Foreign Currency Future Cash Flows

46. Future cash flows are estimated in the currency in which they will be generated and then discounted using a discount rate appropriate for that currency. An enterprise translates the present value obtained using the exchange rate at the balance sheet date (described in Accounting Standard (AS) 11, Accounting for the Effects of Changes in Foreign Exchange Rates, as the closing rate).

Discount Rate

47. The discount rate(s) should be a pre tax rate(s) that reflect(s) current market assessments of the time value of money and the risks specific to the asset. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted.

48. A rate that reflects current market assessments of the time value of money and the risks specific to the asset is the return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the enterprise expects to derive from the asset. This rate is estimated from the rate implicit in current market transactions for similar assets or from the weighted average cost of capital of a listed enterprise that has a single asset (or a portfolio of assets) similar in terms of service potential and risks to the asset under review.

49. When an asset-specific rate is not directly available from the market, an enterprise uses other bases to estimate the discount rate. The purpose is to estimate, as far as possible, a market assessment of:

(a) the time value of money for the periods until the end of the asset's useful life; and

(b) the risks that the future cash flows will differ in amount or timing from estimates.

50. As a starting point, the enterprise may take into account the following rates:

(a) the enterprise's weighted average cost of capital determined usingtechniques such as the Capital Asset Pricing Model;

(b) the enterprise's incremental borrowing rate; and

(c) other market borrowing rates.

51. These rates are adjusted:

(a) to reflect the way that the market would assess the specific risks associated with the projected cash flows; and

(b) to exclude risks that are not relevant to the projected cash flows. Consideration is given to risks such as country risk, currency risk, price risk and cash flow risk.

52. To avoid double counting, the discount rate does not reflect risks for which future cash flow estimates have been adjusted.

53. The discount rate is independent of the enterprise's capital structure and the way the enterprise financed the purchase of the asset because the future cash flows expected to arise from an asset do not depend on the way in which the enterprise financed the purchase of the asset.

54. When the basis for the rate is post-tax, that basis is adjusted to reflect a pre-tax rate.

55. An enterprise normally uses a single discount rate for the estimate of an asset's value in use. However, an enterprise uses separate discount rates for different future periods where value in use is sensitive to a difference in risks for different periods or to the term structure of interest rates.

Recognition and Measurement of an Impairment

Loss

56. Paragraphs 57 to 62 set out the requirements for recognising and measuring impairment losses for an individual asset. Recognition and measurement of impairment losses for a cash-generating unit are dealt with in paragraphs 87 to 92.

57. If the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset should be reduced to its recoverable amount. That reduction is an impairment loss.

58. An impairment loss should be recognised as an expense in the statement of profit and loss immediately, unless the asset is carried at revalued amount in accordance with another Accounting Standard (see Accounting Standard (AS) 10, Accounting for Fixed Assets), in which case any impairment loss of a revalued asset should be treated as a revaluation decrease under that Accounting Standard.

59. An impairment loss on a revalued asset is recognised as an expense in the statement of profit and loss. However, an impairment loss on a revalued asset is recognised directly against any revaluation surplus for the asset to the extent that the impairment loss does not exceed the amount held in the revaluation surplus for that same asset.

60. When the amount estimated for an impairment loss is greater than the carrying amount of the asset to which it relates, an enterprise should recognise a liability if, and only if, that is required by another Accounting Standard.

61. After the recognition of an impairment loss, the depreciation (amortisation) charge for the asset should be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

62. If an impairment loss is recognised, any related deferred tax assets or liabilities are determined under Accounting Standard (AS) 22, Accounting for Taxes on Income (see Illustration 3 given in the Illustrations attached to the Standard).

Cash-Generating Units

63. Paragraphs 64 to 92 set out the requirements for identifying the cash- generating unit to which an asset belongs and determining the carrying amount of, and recognising impairment losses for, cash-generating units.

Identification of the Cash-Generating Unit to Which an

Asset Belongs

64. If there is any indication that an asset may be impaired, the recoverable amount should be estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, an enterprise should determine the recoverable amount of the cash-generating unit to which the asset belongs (the asset's cash-generating unit).

65. The recoverable amount of an individual asset cannot be determined if:

(a) the asset's value in use cannot be estimated to be close to its net selling price (for example, when the future cash flows from continuing use of the asset cannot be estimated to be negligible); and

(b) the asset does not generate cash inflows from continuing use that are largely independent of those from other assets. In such cases, value in use and, therefore, recoverable amount, can be determined only for the asset's cash-generating unit.

Example

A mining enterprise owns a private railway to support its mining activities. The private railway could be sold only for scrap value and the private railway does not generate cash inflows from continuing use that are largely independent of the cash inflows from the other assets of the mine.

It is not possible to estimate the recoverable amount of the private railway because the value in use of the private railway cannot be determined and it is probably different from scrap value. Therefore, the enterprise estimates the recoverable amount of the cash-generating unit to which the private railway belongs, that is, the mine as a whole.

66. As defined in paragraph 4, an asset's cash-generating unit is the smallest group of assets that includes the asset and that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets. Identification of an asset's cash-generating unit involves judgement. If recoverable amount cannot be determined for an individual asset, an enterprise identifies the lowest aggregation of assets that generate largely independent cash inflows from continuing use.

Example

A bus company provides services under contract with a municipality that requires minimum service on each of five separate routes. Assets devoted to each route and the cash flows from each route can be identified separately. One of the routes operates at a significant loss.

Because the enterprise does not have the option to curtail any one bus route, the lowest level of identifiable cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets is the cash inflows generated by the five routes together. The cash-generating unit for each route is the bus company as a whole.

67. Cash inflows from continuing use are inflows of cash and cash equivalents received from parties outside the reporting enterprise. In identifying whether cash inflows from an asset (or group of assets) are largely independent of the cash inflows from other assets (or groups of assets), an enterprise considers various factors including how management monitors the enterprise's operations (such as by product lines, businesses, individual locations, districts or regional areas or in some other way) or how management makes decisions about continuing or disposing of the enterprise's assets and operations. Illustation 1 in the Illustrations attached to the Standard illustrates identification of a cash-generating unit.

68. If an active market exists for the output produced by an asset or a group of assets, this asset or group of assets should be identified as a separate cash-generating unit, even if some or all of the output is used internally. If this is the case, management's best estimate of future market prices for the output should be used:

(a) in determining the value in use of this cash-generating unit, when estimating the future cash inflows that relate to the internal use of the output; and

(b) in determining the value in use of other cash-generating units of the reporting enterprise, when estimating the future cash outflows that relate to the internal use of the output.

69. Even if part or all of the output produced by an asset or a group of assets is used by other units of the reporting enterprise (for example, products at an intermediate stage of a production process), this asset or group of assets forms a separate cash-generating unit if the enterprise could sell this output in an active market. This is because this asset or group of assets could generate cash inflows from continuing use that would be largely independent of the cash inflows from other assets or groups of

assets. In using information based on financial budgets/forecasts that relates to such a cash-generating unit, an enterprise adjusts this information if internal transfer prices do not reflect management's best estimate of future market prices for the cash-generating unit's output.

70. Cash-generating units should be identified consistently from period to period for the same asset or types of assets, unless a change is justified.

71. If an enterprise determines that an asset belongs to a different cash- generating unit than in previous periods, or that the types of assets aggregated for the asset's cash-generating unit have changed, paragraph 121 requires certain disclosures about the cash-generating unit, if an impairment loss is recognised or reversed for the cash-generating unit and is material to the financial statements of the reporting enterprise as a whole.

Recoverable Amount and Carrying Amount of a Cash- Generating Unit

72. The recoverable amount of a cash-generating unit is the higher of the cash-generating unit's net selling price and value in use. For the purpose of determining the recoverable amount of a cash-generating unit, any reference in paragraphs 15 to 55 to 'an asset' is read as a reference to 'a cash-generating unit'.

73. The carrying amount of a cash-generating unit should be determined consistently with the way the recoverable amount of the cash-generating unit is determined.

74. The carrying amount of a cash-generating unit:

(a) includes the carrying amount of only those assets that can be attributed directly, or allocated on a reasonable and consistent basis, to the cash-generating unit and that will generate the future cash inflows estimated in determining the cash-generating unit's value in use; and

(b) does not include the carrying amount of any recognised liability, unless the recoverable amount of the cash-generating unit cannot be determined without consideration of this liability.

This is because net selling price and value in use of a cash-generating unit are determined excluding cash flows that relate to assets that are not part of the cash-generating unit and liabilities that have already been recognised in the financial statements, as set out in paragraphs 23 and 35.

75. Where assets are grouped for recoverability assessments, it is important to include in the cash-generating unit all assets that generate the relevant stream of cash inflows from continuing use. Otherwise, the cash-generating unit may appear to be fully recoverable when in fact an impairment loss has occurred. In some cases, although certain assets contribute to the estimated future cash flows of a cash-generating unit, they cannot be allocated to the cash-generating unit on a reasonable and consistent basis. This might be the case for goodwill or corporate assets such as head office assets. Paragraphs 78 to 86 explain how to deal with these assets in testing a cash-generating unit for impairment

76. It may be necessary to consider certain recognised liabilities in order to determine the recoverable amount of a cash-generating unit. This may occur if the disposal of a cash-generating unit would require the buyer to take over a liability. In this case, the net selling price (or the estimated cash flow from ultimate disposal) of the cash-generating unit is the estimated selling price for the assets of the cash-generating unit and the liability together, less the costs of disposal. In order to perform a meaningful comparison between the carrying amount of the cash-generating unit and its recoverable amount, the carrying amount of the liability is deducted in determining both the cash-generating unit's value in use and its carrying amount.

Example

A company operates a mine in a country where legislation requires that the owner must restore the site on completion of its mining operations. The cost of restoration includes the replacement of the overburden, which must be removed before mining operations commence. A provision for the costs to replace the overburden was recognised as soon as the overburden was removed. The amount provided was recognised as part of the cost of the mine and is being depreciated over the mine's useful life. The carrying amount of the provision for restoration costs is ₹ 50,00,000, which is equal to the present value of the restoration costs.

The enterprise is testing the mine for impairment. The cash-generating unit for the mine is the mine as a whole. The enterprise has received various offers to buy the mine at a price of around ₹ 80,00,000; this price encompasses the fact that the buyer will take over the obligation to restore the overburden. Disposal costs for the mine are negligible. The value in use of the mine is approximately ₹ 1,20,00,000 excluding restoration costs. The carrying amount of the mine is ₹ 1,00,00,000.

The net selling price for the cash-generating unit is ₹ 80,00,000. This amount considers restoration costs that have already been provided for. As a consequence, the value in use for the cash-generating unit is determined after consideration of the restoration costs and is estimated to be ₹ 70,00,000 (₹ 1,20,00,000 less ₹ 50,00,000). The carrying amount of the cash-generating unit is ₹ 50,00,000, which is the carrying amount of the mine (₹ 1,00,00,000) less the carrying amount of the provision for restoration costs (₹ 50,00,000).

77. For practical reasons, the recoverable amount of a cash-generating unit is sometimes determined after consideration of assets that are not part of the cash-generating unit (for example, receivables or other financial assets) or liabilities that have already been recognised in the financial statements (for example, payables, pensions and other provisions). In such cases, the carrying amount of the cash-generating unit is increased by the carrying amount of those assets and decreased by the carrying amount of those liabilities.

Goodwill

78. In testing a cash-generating unit for impairment, an enterprise should identify whether goodwill that relates to this cash-generating unit is recognised in the financial statements. If this is the case, an enterprise should:

(a) perform a 'bottom-up' test, that is, the enterprise should:

(i) identify whether the carrying amount of goodwill can be allocated on a reasonable and consistent basis to the cash- generating unit under review; and

(ii) then, compare the recoverable amount of the cash- generating unit under review to its carrying amount (including the carrying amount of allocated goodwill, if any) and recognise any impairment loss in accordance with paragraph 87.

The enterprise should perform the step at (ii) above even if none of the carrying amount of goodwill can be allocated on a reasonable and consistent basis to the cash-generating unit under review; and

(b) if, in performing the 'bottom-up' test, the enterprise could not allocate the carrying amount of goodwill on a reasonable and consistent basis to the cash-generating unit under review, the enterprise should also perform a 'top-down' test, that is, the enterprise should:

(i) identify the smallest cash-generating unit that includes the cash-generating unit under review and to which the carrying amount of goodwill can be allocated on a the reasonable and consistent basis (the 'larger ' cash- generating unit); and

(ii) then, compare the recoverable amount of the larger cash- generating unit to its carrying amount (including the carrying amount of allocated goodwill) and recognise any impairment loss in accordance with paragraph 87.

