,300	
	To Gain A/c			6,300
31.01.2012	Loss A/c	Dr.	4,300	
	To Forward Asset A/c			4,300
31.1.2012	Cash A/c	Dr.	2,000	
	To Forward Asset A/c			2,000

(ii) If net settled by delivery of share

First three entries will be same. Only the last entry will change as under:

Equity A/c	Dr.	2,000	
To Forward Asset A/c			2,000

Reference: The students are advised to refer AS 30, 31, 32 given in Appendix II at the end of the Study Material Volume II.