79. Goodwill arising on acquisition represents a payment made by an acquirer in anticipation of future economic benefits. The future economic benefits may result from synergy between the identifiable assets acquired or from assets that individually do not qualify for recognition in the financial statements. Goodwill does not generate cash flows independently from other assets or groups of assets and, therefore, the recoverable amount of goodwill as an individual asset cannot be determined. As a consequence, if there is an indication that goodwill may be impaired, recoverable amount is determined for the cash-generating unit to which goodwill belongs. This amount is then compared to the carrying amount of this cash-generating unit and any impairment loss is recognised in accordance with paragraph 87.

80. Whenever a cash-generating unit is tested for impairment, an enterprise considers any goodwill that is associated with the future cash flows to be generated by the cash-generating unit. If goodwill can be allocated on a reasonable and consistent basis, an enterprise applies the 'bottom-up' test only. If it is not possible to allocate goodwill on a reasonable and consistent basis, an enterprise applies both the 'bottom-up' test and 'top-down' test (see Illustration 7 given in the Illustrations attached to the Standard).

81. The 'bottom-up' test ensures that an enterprise recognises any impairment loss that exists for a cash-generating unit, including for goodwill that can be allocated on a reasonable and consistent basis. Whenever it is impracticable to allocate goodwill on a reasonable and consistent basis in the 'bottom-up' test, the combination of the 'bottom-up' and the 'top-down' test ensures that an enterprise recognises:

(a) first, any impairment loss that exists for the cash-generating unit excluding any consideration of goodwill; and

(b) then, any impairment loss that exists for goodwill. Because an enterprise applies the 'bottom-up' test first to all assets that may be impaired, any impairment loss identified for the larger cash- generating unit in the 'top-down' test relates only to goodwill allocated to the larger unit.

82. If the 'top-down' test is applied, an enterprise formally determines the recoverable amount of the larger cash-generating unit, unless there is persuasive evidence that there is no risk that the larger cash-generating unit is impaired.

Corporate Assets

83. Corporate assets include group or divisional assets such as the building of a headquarters or a division of the enterprise, EDP equipment or a research centre. The structure of an enterprise determines whether an asset meets the definition of corporate assets (see paragraph 4) for a particular cash- generating unit. Key characteristics of corporate assets are that they do not generate cash inflows independently from other assets or groups of assets and their carrying amount cannot be fully attributed to the cash-generating unit under review.

84. Because corporate assets do not generate separate cash inflows, the recoverable amount of an individual corporate asset cannot be determined unless management has decided to dispose of the asset. As a consequence, if there is an indication that a corporate asset may be impaired, recoverable amount is determined for the cash-generating unit to which the corporate asset belongs, compared to the carrying amount of this cash-generating unit and any impairment loss is recognised in accordance with paragraph 87.

85. In testing a cash-generating unit for impairment, an enterprise should identify all the corporate assets that relate to the cash-generating unit under review. For each identified corporate asset, an enterprise should then apply paragraph 78, that is:

(a) if the carrying amount of the corporate asset can be allocated on a reasonable and consistent basis to the cash-generating unit under review, an enterprise should apply the 'bottom-up' test only; and

(b) if the carrying amount of the corporate asset cannot be allocated on a reasonable and consistent basis to the cash-generating unit under review, an enterprise should apply both the 'bottom- up' and 'top-down' tests.

86. An Illustrations of how to deal with corporate assets is given as Illustration 8 in the Illustrations attached to the Standard.

Impairment Loss for a Cash-Generating Unit

87. An impairment loss should be recognised for a cash-generating unit if, and only if, its recoverable amount is less than its carrying amount. The impairment loss should be allocated to reduce the carrying amount of the assets of the unit in the following order:

(a) first, to goodwill allocated to the cash-generating unit (if any); and

(b) then, to the other assets of the unit on a pro-rata basis based on the carrying amount of each asset in the unit.

These reductions in carrying amounts should be treated as impairment losses on individual assets and recognised in accordance with paragraph 58.

88. In allocating an impairment loss under paragraph 87, the carrying amount of an asset should not be reduced below the highest of:

(a) its net selling price (if determinable);

(b) its value in use (if determinable); and

(c) zero.

The amount of the impairment loss that would otherwise have been allocated to the asset should be allocated to the other assets of the unit on a pro-rata basis.

89. The goodwill allocated to a cash-generating unit is reduced before reducing the carrying amount of the other assets of the unit because of its nature.

90. If there is no practical way to estimate the recoverable amount of each individual asset of a cash-generating unit, this Standard requires the allocation of the impairment loss between the assets of that unit other than goodwill on a pro-rata basis, because all assets of a cash-generating unit work together.

91. If the recoverable amount of an individual asset cannot be determined (see paragraph 65):

(a) an impairment loss is recognised for the asset if its carrying amount is greater than the higher of its net selling price and the results of the allocation procedures described in paragraphs 87 and 88; and

(b) no impairment loss is recognised for the asset if the related cash- generating unit is not impaired. This applies even if the asset's net selling price is less than its carrying amount.

Example

A machine has suffered physical damage but is still working, although not as well as it used to. The net selling price of the machine is less than its carrying amount. The machine does not generate

independent cash inflows from continuing use. The smallest identifiable group of assets that includes the machine and generates cash inflows from continuing use that are largely independent of the cash inflows from other assets is the production line to which the machine belongs. The recoverable amount of the production line shows that the production line taken as a whole is not impaired.

Assumption 1: Budgets/forecasts approved by management reflect no commitment of management to replace the machine.

The recoverable amount of the machine alone cannot be estimated since the machine's value in use:

(a) may differ from its net selling price; and

(b) can be determined only for the cash-generating unit to which the machine belongs (the production line).

The production line is not impaired, therefore, no impairment loss is recognised for the machine. Nevertheless, the enterprise may need to reassess the depreciation period or the depreciation method for the machine. Perhaps, a shorter depreciation period or a faster depreciation method is required to reflect the expected remaining useful life of the machine or the pattern in which economic benefits are consumed by the enterprise.

Assumption 2: Budgets/forecasts approved by management reflect a commitment of management to replace the machine and sell it in the near future. Cash flows from continuing use of the machine until its disposal are estimated to be negligible.

The machine's value in use can be estimated to be close to its net selling price. Therefore, the recoverable amount of the machine can be determined and no consideration is given to the cash-generating unit to which the machine belongs (the production line). Since the machine's net selling price is less than its carrying amount, an impairment loss is recognised for the machine.

92. After the requirements in paragraphs 87 and 88 have been applied, a liability should be recognised for any remaining amount of an impairment loss for a cash-generating unit if that is required by another Accounting Standard.

Reversal of an Impairment Loss

93. Paragraphs 94 to 100 set out the requirements for reversing an impairment loss recognised for an asset or a cash-generating unit in prior accounting periods. These requirements use the term 'an asset' but apply equally to an individual asset or a cash-generating unit. Additional requirements are set out for an individual asset in paragraphs 101 to 105, for a cash-generating unit in paragraphs 106 to 107 and for goodwill in paragraphs 108 to 111.

94. An enterprise should assess at each balance sheet date whether there is any indication that an impairment loss recognised for an asset in prior accounting periods may no longer exist or may have decreased. If any such indication exists, the enterprise should estimate the recoverable amount of that asset.

95. In assessing whether there is any indication that an impairment loss recognised for an asset in prior accounting periods may no longer exist or may have decreased, an enterprise should consider, as a minimum, the following indications:

External sources of information

(a) the asset's market value has increased significantly during the period;

(b) significant changes with a favourable effect on the enterprise have taken place during the period, or will take place in the near future, in the technological, market, economic

or legal environment in which the enterprise operates or in the market to which the asset is dedicated;

(c) market interest rates or other market rates of return on investments have decreased during the period, and those decreases are likely to affect the discount rate used in calculating the asset's value in use and increase the asset's recoverable amount materially;

Internal sources of information

(d) significant changes with a favourable effect on the enterprise have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, the asset is used or is expected to be used. These changes include capital expenditure that has been incurred during the period to improve or enhance an asset in excess of its originally assessed standard of performance or a commitment to discontinue or restructure the operation to which the asset belongs; and

(e) evidence is available from internal reporting that indicates that the economic performance of the asset is, or will be, better than expected.

96. Indications of a potential decrease in an impairment loss in paragraph 95 mainly mirror the indications of a potential impairment loss in paragraph 8. The concept of materiality applies in identifying whether an impairment loss recognised for an asset in prior accounting periods may need to be reversed and the recoverable amount of the asset determined.

97. If there is an indication that an impairment loss recognised for an asset may no longer exist or may have decreased, this may indicate that the remaining useful life, the depreciation (amortisation) method or the residual value may need to be reviewed and adjusted in accordance with the Accounting Standard applicable to the asset, even if no impairment loss is reversed for the asset.

98. An impairment loss recognised for an asset in prior accounting periods should be reversed if there has been a change in the estimates of cash inflows, cash outflows or discount rates used to determine the asset's recoverable amount since the last impairment loss was recognised. If this is the case, the carrying amount of the asset should be increased to its recoverable amount. That increase is a reversal of an impairment loss.

99. A reversal of an impairment loss reflects an increase in the estimated service potential of an asset, either from use or sale, since the date when an enterprise last recognised an impairment loss for that asset. An enterprise is required to identify the change in estimates that causes the increase in estimated service potential. Examples of changes in estimates include:

(a) a change in the basis for recoverable amount (i.e., whether recoverable amount is based on net selling price or value in use);

(b) if recoverable amount was based on value in use: a change in the amount or timing of estimated future cash flows or in the discount rate; or

(c) if recoverable amount was based on net selling price: a change in estimate of the components of net selling price.

100. An asset's value in use may become greater than the asset's carrying amount simply because the present value of future cash inflows increases as they become closer. However, the service potential of the asset has not increased. Therefore, an impairment loss is not reversed just because of the passage of time (sometimes called the 'unwinding' of the discount), even if the recoverable amount of the asset becomes higher than its carrying amount.

Reversal of an Impairment Loss for an Individual Asset

101. The increased carrying amount of an asset due to a reversal of an impairment loss should not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior accounting periods.

102. Any increase in the carrying amount of an asset above the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior accounting periods is a revaluation. In accounting for such a revaluation, an enterprise applies the Accounting Standard applicable to the asset.

103. A reversal of an impairment loss for an asset should be recognised as income immediately in the statement of profit and loss, unless the asset is carried at revalued amount in accordance with another Accounting Standard (see Accounting Standard (AS) 10, Accounting for Fixed Assets) in which case any reversal of an impairment loss on a revalued asset should be treated as a revaluation increase under that Accounting Standard.

104. A reversal of an impairment loss on a revalued asset is credited directly to equity under the heading revaluation surplus. However, to the extent that an impairment loss on the same revalued asset was previously recognised as an expense in the statement of profit and loss, a reversal of that impairment loss is recognised as income in the statement of profit and loss.

105. After a reversal of an impairment loss is recognised, the depreciation (amortisation) charge for the asset should be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

Reversal of an Impairment Loss for a Cash-Generating Unit

106. A reversal of an impairment loss for a cash-generating unit should be allocated to increase the carrying amount of the assets of the unit in the following order:

(a) first, assets other than goodwill on a pro-rata basis based on the carrying amount of each asset in the unit; and

(b) then, to goodwill allocated to the cash-generating unit (if any), if the requirements in paragraph 108 are met.

These increases in carrying amounts should be treated as reversals of impairment losses for individual assets and recognised in accordance with paragraph 103.

107. In allocating a reversal of an impairment loss for a cash-generating unit under paragraph 106, the carrying amount of an asset should not be increased above the lower of:

(a) its recoverable amount (if determinable); and

(b) the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior accounting periods.

The amount of the reversal of the impairment loss that would otherwise have been allocated to the asset should be allocated to the other assets of the unit on a pro-rata basis.

Reversal of an Impairment Loss for Goodwill

108. As an exception to the requirement in paragraph 98, an impairment loss recognised for goodwill should not be reversed in a subsequent period unless:

(a) the impairment loss was caused by a specific external event of an exceptional nature that is not expected to recur; and

(b) subsequent external events have occurred that reverse the effect of that event.

109. Accounting Standard (AS) 26, Intangible Assets, prohibits the recognition of internally generated goodwill. Any subsequent increase in the recoverable amount of goodwill is likely to be an increase in internally generated goodwill, unless the increase relates clearly to the reversal of the effect of a specific external event of an exceptional nature.

110. This Standard does not permit an impairment loss to be reversed for goodwill because of a change in estimates (for example, a change in the discount rate or in the amount and timing of future cash flows of the cash- generating unit to which goodwill relates).

111. A specific external event is an event that is outside of the control of the enterprise. Examples of external events of an exceptional nature include new regulations that significantly curtail the operating activities, or decrease the profitability, of the business to which the goodwill relates.

Impairment in case of Discontinuing Operations

112. The approval and announcement of a plan for discontinuance[6] is an indication that the assets attributable to the discontinuing operation may be impaired or that an impairment loss previously recognised for those assets should be increased or reversed. Therefore, in accordance with this Standard an enterprise estimates the recoverable amount of each asset of the discontinuing operation and recognises an impairment loss or reversal of a prior impairment loss, if any.

113. In applying this Standard to a discontinuing operation, an enterprise determines whether the recoverable amount of an asset of a discontinuing operation is assessed for the individual asset or for the asset's cash-generating unit. For example:

(a) if the enterprise sells the discontinuing operation substantially in its entirety, none of the assets of the discontinuing operation generate cash inflows independently from other assets within the discontinuing operation. Therefore, recoverable amount is determined for the discontinuing operation as a whole and an impairment loss, if any, is allocated among the assets of the discontinuing operation in accordance with this Standard;

(b) if the enterprise disposes of the discontinuing operation in other ways such as piecemeal sales, the recoverable amount is determined for individual assets, unless the assets are sold in groups; and

(c) if the enterprise abandons the discontinuing operation, the recoverable amount is determined for individual assets as set out in this Standard.

114. After announcement of a plan, negotiations with potential purchasers of the discontinuing operation or actual binding sale agreements may indicate that the assets of the discontinuing operation may be further impaired or that impairment losses recognised for these assets in prior periods may have decreased. As a consequence, when such events occur, an enterprise re- estimates the recoverable amount of the assets of the discontinuing operation and recognises resulting impairment losses or reversals of impairment losses in accordance with this Standard.

115. A price in a binding sale agreement is the best evidence of an asset's (cash-generating unit's) net selling price or of the estimated cash inflow from ultimate disposal in determining the asset's (cash-generating unit's) value in use.

---

[6] See Accounting Standard (AS) 24 'Discontinuing Operations'

116. The carrying amount (recoverable amount) of a discontinuing operation includes the carrying amount (recoverable amount) of any goodwill that can be allocated on a reasonable and consistent basis to that discontinuing operation.

Disclosure

117. For each class of assets, the financial statements should disclose:

(a) the amount of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are included;

(b) the amount of reversals of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are reversed;

(c) the amount of impairment losses recognised directly against revaluation surplus during the period; and

(d) the amount of reversals of impairment losses recognised directly in revaluation surplus during the period.

118. A class of assets is a grouping of assets of similar nature and use in an enterprise's operations.

119. The information required in paragraph 117 may be presented with other information disclosed for the class of assets. For example, this information may be included in a reconciliation of the carrying amount of fixed assets, at the beginning and end of the period, as required under AS 10, Accounting for Fixed Assets.

120. An enterprise that applies AS 17, Segment Reporting, should disclose the following for each reportable segment based on an enterprise's primary format (as defined in AS 17):

(a) the amount of impairment losses recognised in the statement of profit and loss and directly against revaluation surplus during the period; and

(b) the amount of reversals of impairment losses recognised in the statement of profit and loss and directly in revaluation surplus during the period.

121. If an impairment loss for an individual asset or a cash-generating unit is recognised or reversed during the period and is material to the financial statements of the reporting enterprise as a whole, an enterprise should disclose:

(a) the events and circumstances that led to the recognition or reversal of the impairment loss;

(b) the amount of the impairment loss recognised or reversed;

(c) for an individual asset:

(i) the nature of the asset; and

(ii) the reportable segment to which the asset belongs, based on the enterprise's primary format (as defined in AS 17, Segment Reporting);

(d) for a cash-generating unit:

(i) a description of the cash-generating unit (such as whether it is a product line, a plant, a business operation, a geographical area, a reportable segment as defined in AS 17 or other);

(ii) the amount of the impairment loss recognised or reversed by class of assets and by reportable segment based on the enterprise's primary format (as defined in AS 17); and

(iii) if the aggregation of assets for identifying the cash-generating unit has changed since the previous estimate of the cash- generating unit's recoverable amount (if any), the enterprise should describe the current and former way of aggregating assets and the reasons for changing the way the cash- generating unit is identified;

(e) whether the recoverable amount of the asset (cash-generating unit) is its net selling price or its value in use;

(f) if recoverable amount is net selling price, the basis used to determine net selling price (such as whether selling price was determined by reference to an active market or in some other way); and

(g) if recoverable amount is value in use, the discount rate(s) used in the current estimate and previous estimate (if any) of value in use. Provided that if a Small and Medium-sized Company (SMC) or a Small and Medium-sized Enterprise (SME) (Level II or Level III non-corporate entity), chooses to measure the 'value in use' as per the proviso to paragraph 4.2 of the Standard, such an SMC/ SME need not disclose the information required by paragraph 121(g) of the Standard.

122. If impairment losses recognised (reversed) during the period are material in aggregate to the financial statements of the reporting enterprise as a whole, an enterprise should disclose a brief description of the following:

(a) the main classes of assets affected by impairment losses (reversals of impairment losses) for which no information is disclosed under paragraph 121; and

(b) the main events and circumstances that led to the recognition (reversal) of these impairment losses for which no information is disclosed under paragraph 121.

123. An enterprise is encouraged to disclose key assumptions used to determine the recoverable amount of assets (cash-generating units) during the period.

Transitional Provisions

124. On the date of this Standard becoming mandatory, an enterprise should assess whether there is any indication that an asset may be impaired (see paragraphs 5-13). If any such indication exists, the enterprise should determine impairment loss, if any, in accordance with this Standard. The impairment loss, so determined, should be adjusted against opening balance of revenue reserves being the accumulated impairment loss relating to periods prior to this Standard becoming mandatory unless the impairment loss is on a revalued asset. An impairment loss on a revalued asset should be recognised directly against any revaluation surplus for the asset to the extent that the impairment loss does not exceed the amount held in the revaluation surplus for that same asset. If the impairment loss exceeds the amount held in the revaluation surplus for that same asset, the excess should be adjusted against opening balance of revenue reserves.

125. Any impairment loss arising after the date of this Standard becoming mandatory should be recognised in accordance with this Standard (i.e., in the statement of profit and loss unless an asset is carried at revalued amount. An impairment loss on a revalued asset should be treated as a revaluation decrease).

Illustrations

These illustrations do not form part of the Accounting Standard. The purpose of these Illustration is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.

All these illustrations assume the enterprises concerned have no transactions other than those described.

Illustration 1 - Identification of Cash-Generating Units

The purpose of this Illustration is:

(a) to give an indication of how cash-generating units are identified in various situations; and

(b) to highlight certain factors that an enterprise may consider in identifying the cash-generating unit to which an asset belongs.

A - Retail Store Chain

Background

A1. Store X belongs to a retail store chain M. X makes all its retail purchases through M's purchasing centre. Pricing, marketing, advertising and human resources policies (except for hiring X's cashiers and salesmen) are decided by M. M also owns 5 other stores in the same city as X (although in different neighbourhoods) and 20 other stores in other cities. All stores are managed in the same way as X. X and 4 other stores were purchased 4 years ago and goodwill was recognised.

What is the cash-generating unit for X (X's cash-generating unit)?

Analysis

A2. In identifying X's cash-generating unit, an enterprise considers whether, for example:

(a) internal management reporting is organised to measure performance on a store-by-store basis; and

(b) the business is run on a store-by-store profit basis or on region/city basis.

A3. All M's stores are in different neighbourhoods and probably have different customer bases. So, although X is managed at a corporate level, X generates cash inflows that are largely independent from those of M's other stores. Therefore, it is likely that X is a cash-generating unit.

A4. If the carrying amount of the goodwill can be allocated on a reasonable and consistent basis to X's cash-generating unit, M applies the 'bottom-up' test described in paragraph 78 of this Standard. If the carrying amount of the goodwill cannot be allocated on a reasonable and consistent basis to X's cash-generating unit, M applies the 'bottom-up' and 'top-down' tests.

B - Plant for an Intermediate Step in a Production Process

Background

A5. A significant raw material used for plant Y's final production is an intermediate product bought from plant X of the same enterprise. X's products are sold to Y at a transfer price that passes all margins to X. 80% of Y's final production is sold to customers outside of the reporting enterprise.

60% of X's final production is sold to Y and the remaining 40% is sold to customers outside of the reporting enterprise.

For each of the following cases, what are the cash-generating units for X and Y?

Case 1: X could sell the products it sells to Y in an active market. Internal transfer prices are higher than market prices.

Case 2: There is no active market for the products X sells to Y.

Analysis

Case 1

A6. X could sell its products on an active market and, so, generate cash inflows from continuing use that would be largely independent of the cash inflows from Y. Therefore, it is likely that X is a separate cash-generating unit, although part of its production is used by Y (see paragraph 68 of this Standard).

A7. It is likely that Y is also a separate cash-generating unit. Y sells 80% of its products to customers outside of the reporting enterprise. Therefore, its cash inflows from continuing use can be considered to be largely independent.

A8. Internal transfer prices do not reflect market prices for X's output. Therefore, in determining value in use of both X and Y, the enterprise adjusts financial budgets/forecasts to reflect management's best estimate of future market prices for those of X's products that are used internally (see paragraph 68 of this Standard).

Case 2

A9. It is likely that the recoverable amount of each plant cannot be assessed independently from the recoverable amount of the other plant because:

(a) the majority of X's production is used internally and could not be sold in an active market. So, cash inflows of X depend on demand for Y's products. Therefore, X cannot be considered to generate cash inflows that are largely independent from those of Y; and

(b) the two plants are managed together.

A10. As a consequence, it is likely that X and Y together is the smallest group of assets that generates cash inflows from continuing use that are largely independent.

C - Single Product Enterprise

Background

A11. Enterprise M produces a single product and owns plants A, B and C. Each plant is located in a different continent. A produces a component that is assembled in either B or C. The combined capacity of B and C is not fully utilised. M's products are sold world-wide from either B or C. For example, B's production can be sold in C's continent if the products can be delivered faster from B than from C. Utilisation levels of B and C depend on the allocation of sales between the two sites.

For each of the following cases, what are the cash-generating units for A, B and C?

Case 1: There is an active market for A's products.

Case 2: There is no active market for A's products.

Analysis

Case 1

A12. It is likely that A is a separate cash-generating unit because there is an active market for its products (see Example B-Plant for an Intermediate Step in a Production Process, Case 1).

A13. Although there is an active market for the products assembled by B and C, cash inflows for B and C depend on the allocation of production across the two sites. It is unlikely that the future cash inflows for B and C can be determined individually. Therefore, it is likely that B and C together is the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent.

A14. In determining the value in use of A and B plus C, M adjusts financial budgets/forecasts to reflect its best estimate of future market prices for A's products (see paragraph 68 of this Standard).

Case 2

A15. It is likely that the recoverable amount of each plant cannot be assessed independently because:

(a) there is no active market for A's products. Therefore, A's cash inflows depend on sales of the final product by B and C; and

(b) although there is an active market for the products assembled by B and C, cash inflows for B and C depend on the allocation of production across the two sites. It is unlikely that the future cash inflows for B and C can be determined individually.

A16. As a consequence, it is likely that A, B and C together (i.e., M as a whole) is the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent.

D - Magazine Titles

Background

A17. A publisher owns 150 magazine titles of which 70 were purchased and 80 were self-created. The price paid for a purchased magazine title is recognised as an intangible asset. The costs of creating magazine titles and maintaining the existing titles are recognised as an expense when incurred. Cash inflows from direct sales and advertising are identifiable for each magazine title. Titles are managed by customer segments. The level of advertising income for a magazine title depends on the range of titles in the customer segment to which the magazine title relates. Management has a policy to abandon old titles before the end of their economic lives and replace them immediately with new titles for the same customer segment.

What is the cash-generating unit for an individual magazine title?

Analysis

A18. It is likely that the recoverable amount of an individual magazine title can be assessed. Even though the level of advertising income for a title is influenced, to a certain extent, by the other titles in the customer segment, cash inflows from direct sales and advertising are identifiable for each title. In addition, although titles are managed by customer segments, decisions to abandon titles are made on an individual title basis.

A19. Therefore, it is likely that individual magazine titles generate cash inflows that are largely independent one from another and that each magazine title is a separate cash-generating unit.

E - Building: Half-Rented to Others and Half-Occupied for Own Use

Background

A20. M is a manufacturing company. It owns a headquarter building that used to be fully occupied for internal use. After down-sizing, half of the building is now used internally and half rented to third parties. The lease agreement with the tenant is for five years.

What is the cash-generating unit of the building?

Analysis

A21. The primary purpose of the building is to serve as a corporate asset, supporting M's manufacturing activities. Therefore, the building as a whole cannot be considered to generate cash inflows that are largely independent of the cash inflows from the enterprise as a whole. So, it is likely that the cash-generating unit for the building is M as a whole.

A22. The building is not held as an investment. Therefore, it would not be appropriate to determine the value in use of the building based on projections of future market related rents.

Illustration 2 - Calculation of Value in Use and Recognition of an Impairment Loss

In this illustration, tax effects are ignored.

Background and Calculation of Value in Use

A23. At the end of 20X0, enterprise T acquires enterprise M for ₹ 10,000 lakhs. M has manufacturing plants in 3 countries. The anticipated useful life of the resulting merged activities is 15 years.

Schedule 1. Data at the end of 20X0 (Amount in ₹ lakhs)

End of 20X0	*Allocation of purchase price*	*Fair value of identifiable assets*	*Goodwill*[1]
Activities in Country A	3,000	2,000	1,000
Activities in Country B	2,000	1,500	500
Activities in Country C	5,000	3,500	1,500
Total	10,000	7,000	3,000

A24. T uses straight-line depreciation over a 15-year life for the Country A assets and no residual value is anticipated. In respect of goodwill, T uses straight-line amortisation over a 5 year life.

A25. In 20X4, a new government is elected in Country A. It passes legislation significantly restricting exports of T's main product. As a result, and for the foreseeable future, T's production will be cut by 40%.

A26. The significant export restriction and the resulting production decrease require T to estimate the recoverable amount of the goodwill and net assets of the Country A operations. The cash-generating unit for the goodwill and the identifiable assets of the Country A operations is the Country A operations, since no independent cash inflows can be identified for individual assets.

A27. The net selling price of the Country A cash-generating unit is not determinable, as it is unlikely that a ready buyer exists for all the assets of that unit.

A28. To determine the value in use for the Country A cash-generating unit (see Schedule 2), T:

(a) prepares cash flow forecasts derived from the most recent financial budgets/forecasts for the next five years (years 20X5-20X9) approved by management;

(b) estimates subsequent cash flows (years 20X10-20X15) based on declining growth rates. The growth rate for 20X10 is estimated to be 3%. This rate is lower than the average long-term growth rate for the market in Country A; and

(c) selects a 15% discount rate, which represents a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the Country A cash-generating unit.

---

[1] Activities in each country are the smallest cash-generating units to which goodwill can be allocated on a reasonable and consistent basis (allocation based on the purchase price of the activities in each country, as specified in the purchase agreement).

Recognition and Measurement of Impairment Loss

A29. The recoverable amount of the Country A cash-generating unit is 1,360 lakhs: the higher of the net selling price of the Country A cash- generating unit (not determinable) and its value in use (₹ 1,360 lakhs).

A30. T compares the recoverable amount of the Country A cash-generating unit to its carrying amount (see Schedule 3).

A31. T recognises an impairment loss of ₹ 307 lakhs immediately in the statement of profit and loss. The carrying amount of the goodwill that relates to the Country A operations is eliminated before reducing the carrying amount of other identifiable assets within the Country A cash-generating unit (see paragraph 87 of this Standard).

A32. Tax effects are accounted for separately in accordance with AS 22, Accounting for Taxes on Income.

Schedule 2. Calculation of the value in use of the Country A cash-generating unit at the end of 20X4 (Amount in ₹ lakhs)

Year	*Long-term growth rates*	*Future cash flows*	*Present value factor at 15% discount rate*[3]	*Discounted future cash flows*
20X5 (n=1)		230(1)	0.86957	200
20X6		253(1)	0.75614	191
20X7		273(1)	0.65752	180
20X8		290(1)	0.57175	166
20X9		304(1)	0.49718	151
20X10	3%	313(2)	0.43233	135
20X11	–2%	307(2)	0.37594	115
20X12	–6%	289(2)	0.32690	94
20X13	–15%	245(2)	0.28426	70
20X14	–25%	184(2)	0.24719	45
20X15	–67%	61(2)	0.21494	13
Value in use				1,360

Schedule 3. Calculation and allocation of the impairment loss for the Country A cash-generating unit at the end of 20X4 (Amount in ₹ lakhs)

End of 20X4	*Goodwill*	*Identifiable assets*	*Total*
Historical cost	1,000	2,000	3,000
Accumulated depreciation/amortisation	(800)	(533)	(1,333)

[3] The present value factor is calculated as $k = 1/(1+a)^n$, where a = discount rate and n = period of discount.

(1) Based on management's best estimate of net cash flow projections (after the 40% cut).

(2) Based on an extrapolation from preceding year cash flow using declining growth rates.

(20X1-20X4)			
Carrying amount	200	1,467	1,667
Impairment Loss	(200)	(107)	(307)
Carrying amount after impairment loss	0	1,360	1,360

Illustration 3 - Deferred Tax Effects

A33. An enterprise has an asset with a carrying amount of ₹ 1,000 lakhs. Its recoverable amount is ₹ 650 lakhs. The tax rate is 30% and the carrying amount of the asset for tax purposes is ₹ 800 lakhs. Impairment losses are not allowable as deduction for tax purposes. The effect of the impairment loss is as follows:

	Amount in ₹ lakhs
Impairment Loss recognised in the statement of profit and loss	350
Impairment Loss allowed for tax purposes	----
— Timing Difference	350
Tax Effect of the above timing difference at 30%	
(deferred tax asset)	105
Less: Deferred tax liability due to difference in depreciation for accounting	
purposes and tax purposes [(1,000 – 800) x 30%]	60
Deferred tax asset	45

A34. In accordance with AS 22, Accounting for Taxes on Income, the enterprise recognises the deferred tax asset subject to the consideration of prudence as set out in AS 22.

Illustration 4 - Reversal of an Impairment Loss

Use the data for enterprise T as presented in Illustration 2, with supplementary information as provided in this illustration. In this illustration tax effects are ignored.

Background

A35. In 20X6, the government is still in office in Country A, but the business situation is improving. The effects of the export laws on T's production are proving to be less drastic than initially expected by management. As a result, management estimates that production will increase by 30%. This favourable change requires T to re-estimate the recoverable amount of the net assets of the Country A operations (see paragraphs 94-95 of this Standard). The cash-generating unit for the net assets of the Country A operations is still the Country A operations.

A36. Calculations similar to those in Illustration 2 show that the recoverable amount of the Country A cash-generating unit is now ₹ 1,710 lakhs.

Reversal of Impairment Loss

A37. T compares the recoverable amount and the net carrying amount of the Country A cash-generating unit.

Schedule 1. Calculation of the carrying amount of the Country A cash- generating unit at the end of 20X6 (Amount in ₹ lakhs)

End of 20X4 (Example 2)

	Goodwill	*Identifiable assets*	*Total*
Historical cost	*1,000*	*2,000*	*3,000*
Accumulated depreciation/amortisation (4 years)	*(800)*	*(533)*	*(1,333)*
Impairment loss	*(200)*	*(107)*	*(307)*
Carrying amount afterimpairment loss	*0*	*1,360*	*1,360*
End of 20X6			
Additional depreciation (2 years)[1]	*–*	*(247)*	*(247)*
Carrying amount	*0*	*1,113*	*1,113*
Recoverable amount			*1,710*
Excess of recoverable amount over carrying amount			*597*

A38. There has been a favourable change in the estimates used to determine the recoverable amount of the Country A net assets since the last impairment loss was recognised. Therefore, in accordance with paragraph 98 of this Standard, T recognises a reversal of the impairment loss recognised in 20X4.

A39. In accordance with paragraphs 106 and 107 of this Standard, T increases the carrying amount of the Country A identifiable assets by ₹ 87 lakhs (see Schedule 3), i.e., up to the lower of recoverable amount (₹ 1,710 lakhs) and the identifiable assets' depreciated historical cost (₹ 1,200 lakhs) (see Schedule 2). This increase is recognised in the statement of profit and loss immediately.

Schedule 2. Determination of the depreciated historical cost of the Country

A identifiable assets at the end of 20X6 (Amount in ₹ lakhs)

End of 20X6	*Identifiable assets*
Historical cost	2,000
Accumulated depreciation (133.3 * 6 years)	(800)
Depreciated historical cost	1,200
Carrying amount (Schedule 1)	1,113
Difference	87

Schedule 3. Carrying amount of the Country A assets at the end of 20X6 (Amount in ₹ lakhs)

End of 20X6	*Goodwill*	*Identifiable assets*	*Total*
Gross carrying amount	1,000	2,000	3,000
Accumulated depreciation/amortisation	(800)	(780)	(1,580)
Accumulated impairment loss	(200)	(107)	(307)

[1] After recognition of the impairment loss at the end of 20X4, T revised the depreciation charge for the Country A identifiable assets (from ₹ 133.3 lakhs per year to ₹ 123.7 lakhs per year), based on the revised carrying amount and remaining useful life (11 years).

Carrying amount	0	1,113	1,113
Reversal of impairment loss	0	87	87
Carrying amount after reversal of impairment loss	0	1,200	1,200

Illustration 5 - Treatment of a Future Restructuring

In this illustration, tax effects are ignored.

Background

A40. At the end of 20X0, enterprise K tests a plant for impairment. The plant is a cash-generating unit. The plant's assets are carried at depreciated historical cost. The plant has a carrying amount of ₹ 3,000 lakhs and a remaining useful life of 10 years.

A41. The plant is so specialised that it is not possible to determine its net selling price. Therefore, the plant's recoverable amount is its value in use. Value in use is calculated using a pre-tax discount rate of 14%.

A42. Management approved budgets reflect that:

(a) at the end of 20X3, the plant will be restructured at an estimated cost of ₹ 100 lakhs. Since K is not yet committed to the restructuring, a provision has not been recognised for the future restructuring costs; and

(b) there will be future benefits from this restructuring in the form of reduced future cash outflows.

A43. At the end of 20X2, K becomes committed to the restructuring. The costs are still estimated to be ₹ 100 lakhs and a provision is recognised accordingly. The plant's estimated future cash flows reflected in the most recent management approved budgets are given in paragraph A47 and a current discount rate is the same as at the end of 20X0.

A44. At the end of 20X3, restructuring costs of ₹ 100 lakhs are paid. Again, the plant's estimated future cash flows reflected in the most recent management approved budgets and a current discount rate are the same as those estimated at the end of 20X2.

At the End of 20X0

Schedule 1. Calculation of the plant's value in use at the end of 20X0 (Amount in ₹ lakhs)

Year	*Future cash flows*	*Discounted at 14%*
20X1	300	263
20X2	280	215
20X3	420[1]	283
20X4	520[2]	308
20X5	350[2]	182
20X6	420[2]	191

[1] Excludes estimated restructuring costs reflected in management budgets.
[2] Excludes estimated benefits expected from the restructuring reflected in management budgets.

20X7	480(2)	192
20X8	480(2)	168
20X9	460(2)	141
20X10	400(2)	108
Value in use		2,051

(1) Excludes estimated restructuring costs reflected in management budgets.
(2) Excludes estimated benefits expected from the restructuring reflected in management budgets.

A45.The plant's recoverable amount (value in use) is less than its carrying amount. Therefore, K recognises an impairment loss for the plant.

Schedule 2. Calculation of the impairment loss at the end of 20X0 (Amount in ₹ lakhs)

	Plant
Carrying amount before impairment loss	3,000
Recoverable amount (Schedule 1)	2,051
Impairment loss	(949)
Carrying amount after impairment loss	2,051

At the End of 20X1

A46. No event occurs that requires the plant's recoverable amount to be re- estimated. Therefore, no calculation of the recoverable amount is required to be performed.

At the End of 20X2

A47. The enterprise is now committed to the restructuring. Therefore, in determining the plant's value in use, the benefits expected from the restructuring are considered in forecasting cash flows. This results in an increase in the estimated future cash flows used to determine value in use at the end of 20X0. In accordance with paragraphs 94-95 of this Standard, the recoverable amount of the plant is re-determined at the end of 20X2.

Schedule 3. Calculation of the plant's value in use at the end of 20X2 (Amount in ₹ lakhs)

Year	*Future cash flows*	*Discounted at 14%*
20X3	*420(1)*	*368*
20X4	570(2)	439
20X5	380(2)	256
20X6	450(2)	266
20X7	510(2)	265
20X8	510(2)	232
20X9	480(2)	192

(1) Excludes estimated restructuring costs because a liability has already been recognised.
(2) Includes estimated benefits expected from the restructuring reflected in management budgets.

20X10	410[(2)]	144
Value in use		2,162

A48. The plant's recoverable amount (value in use) is higher than its carrying amount (see Schedule 4). Therefore, K reverses the impairment loss recognised for the plant at the end of 20X0.

Schedule 4. Calculation of the reversal of the impairment loss at the end of 20X2 (Amount in ₹ lakhs)

Plant

Carrying amount at the end of 20X0 (Schedule 2)	2,051
End of 20X2	
Depreciation charge (for 20X1 and 20X2 Schedule 5)	(410)
Carrying amount before reversal	1,641
Recoverable amount (Schedule 3)	2,162
Reversal of the impairment loss	521
Carrying amount after reversal	2,162
Carrying amount: depreciated historical cost (Schedule 5)	2,400[(1)]

At the End of 20X3

A49. There is a cash outflow of ₹ 100 lakhs when the restructuring costs are paid. Even though a cash outflow has taken place, there is no change in the estimated future cash flows used to determine value in use at the end of 20X2. Therefore, the plant's recoverable amount is not calculated at the end of 20X3

Schedule 5. Summary of the carrying amount of the plant (Amount in ₹ lakhs)

End of year	*Depreciated historical cost*	*Recoverable amount charge*	*Adjusted depreciation*	*Impairment loss after*	*Carrying amount impairment*
20X0	3,000	2,051	0	(949)	2,051
20X1	2,700	n.c.	(205)	0	1,846
20X2	2,400	2,162	(205)	521	2,162
20X3	2,100	n.c.	(270)	0	1,892

n.c. = not calculated as there is no indication that the impairment loss may have increased/decreased.

Illustration 6 - Treatment of Future Capital Expenditure

In this illustration, tax effects are ignored.

Background

A50. At the end of 20X0, enterprise F tests a plane for impairment. The plane is a cash-generating unit. It is carried at depreciated historical cost and its carrying amount is ₹ 1,500 lakhs. It has an estimated remaining useful life of 10 years.

---

(1) The reversal does not result in the carrying amount of the plant exceeding what its carrying amount would have been at depreciated historical cost. Therefore, the full reversal of the impairment loss is recognised.

A51. For the purpose of this illustration, it is assumed that the plane's net selling price is not determinable. Therefore, the plane's recoverable amount is its value in use. Value in use is calculated using a pre-tax discount rate of 14%.

A52. Management approved budgets reflect that:

(a) in 20X4, capital expenditure of ₹ 250 lakhs will be incurred to renew the engine of the plane; and

(b) this capital expenditure will improve the performance of the plane by decreasing fuel consumption.

A53. At the end of 20X4, renewal costs are incurred. The plane's estimated future cash flows reflected in the most recent management approved budgets are given in paragraph A56 and a current discount rate is the same as at the end of 20X0.

At the End of 20X0

Schedule 1. Calculation of the plane's value in use at the end of 20X0 (Amount in ₹ lakhs)

Year	*Future cash flows*	*Discounted at 14%*
20X1	221.65	194.43
20X2	214.50	165.05
20X3	205.50	138.71
20X4	247.25[1]	146.39
20X5	253.25[2]	131.53
20X6	248.25[2]	113.10
20X7	241.22[2]	96.40
20X8	255.33[2]	89.51
20X9	242.34[2]	74.52
20X10	228.50[2]	61.64
Value in use		1,211.28

A54. The plane's carrying amount is less than its recoverable amount (value in use). Therefore, F recognises an impairment loss for the plane.

Schedule 2. Calculation of the impairment loss at the end of 20X0 (Amount in ₹ lakhs)

	Plane
Carrying amount before impairment loss	1,500.00
Recoverable amount (Schedule 1)	1,211.28
Impairment loss	(288.72)
Carrying amount after impairment loss	1,211.28

[1] Excludes estimated renewal costs reflected in management budgets.

[2] Excludes estimated benefits expected from the renewal of the engine reflected in management budgets.

Years 20X1-20X3

A55. No event occurs that requires the plane's recoverable amount to be re-estimated. Therefore, no calculation of recoverable amount is required to be performed.

At the End of 20X4

A56. The capital expenditure is incurred. Therefore, in determining the plane's value in use, the future benefits expected from the renewal of the engine are considered in forecasting cash flows. This results in an increase in the estimated future cash flows used to determine value in use at the end of 20X0. As a consequence, in accordance with paragraphs 94-95 of this Standard, the recoverable amount of the plane is recalculated at the end of 20X4.

Schedule 3. Calculation of the plane's value in use at the end of 20X4 (Amount in ₹ lakhs)

Year	*Future cash flows*[1]	*Discounted at 14%*
20X5	303.21	265.97
20X6	327.50	252.00
20X7	317.21	214.11
20X8	319.50	189.17
20X9	331.00	171.91
20X10	279.99	127.56
Value in use		1,220.72

A57. The plane's recoverable amount (value in use) is higher than the plane's carrying amount and depreciated historical cost (see Schedule 4). Therefore, K reverses the impairment loss recognised for the plane at the end of 20X0 so that the plane is carried at depreciated historical cost.

Schedule 4. Calculation of the reversal of the impairment loss at the end of 20X4 (Amount in ₹ lakhs)

	Plane
Carrying amount at the end of 20X0 (Schedule 2)	1,211.28
End of 20X4	
Depreciation charge (20X1 to 20X4-Schedule 5)	(484.52)
Renewal expenditure	250.00
Carrying amount before reversal	976.76
Recoverable amount (Schedule 3)	1,220.72
Reversal of the impairment loss	173.24
Carrying amount after reversal	1,150.00
Carrying amount: depreciated historical cost (Schedule 5)	1,150.00[1]

[1] Includes estimated benefits expected from the renewal of the engine reflected in management budgets.
[1] The value in use of the plane exceeds what its carrying amount would have been at depreciated historical cost. Therefore, the reversal is limited to an amount that does not result in the carrying amount of the plane exceeding depreciated historical cost.

Schedule 5. Summary of the carrying amount of the plane (Amount in ₹ lakhs)

Year	*Depreciated historical cost*	*Recoverable amount*	*Adjusted depreciation charge*	*Impairment loss*	*Carrying amount after impairment*
20X0	1,500.00	1,211.28	0	(288.72)	1,211.28
20X1	1,350.00	n.c.	(121.13)	0	1,090.15
20X2	1,200.00	n.c.	(121.13)	0	969.02
20X3	1,050.00	n.c.	(121.13)	0	847.89
20X4	900.00		(121.13)		
Renewal	250.00		–		
	1,150.00	1,220.72	(121.13)	173.24	1,150.00
20X5	958.33	n.c.	(191.67)	0	958.33

n.c. = not calculated as there is no indication that the impairment loss may have increased/decreased.

Illustration 7 - Application of the 'Bottom-Up' and 'Top-Down' Tests to Goodwill

In this illustration, tax effects are ignored.

A58. At the end of 20X0, enterprise M acquired 100% of enterprise Z for ₹ 3,000 lakhs. Z has 3 cash-generating units A, B and C with net fair values of ₹ 1,200 lakhs, ₹ 800 lakhs and ₹ 400 lakhs respectively. M recognises goodwill of ₹ 600 lakhs (₹ 3,000 lakhs less ₹ 2,400 lakhs) that relates to Z.

A59. At the end of 20X4, A makes significant losses. Its recoverable amount is estimated to be ₹ 1,350 lakhs. Carrying amounts are detailed below.

Schedule 1. Carrying amounts at the end of 20X4 (Amount in ₹ lakhs)

End of 20X4	*A*	*B*	*C*	*Goodwill*	*Total*
Net carrying amount	1,300	1,200	800	120	3,420

A - Goodwill Can be Allocated on a Reasonable and Consistent Basis

A60. At the date of acquisition of Z, the net fair values of A, B and C are considered a reasonable basis for a pro-rata allocation of the goodwill to A, B and C.

Schedule 2. Allocation of goodwill at the end of 20X4

End of 20X0				
	A	B	C	Total
Net fair values	1,200	800	400	2,400
Pro-rata	50%	33%	17%	100%
End of 20X4				
Net carrying amount	1,300	1,200	800	3,300
Allocation of goodwill				
(using the pro-rata above)	60	40	20	120
Net carrying amount	1,360	1,240	820	3,420
(after allocation of goodwill				

A61. In accordance with the 'bottom-up' test in paragraph 78(a) of this Standard, M compares A's recoverable amount to its carrying amount after the allocation of the carrying amount of goodwill.

Schedule 3. Application of 'bottom-up' test (Amount in ₹ lakhs)

End of 20X4	*A*
Carrying amount after allocation of goodwill (Schedule 2)	1,360
Recoverable amount	1,350
Impairment loss	10

A62. M recognises an impairment loss of ₹ 10 lakhs for A. The impairment loss is fully allocated to the goodwill in accordance with paragraph 87 of this Standard.

B - Goodwill Cannot Be Allocated on a Reasonable and Consistent Basis

A63. There is no reasonable way to allocate the goodwill that arose on the acquisition of Z to A, B and C. At the end of 20X4, Z's recoverable amount is estimated to be ₹ 3,400 lakhs.

A64. At the end of 20X4, M first applies the 'bottom-up' test in accordance with paragraph 78(a) of this Standard. It compares A's recoverable amount to its carrying amount excluding the goodwill.

Schedule 4. Application of 'bottom-up' test (Amount in ₹ lakhs)

End of 20X4	*A*
Carrying amount	1,300
Recoverable amount	1,350
Impairment loss	0

A65. Therefore, no impairment loss is recognised for A as a result of the 'bottom-up' test.

A66. Since the goodwill could not be allocated on a reasonable and consistent basis to A, M also performs a 'top-down' test in accordance with paragraph 78(b) of this Standard. It compares the carrying amount of Z as a whole to its recoverable amount (Z as a whole is the smallest cash-generating unit that includes A and to which goodwill can be allocated on a reasonable and consistent basis).

Schedule 5. Application of the 'top-down' test (Amount in ₹ lakhs)

End of 20X4	*A*	*B*	*C*	*Goodwill*	*Z*
Carrying amount	1,300	1,200	800	120	3,420
Impairment loss arising from the 'bottom-up' test	0	–	–	–	0
Carrying amount after the 'bottom-up' test	1,300	1,200	800	120	3,420
Recoverable amount					3,400
Impairment loss arising from 'top-down' test					20

A67. Therefore, M recognises an impairment loss of ₹ 20 lakhs that it allocates fully to goodwill in accordance with paragraph 87 of this Standard.

Illustration 8 - Allocation of Corporate Assets

In this illustration tax effects are ignored.

Background

A68. Enterprise M has three cash-generating units: A, B and C. There are adverse changes in the technological environment in which M operates. Therefore, M conducts impairment tests of each of its cash-generating units. At the end of 20X0, the carrying amounts of A, B and C are ₹ 100 lakhs, ₹ 150 lakhs and ₹ 200 lakhs respectively.

A69. The operations are conducted from a headquarter. The carrying amount of the headquarter assets is ₹ 200 lakhs: a headquarter building of ₹ 150 lakhs and a research centre of ₹ 50 lakhs. The relative carrying amounts of the cash-generating units are a reasonable indication of the proportion of the head-quarter building devoted to each cash-generating unit. The carrying amount of the research centre cannot be allocated on a reasonable basis to the individual cash-generating units.

A70. The remaining estimated useful life of cash-generating unit A is 10 years. The remaining useful lives of B, C and the headquarter assets are 20 years. The headquarter assets are depreciated on a straight-line basis.

A71. There is no basis on which to calculate a net selling price for each cash-generating unit. Therefore, the recoverable amount of each cash- generating unit is based on its value in use. Value in use is calculated using a pre-tax discount rate of 15%.

Identification of Corporate Assets

A72. In accordance with paragraph 85 of this Standard, M first identifies all the corporate assets that relate to the individual cash-generating units under review. The corporate assets are the headquarter building and the research centre.

A73. M then decides how to deal with each of the corporate assets:

(a) the carrying amount of the headquarter building can be allocated on a reasonable and consistent basis to the cash-generating units under review. Therefore, only a 'bottom-up' test is necessary; and

(b) the carrying amount of the research centre cannot be allocated on a reasonable and consistent basis to the individual cash- generating units under review. Therefore, a 'top-down' test will be applied in addition to the 'bottom-up' test.

Allocation of Corporate Assets

A74. The carrying amount of the headquarter building is allocated to the carrying amount of each individual cash-generating unit. A weighted allocation basis is used because the estimated remaining useful life of A's cash-generating unit is 10 years, whereas the estimated remaining useful lives of B and C's cash-generating units are 20 years.

Schedule 1. Calculation of a weighted allocation of the carrying amount of the headquarter building (Amount in ₹ lakhs)

End of 20X0	*A*	*B*	*C*	*Total*
Carrying amount	100	150	200	450
Useful life	10 years	20 years	20 years	
Weighting based on useful life	1	2	2	
Carrying amount after weighting	100	300	400	800

Pro-rata allocation of the building	12.5% (100/800)	37.5% (300/800)	50% (400/800)	100%
Allocation of the carrying amount of the building(based on pro-rata above)	19	56	75	150
Carrying amount (after allocation of the building)	119	206	275	600

Determination of Recoverable Amount

A75. The 'bottom-up' test requires calculation of the recoverable amount of each individual cash-generating unit. The 'top-down' test requires calculation of the recoverable amount of M as a whole (the smallest cash- generating unit that includes the research centre).

Schedule 2. Calculation of A, B, C and M's value in use at the end of 20X0 (Amount in ₹ lakhs)

Year	A		B		C		M	
	Future cash flows	*Discount at 15%*	*Future cash flows*	*Discount at 15%*	*Future cash flows*	*Discount at 15%*	*Future cash flows*	*Discount at 15%*
1	2	3	4	5	6	7	8	9
1	18	16	9	8	10	9	39	34
2	31	23	16	12	20	15	72	54
3	37	24	24	16	34	22	105	69
4	42	24	29	17	44	25	128	73
5	47	24	32	16	51	25	143	71
6	52	22	33	14	56	24	155	67
7	55	21	34	13	60	22	162	61
8	55	18	35	11	63	21	166	54
9	53	15	35	10	65	18	167	48
10	48	12	35	9	66	16	169	42
11			36	8	66	14	132	28
12			35	7	66	12	131	25
13			35	6	66	11	131	21
14			33	5	65	9	128	18
15			30	4	62	8	122	15
16			26	3	60	6	115	12
17			22	2	57	5	108	10
18			18	1	51	4	97	8
19			14	1	43	3	85	6

20			10	1	35	2	71	4
Value in use		199		164		271		720[1]

Calculation of Impairment Losses

A76. In accordance with the 'bottom-up' test, M compares the carrying amount of each cash-generating unit (after allocation of the carrying amount of the building) to its recoverable amount.

Schedule 3. Application of 'bottom-up' test (Amount in ₹ lakhs)

End of 20X0	*A*	*B*	*C*
Carrying amount (after allocation of the building) (Schedule 1)	119	206	275
Recoverable amount (Schedule 2)	199	164	271
Impairment loss	0	(42)	(4)

A77. The next step is to allocate the impairment losses between the assets of the cash-generating units and the headquarter building.

Schedule 4 Allocation of the impairment losses for cash-generating units B and C (Amount in ₹ lakhs)

Cash-generating unit	*B*	*C*
To headquarter building	(12) (42*56/206)	(1) (4*75/275)
To assets in cash-generating unit	(30) (42*150/206)	(3) (4*200/275)
	(42)	(4)

A78. In accordance with the 'top-down' test, since the research centre could not be allocated on a reasonable and consistent basis to A, B and C's cash-generating units, M compares the carrying amount of the smallest cash- generating unit to which the carrying amount of the research centre can be allocated (i.e., M as a whole) to its recoverable amount.

Schedule 5. Application of the 'top-down' test (Amount in ₹ lakhs)

End of 20X0	*A*	*B*	*C*	*Building*	*Research centre*	*M*
Carrying amount	100	150	200	150	50	650
Impairment loss arising from the 'bottom-up' test	–	(30)	(3)	(13)	–	(46)
Carrying amount after The 'bottom-up' test	100	120	197	137	50	604

[1] It is assumed that the research centre generates additional future cash flows for the enterprise as a whole. Therefore, the sum of the value in use of each individual cash- generating unit is less than the value in use of the business as a whole. The additional cash flows are not attributable to the headquarter building.

Recoverable amount	
(Schedule 2)	720
Impairment loss arising from 'top-down' test	0

A79. Therefore, no additional impairment loss results from the application of the 'top-down' test. Only an impairment loss of ₹ 46 lakhs is recognised as a result of the application of the 'bottom-up' test.

AS 29* : Provisions, Contingent Liabilities and Contingent Assets

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities'.]*

Pursuant to this Accounting Standard coming into effect, all paragraphs of Accounting Standards (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date, that deal with contingencies (viz., paragraphs 1(a), 2, 3.1, 4 (4.1 to 4.4), 5(5.1 to 5.6), 6, 7 (7.1 to 7.3), 9.1 (relevant partion). 9.2, 10, 11, 12 and 16), stand withdrawn except to the extent they deal with impairment of assets not covered by other Accounting Standards.

Objective

The objective of this Standard is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount. The objective of this Standard is also to lay down appropriate accounting for contingent assets.

Scope

1. This Standard should be applied in accounting for provisions and contingent liabilities and in dealing with contingent assets, except:

(a) those resulting from financial instruments[2] that are carried at fair value;

(b) those resulting from executory contracts, except where the contract is onerous;

Explanation:

(i) An 'onerous contract' is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. Thus, for a contract to qualify as an onerous contract, the unavoidable costs of meeting the obligation under the contract should exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it.

(ii) If an enterprise has a contract that is onerous, the present obligation under the contract is recognised and measured as a provision as per this Standard.

---

* Issued in 2003.

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

[2] For the purpose of this Standard, the term 'financial instruments' shall have the same meaning as in Accounting Standard (AS) 20, Earnings Per Share.

The application of the above explanation is illustrated in Illustration 10 of Illustration C attached to the Standard.

(c) those arising in insurance enterprises from contracts with policy-holders; and

(d) those covered by another Accounting Standard.

2. This Standard applies to financial instruments (including guarantees) that are not carried at fair value.

3. Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent. This Standard does not apply to executory contracts unless they are onerous.

4. This Standard applies to provisions, contingent liabilities and contingent assets of insurance enterprises other than those arising from contracts with policy-holders.

5. Where another Accounting Standard deals with a specific type of provision, contingent liability or contingent asset, an enterprise applies that Standard instead of this Standard. For example, certain types of provisions are also addressed in Accounting Standards on:

(a) construction contracts (see AS 7, Construction Contracts);

(b) taxes on income (see AS 22, Accounting for Taxes on Income);

(c) leases (see AS 19, Leases). However, as AS 19 contains no specific requirements to deal with operating leases that have become onerous, this Standard applies to such cases; and

(d) retirement benefits (see AS 15, Accounting for Retirement Benefits in the Financial Statements of Employers).[3]

6. Some amounts treated as provisions may relate to the recognition of revenue, for example where an enterprise gives guarantees in exchange for a fee. This Standard does not address the recognition of revenue. AS 9, Revenue Recognition, identifies the circumstances in which revenue is recognised and provides practical guidance on the application of the recognition criteria. This Standard does not change the requirements of AS 9.

7. This Standard defines provisions as liabilities which can be measured only by using a substantial degree of estimation. The term 'provision' is also used in the context of items such as depreciation, impairment of assets and doubtful debts: these are adjustments to the carrying amounts of assets and are not addressed in this Standard.

8. Other Accounting Standards specify whether expenditures are treated as assets or as expenses. These issues are not addressed in this Standard. Accordingly, this Standard neither prohibits nor requires capitalisation of the costs recognised when a provision is made.

9. This Standard applies to provisions for restructuring (including discontinuing operations). Where a restructuring meets the definition of a discontinuing operation, additional disclosures are required by AS 24, Discontinuing Operations.

Definitions

10. The following terms are used in this Standard with the meanings specified:

10.1 A provision is a liability which can be measured only by using a substantial degree of estimation.

[3] AS 15 (issued 1995) has since been revised and is now titled as 'Employee Benefits'.

10.2 A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

10.3 An obligating event is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.

10.4 A contingent liability is:

(a) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

(b) a present obligation that arises from past events but is not recognised because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) a reliable estimate of the amount of the obligation cannot be made.

10.5 A contingent asset is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or non- occurrence of one or more uncertain future events not wholly within the control of the enterprise.

10.6 Present obligation - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.

10.7 Possible obligation - an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable.

10.8 A restructuring is a programme that is planned and controlled by management, and materially changes either:

(a) the scope of a business undertaken by an enterprise; or

(b) the manner in which that business is conducted.

11. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.

12. Provisions can be distinguished from other liabilities such as trade payables and accruals because in the measurement of provisions substantial degree of estimation is involved with regard to the future expenditure required in settlement. By contrast:

(a) trade payables are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier; and

(b) accruals are liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees. Although it is sometimes necessary to estimate the amount of accruals, the degree of estimation is generally much less than that for provisions.

13. In this Standard, the term 'contingent' is used for liabilities and assets that are not recognised because their existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise. In addition, the term 'contingent liability' is used for liabilities that do not meet the recognition criteria.

Recognition

Provisions

14. A provision should be recognised when:

(a) an enterprise has a present obligation as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision should be recognised.

Present Obligation

15. In almost all cases it will be clear whether a past event has given rise to a present obligation. In rare cases, for example in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such a case, an enterprise determines whether a present obligation exists at the balance sheet date by taking account of all available evidence, including, for example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the balance sheet date. On the basis of such evidence:

(a) where it is more likely than not that a present obligation exists at the balance sheet date, the enterprise recognises a provision (if the recognition criteria are met); and

(b) where it is more likely that no present obligation exists at the balance sheet date, the enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 68).

Past Event

16. A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event.

17. Financial statements deal with the financial position of an enterprise at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an enterprise's balance sheet are those that exist at the balance sheet date.

18. It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the enterprise. Similarly, an enterprise recognises a provision for the decommissioning costs of an oil installation to the extent that the enterprise is obliged to rectify damage already caused. In contrast, because of commercial pressures or legal requirements, an enterprise may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the enterprise can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.

19. An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed – indeed the obligation may be to the public at large.

20. An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law. For example, when environmental damage is caused there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified.

21. Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted. Differences in circumstances surrounding enactment usually make it impossible to specify a single event that would make the enactment of a law virtually certain. In many cases it will be impossible to be virtually certain of the enactment of a law until it is enacted.

Probable Outflow of Resources Embodying Economic Benefits

22. For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation. For the purpose of this Standard[4], an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, i.e., the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 68).

23. Where there are a number of similar obligations (e.g. product warranties or similar contracts) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision is recognised (if the other recognition criteria are met).

Reliable Estimate of the Obligation

24. The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature involve a greater degree of estimation than most other items. Except in extremely rare cases, an enterprise will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is reliable to use in recognising a provision.

25. In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is disclosed as a contingent liability (see paragraph 68).

Contingent Liabilities

26. An enterprise should not recognise a contingent liability.

27. A contingent liability is disclosed, as required by paragraph 68, unless the possibility of an outflow of resources embodying economic benefits is remote.

28. Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability. The enterprise recognises a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made (see paragraph 14).

---

[4] The interpretation of 'probable' in this Standard as 'more likely than not' does not necessarily apply in other Accounting Standards.

29. Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in accordance with paragraph 14 in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made).

Contingent Assets

30. An enterprise should not recognise a contingent asset.

31. Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the enterprise. An example is a claim that an enterprise is pursuing through legal processes, where the outcome is uncertain.

32. Contingent assets are not recognised in financial statements since this may result in the recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

33. A contingent asset is not disclosed in the financial statements. It is usually disclosed in the report of the approving authority (Board of Directors in the case of a company, and, the corresponding approving authority in the case of any other enterprise), where an inflow of economic benefits is probable.

34. Contingent assets are assessed continually and if it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs.

Measurement

Best Estimate

35. The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The amount of a provision should not be discounted to its present value.

36. The estimates of outcome and financial effect are determined by the judgment of the management of the enterprise, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The evidence considered includes any additional evidence provided by events after the balance sheet date.

37. The provision is measured before tax; the tax consequences of the provision, and changes in it, are dealt with under AS 22, Accounting for Taxes on Income.

Risks and Uncertainties

38. The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.

39. Risk describes variability of outcome. A risk adjustment may increase the amount at which a liability is measured. Caution is needed in making judgments under conditions of uncertainty, so that income or assets are not overstated and expenses or liabilities are not understated. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the

case. Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.

40. Disclosure of the uncertainties surrounding the amount of the expenditure is made under paragraph 67(b).

Future Events

41. Future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

42. Expected future events may be particularly important in measuring provisions. For example, an enterprise may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology. The amount recognised reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus, it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an enterprise does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.

43. The effect of possible new legislation is taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted. The variety of circumstances that arise in practice usually makes it impossible to specify a single event that will provide sufficient, objective evidence in every case. Evidence is required both of what legislation will demand and of whether it is virtually certain to be enacted and implemented in due course. In many cases sufficient objective evidence will not exist until the new legislation is enacted.

Expected Disposal of Assets

44. Gains from the expected disposal of assets should not be taken into account in measuring a provision.

45. Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an enterprise recognises gains on expected disposals of assets at the time specified by the Accounting Standard dealing with the assets concerned.

Reimbursements

46. Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision.

47. In the statement of profit and loss, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.

48. Sometimes, an enterprise is able to look to another party to pay part or all of the expenditure required to settle a provision (for example, through insurance contracts, indemnity clauses or suppliers' warranties). The other party may either reimburse amounts paid by the enterprise or pay the amounts directly.

49. In most cases, the enterprise will remain liable for the whole of the amount in question so that the enterprise would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognised for the full amount of the liability, and a separate asset for the expected reimbursement is recognised when it is virtually certain that reimbursement will be received if the enterprise settles the liability.

50. In some cases, the enterprise will not be liable for the costs in question if the third party fails to pay. In such a case, the enterprise has no liability for those costs and they are not included in the provision.

51. As noted in paragraph 28, an obligation for which an enterprise is jointly and severally liable is a contingent liability to the extent that it is expected that the obligation will be settled by the other parties.

Changes in Provisions

52. Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.

Use of Provisions

53. A provision should be used only for expenditures for which the provision was originally recognised.

54. Only expenditures that relate to the original provision are adjusted against it. Adjusting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

Application of the Recognition and Measurement Rules

Future Operating Losses

55. Provisions should not be recognised for future operating losses.

56. Future operating losses do not meet the definition of a liability in paragraph 10 and the general recognition criteria set out for provisions in paragraph 14.

57. An expectation of future operating losses is an indication that certain assets of the operation may be impaired. An enterprise tests these assets for impairment under Accounting Standard (AS) 28, Impairment of Assets.

Restructuring

58. The following are examples of events that may fall under the definition of restructuring:

(a) sale or termination of a line of business;

(b) the closure of business locations in a country or region or the relocation of business activities from one country or region to another;

(c) changes in management structure, for example, eliminating a layer of management; and

(d) fundamental re-organisations that have a material effect on the nature and focus of the enterprise's operations.

59. A provision for restructuring costs is recognised only when the recognition criteria for provisions set out in paragraph 14 are met.

60. No obligation arises for the sale of an operation until the enterprise is committed to the sale, i.e., there is a binding sale agreement.

61. An enterprise cannot be committed to the sale until a purchaser has been identified and there is a binding sale agreement. Until there is a binding sale agreement, the enterprise will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms. When the sale of an operation is envisaged as part of a restructuring, the assets of the operation are reviewed for impairment under Accounting Standard (AS) 28, Impairment of Assets.

62. A restructuring provision should include only the direct expenditures arising from the restructuring which are those that are both:

(a) necessarily entailed by the restructuring; and

(b) not associated with the ongoing activities of the enterprise.

63. A restructuring provision does not include such costs as:

(a) retraining or relocating continuing staff;

(b) marketing; or

(c) investment in new systems and distribution networks.

These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the balance sheet date. Such expenditures are recognised on the same basis as if they arose independently of a restructuring.

64. Identifiable future operating losses up to the date of a restructuring are not included in a provision.

65. As required by paragraph 44, gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.

Disclosure

66. For each class of provision, an enterprise should disclose:

(a) the carrying amount at the beginning and end of the period; (b) additional provisions made in the period, including increases to existing provisions;

(c) amounts used (i.e. incurred and charged against the provision) during the period; and

(d) unused amounts reversed during the period.

Provided that a Small and Medium-sized Company and a Small and Medium-sized Enterprise (Level II and Level III non-corporate entities), may not comply with paragraph 66 above.

67. An enterprise should disclose the following for each class of provision:

(a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;

(b) an indication of the uncertainties about those outflows. Where necessary to provide adequate information, an enterprise should disclose the major assumptions made concerning future events, as addressed in paragraph 41; and

(c) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

Provided that a Small and Medium-sized Company and a Small and Medium-sized Enterprise (Level II and Level III non-corporate entities) may not comply with paragraph 67 above.

68. Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:

(a) an estimate of its financial effect, measured under paragraphs 35-45;

(b) an indication of the uncertainties relating to any outflow; and

(c) the possibility of any reimbursement.

69. In determining which provisions or contingent liabilities may be aggregated to form a class, it is necessary to consider whether the nature of the items is sufficiently similar for a single statement about them to fulfill the requirements of paragraphs 67 (a) and (b) and 68 (a) and (b). Thus, it may be appropriate to treat as a single class of provision amounts relating to warranties of different products, but it would not be appropriate to treat as a single class amounts relating to normal warranties and amounts that are subject to legal proceedings.

70. Where a provision and a contingent liability arise from the same set of circumstances, an enterprise makes the disclosures required by paragraphs 66-68 in a way that shows the link between the provision and the contingent liability.

71. Where any of the information required by paragraph 68 is not disclosed because it is not practicable to do so, that fact should be stated.

72. In extremely rare cases, disclosure of some or all of the information required by paragraphs 66-70 can be expected to prejudice seriously the position of the enterprise in a dispute with other parties on the subject matter of the provision or contingent liability. In such cases, an enterprise need not disclose the information, but should disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

Illustration A

Tables - Provisions, Contingent Liabilities and Reimbursements

The purpose of this illustration is to summarise the main requirements of the Accounting Standard. It does not form part of the Accounting Standard and should be read in the context of the full text of the Ac- counting Standard.

Provisions and Contingent Liabilities

Where, as a result of past events, there may be an outflow of resources embodying future economic benefits in settlement of: (a) a present obligation the one whose existence at the balance sheet date is considered probable; or (b) a possible obligation the existence of which at the balance sheet date is considered not probable.		
There is a present obligation that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation.	There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.	There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.

A provision is recognised (paragraph 14). Disclosures are required for the provision (paragraphs 66 and 67).	No provision is recognised (paragraph 26). Disclosures are required for the contingent liability (paragraph 68).	No provision is recognised (paragraph 26). No disclosure is required (paragraph 68).

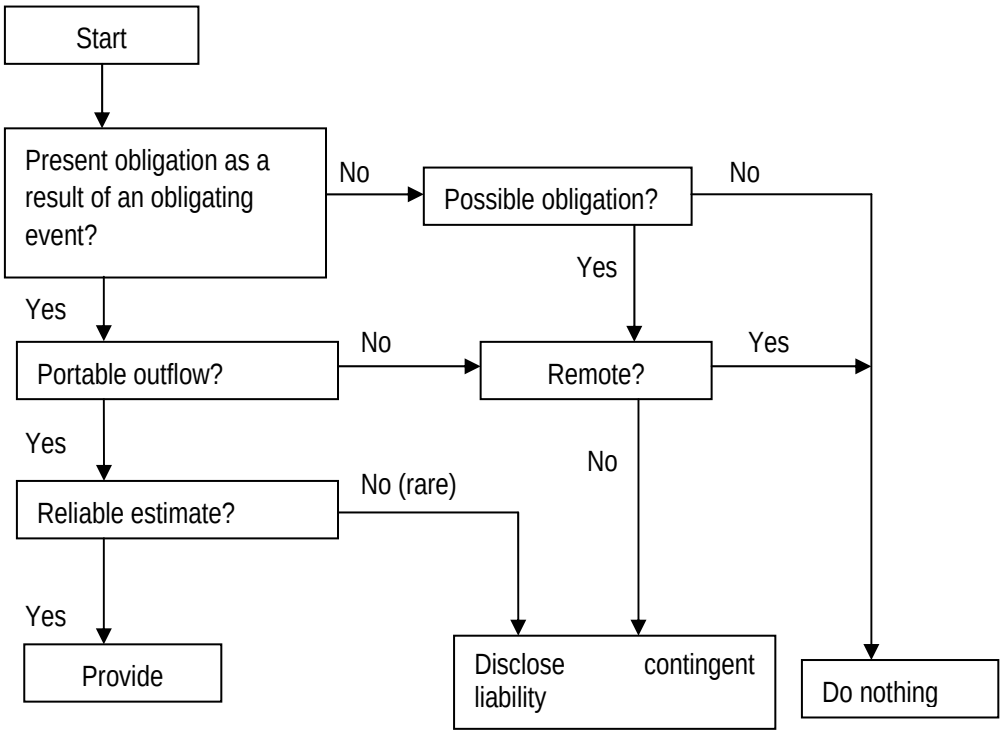
Reimbursements

Some or all of the expenditure required to settle a provision is expected to be reimbursed by another party.		
The enterprise has no obligation for the part of the expenditure to be reimbursed by the other party.	The obligation for the amount expected to be reimbursed remains with the enterprise and it is virtually certain that reimbursement will be received if the enterprise settles the provision.	The obligation for the amount expected to be reimbursed remains with the enterprise and the reimbursement is not virtually certain if the enterprise settles the provision.
The enterprise has no liability for the amount to be reimbursed (paragraph 50).	The reimbursement is recognised as a separate asset in the balance sheet and may be offset against the expense in the statement of profit and loss. The amount recognised for the expected reimbursement does not exceed the liability (paragraphs 46 and 47).	The expected reimbursement is not recognised as an asset (paragraph 46).
No disclosure is required.	The reimbursement is disclosed together with the amount recognised for the reimbursement (paragraph 67(c)).	The expected reimbursement is disclosed (paragraph 67(c)).

Illustration B

Decision Tree

The purpose of the decision tree is to summarise the main recognition requirements of the Accounting Standard for provisions and contingent liabilities. The decision tree does not form part of the Accounting Standard and should be read in the context of the full text of the Accounting Standard.



Note: in rare cases, it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the balance sheet date (paragraph 15 of the Standard).

Illustration C Illustrations: Recognition

This illustration illustrates the application of the Accounting Standard to assist in clarifying its meaning. It does not form part of the Accounting Standard.

All the enterprises in the Illustration have 31 March year ends. In all cases, it is assumed that a reliable estimate can be made of any outflows expected. In some Illustrations the circumstances described may have resulted in impairment of the assets - this aspect is not dealt with in the Illustrations.

The cross references provided in the Illustrations indicate paragraphs of the Accounting Standard that are particularly relevant. The illustration should be read in the context of the full text of the Accounting Standard.

Illustration 1: Warranties

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable (i.e. more likely than not) that there will be some claims under the warranties.

Present obligation as a result of a past obligating event - The obligating event is the sale of the product with a warranty, which gives rise to an obligation.

An outflow of resources embodying economic benefits in settlement - Probable for the warranties as a whole (see paragraph 23).

Conclusion - A provision is recognised for the best estimate of the costs of making good under the warranty products sold before the balance sheet date (see paragraphs 14 and 23).

Illustration 2: Contaminated Land - Legislation Virtually

Certain to be Enacted

An enterprise in the oil industry causes contamination but does not clean up because there is no legislation requiring cleaning up, and the enterprise has been contaminating land for several years. At 31 March 2005 it is virtually certain that a law requiring a clean-up of land already contaminated will be enacted shortly after the year end.

Present obligation as a result of a past obligating event - The obligating event is the contamination of the land because of the virtual certainty of legislation requiring cleaning up.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of the costs of the clean-up (see paragraphs 14 and 21).

Illustration 3: Offshore Oilfield

An enterprise operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Ninety per cent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and ten per cent arise through the extraction of oil. At the balance sheet date, the rig has been constructed but no oil has been extracted.

Present obligation as a result of a past obligating event - The construction of the oil rig creates an obligation under the terms of the licence to remove the rig and restore the seabed and is thus an obligating event. At the balance sheet date, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of ninety per cent of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it (see paragraph 14). These costs are included as part of the cost of the oil rig. The ten per cent of costs that arise through the extraction of oil are recognised as a liability when the oil is extracted.

Illustration 4: Refunds Policy

A retail store has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known.

Present obligation as a result of a past obligating event - The obligating event is the sale of the product, which gives rise to an obligation because obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.

An outflow of resources embodying economic benefits in settlement -

Probable, a proportion of goods are returned for refund (see paragraph 23).

Conclusion - A provision is recognised for the best estimate of the costs of refunds (see paragraphs 11, 14 and 23).

Illustration 5: Legal Requirement to Fit Smoke Filters

Under new legislation, an enterprise is required to fit smoke filters to its factories by 30 September 2005. The enterprise has not fitted the smoke filters.

(a) At the balance sheet date of 31 March 2005

Present obligation as a result of a past obligating event - There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation.

Conclusion - No provision is recognised for the cost of fitting the smoke filters (see paragraphs 14 and 16-18).

(b) At the balance sheet date of 31 March 2006

Present obligation as a result of a past obligating event - There is still no obligation for the costs of fitting smoke filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).

An outflow of resources embodying economic benefits in settlement - Assessment of probability of incurring fines and penalties by non-compliant operation depends on the details of the legislation and the stringency of the enforcement regime.

Conclusion - No provision is recognised for the costs of fitting smoke filters. However, a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed (see paragraphs 14 and 16-18).

Illustration 6: Staff Retraining as a Result of Changes in the Income Tax System

The government introduces a number of changes to the income tax system. As a result of these changes, an enterprise in the financial services sector will need to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with financial services regulation. At the balance sheet date, no retraining of staff has taken place.

Present obligation as a result of a past obligating event - There is no obligation because no obligating event (retraining) has taken place.

Conclusion - No provision is recognised (see paragraphs 14 and 16-18).

Illustration 7: A Single Guarantee

During 2004-05, Enterprise A gives a guarantee of certain borrowings of Enterprise B, whose financial condition at that time is sound. During 2005-06, the financial condition of Enterprise B deteriorates and at 30 September 2005 Enterprise B goes into liquidation.

(a) At 31 March 2005

Present obligation as a result of a past obligating event - The obligating event is the giving of the guarantee, which gives rise to an obligation.

An outflow of resources embodying economic benefits in settlement -

No outflow of benefits is probable at 31 March 2005.

Conclusion - No provision is recognised (see paragraphs 14 and 22). The guarantee is disclosed as a contingent liability unless the probability of any outflow is regarded as remote (see paragraph 68).

(b) At 31 March 2006

Present obligation as a result of a past obligating event - The obligating event is the giving of the guarantee, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement - At 31 March 2006, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

Conclusion - A provision is recognised for the best estimate of the obligation (see paragraphs 14 and 22).

Note: This example deals with a single guarantee. If an enterprise has a portfolio of similar guarantees, it will assess that portfolio as a whole in determining whether an outflow of resources embodying economic benefit is probable (see paragraph 23). Where an enterprise gives guarantees in exchange for a fee, revenue is recognised under AS 9, Revenue Recognition.

Illustration 8 : A Court Case

After a wedding in 2004-05, ten people died, possibly as a result of food poisoning from products sold by the enterprise. Legal proceedings are started seeking damages from the enterprise but it disputes liability. Up to the date of approval of the financial statements for the year 31 March 2005, the enterprise's lawyers advise that it is probable that the enterprise will not be found liable. However, when the enterprise prepares the financial statements for the year 31 March 2006, its lawyers advise that, owing to developments in the case, it is probable that the enterprise will be found liable.

(a) At 31 March 2005

Present obligation as a result of a past obligating event - On the basis of the evidence available when the financial statements were approved, there is no present obligation as a result of past events.

Conclusion - No provision is recognised (see definition of 'present obligation' and paragraph 15). The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote (paragraph 68).

(b) At 31 March 2006

Present obligation as a result of a past obligating event - On the basis of the evidence available, there is a present obligation.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of the amount to settle the obligation (paragraphs 14-15).

Illustration 9A: Refurbishment Costs - No Legislative Requirement

A furnace has a lining that needs to be replaced every five years for technical reasons. At the balance sheet date, the lining has been in use for three years.

Present obligation as a result of a past obligating event - There is no present obligation.

Conclusion - No provision is recognised (see paragraphs 14 and 16-18). The cost of replacing the lining is not recognised because, at the balance sheet date, no obligation to replace the lining exists independently of the company's future actions - even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining.

Illustration 9B: Refurbishment Costs – Legislative Requirement

An airline is required by law to overhaul its aircraft once every three years.

Present obligation as a result of a past obligating event - There is no present obligation.

Conclusion - No provision is recognised (see paragraphs 14 and 16-18). The costs of overhauling aircraft are not recognised as a provision for the same reasons as the cost of replacing the lining is not recognised as a provision in illustration 9A. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the

enterprise's future actions - the enterprise could avoid the future expenditure by its future actions, for example by selling the aircraft.

Illustration 10: An Onerous Contract

An enterprise operates profitably from a factory that it has leased under an operating lease. During December 2005 the enterprise relocates its operations to a new factory. The lease on the old factory continues for the next four years, it connot be cancelled and the factory cannot be re-let to another user.

Present obligation as a result of a past obligating event-The obligating event occurs when the lease contract becomes binding on the enterprise, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement- When the lease becomes onerous, an outflow of resources embodying economic benefits is probable, (Until the lease becomes onerous, the enterprise accounts for the lease under AS 19, Leases).

Conclusion-A provision is recognised for the best estimate of the unavoidable lease payments.

Illustration D

Illustrations: Disclosure

This illustration does not form part of the Accounting Standard. Its purpose is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.

An illustration of the disclosures required by paragraph 67 is provided below.

Illustration 1 Warranties

A manufacturer gives warranties at the time of sale to purchasers of its three product lines. Under the terms of the warranty, the manufacturer undertakes to repair or replace items that fail to perform satisfactorily for two years from the date of sale. At the balance sheet date, a provision of ₹ 60,000 has been recognised. The following information is disclosed:

A provision of ₹ 60,000 has been recognised for expected warranty claims on products sold during the last three financial years. It is expected that the majority of this expenditure will be incurred in the next financial year, and all will be incurred within two years of the balance sheet date.

An illustration is given below of the disclosures required by paragraph 72 where some of the information required is not given because it can be expected to prejudice seriously the position of the enterprise.

Illustration 2 Disclosure Exemption

An enterprise is involved in a dispute with a competitor, who is alleging that the enterprise has infringed patents and is seeking damages of ₹ 1000 lakh. The enterprise recognises a provision for its best estimate of the obligation, but discloses none of the information required by paragraphs 66 and 67 of the Standard. The following information is disclosed:

Litigation is in process against the company relating to a dispute with a competitor who alleges that the company has infringed patents and is seeking damages of ₹ 1000 lakh. The information usually required by AS 29, Provisions, Contingent Liabilities and Contingent Assets is not disclosed on the grounds that it can be expected to prejudice the interests of the company. The directors are of the opinion that the claim can be successfully resisted by the company.

Accounting Standard (AS) 30
Financial Instruments: Recognition and Measurement

*(This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective and the Preface to the Statements of Accounting Standards (revised 2004)[1].)*

Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*, issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years. This Accounting Standard will become mandatory[2] in respect of accounting periods commencing on or after 1-4-2011 for all commercial, industrial and business entities except to a Small and Medium-sized Entity, as defined below:

(i) Whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;
(ii) which is not a bank (including co-operative bank), financial institution or any entity carrying on insurance business;
(iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;
(iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and
(v) which is not a holding or subsidiary entity of an entity which is not a small and medium-sized entity.

For the above purpose an entity would qualify as a Small and Medium-sized Entity, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

From the date of this Standard becoming mandatory for the concerned entities, the following stand withdrawn:

(i) Accounting Standard (AS) 4, *Contingencies and Events Occurring After the Balance Sheet Date*, to the extent it deals with contingencies[3].
(ii) Accounting Standard (AS) 11 (revised 2003), *The Effects of Changes in Foreign Exchange Rates*[4], to the extent it deals with the 'forward exchange contracts'.

---

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which accounting standards are intended to apply only to items which are material.

[2] This implies that, while discharging their attest function, it will be the duty of the members of the Institute to examine whether this Accounting Standard is complied with in the presentation of financial statements covered by their audit. In the event of any deviation from this Accounting Standard, it will be their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviations.

[3] It may be noted that pursuant to Accounting Standard (AS) 29, *Provisions, Contingent Liabilities and Contingent Assets*, becoming mandatory in respect of accounting periods commencing on or after 1-4-2004, all paragraphs of AS 4 dealing with contingencies (viz. paragraphs 1(a), 2, 3.1, 4 (4.1 to 4.4), 5 (5.1 to 5.6), 6, 7 (7.1 to 7.3), 9.1 (relevant portion), 9.2, 10, 11, 12 and 16) were withdrawn except to the extent they deal with impairment of assets not covered by other Indian Accounting Standards. For example, impairment of receivables (commonly referred to as the provision for bad and doubtful debts), continued to be covered by these paragraphs of AS 4 [See Announcement on 'Applicability of AS 4 to impairment of assets not covered by present Indian Accounting Standards' (published in 'The Chartered Accountant', April 2004, pp. 1151)]. From the date of this Standard becoming mandatory, the abovementioned paragraphs of AS 4 dealing with contingencies would stand withdrawn in respect of impairment of assets also.

(iii) Accounting Standard (AS) 13, *Accounting for Investments*, except to the extent it relates to accounting for investment properties.

From the date this Accounting Standard becomes recommendatory in nature, the following Guidance Notes issued by the Institute of Chartered Accountants of India, stand withdrawn:

(i) Guidance Note on Guarantees & Counter Guarantees Given by the Companies.
(ii) Guidance Note on Accounting for Investments in the Financial Statements of Mutual Funds.
(iii) Guidance Note on Accounting for Securitisation.
(iv) Guidance Note on Accounting for Equity Index and Equity Stock Futures and Options.

The following is the text of the Accounting Standard.

Objective

1. The objective of this Standard is to establish principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. Requirements for presenting information about financial instruments are in Accounting Standard (AS) 31, *Financial Instruments: Presentation.* Requirements for disclosing information about financial instruments are in Accounting Standard (AS) 32, *Financial Instruments: Disclosures*[5].

Scope

2. This Standard should be applied by all entities to all types of financial instruments except:

(a) those interests in subsidiaries, associates and joint ventures that are accounted for under AS 21, Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements, AS 23, Accounting for Investments in Associates, or AS 27, Financial Reporting of Interests in Joint Ventures[6]*. However, entities should apply this Standard to an interest in a subsidiary, associate or joint venture that according to AS 21, AS 23 or AS 27 is accounted for under this Standard. Entities should also apply this Standard to derivatives on an interest in a subsidiary, associate or joint venture unless the derivative meets the definition of an equity instrument of the entity in AS 31, Financial Instruments: Presentation*

(b) rights and obligations under leases to which AS 19, Leases, applies. However:

(i) lease receivables recognised by a lessor are subject to the derecognition and impairment provisions of this Standard (see paragraphs 15-37, 64, 65, 69-71 and Appendix A paragraphs A59-A75 and A104-A113);

(ii) finance lease payables recognised by a lessee are subject to the derecognition provisions of this Standard (see paragraphs 43-46 and Appendix A paragraphs A76-A82); and

---

[4] Limited Revision has also been made to AS 11 (revised 2003) to withdraw the requirements concerning 'forward exchange contracts' from the standard.

[5] A separate Accounting Standard (AS) 32 on *Financial Instruments: Disclosures* is being formulated.

[6] It may be noted that AS 21, AS 23 and AS 27, at present, make reference to Accounting Standard (AS) 13, *Accounting for Investments*, with regard to the accounting for an investment in a subsidiary, associate and joint venture in the separate financial statements, respectively. On this Standard becoming mandatory, AS 13 would stand withdrawn except to the extent it relates to accounting for investment properties. Thus, accounting for an investment in a subsidiary, associate and joint venture would no longer be covered by AS 13. The same would be dealt with in AS 21, AS 23 and AS 27. Accordingly, Limited Revisions have also been made to AS 21, AS 23 and AS 27.

(iii) derivatives that are embedded in leases are subject to the embedded derivatives provisions of this Standard (see paragraphs 9-13 and Appendix A paragraphs A47-A53).

(c) employers' rights and obligations under employee benefit plans, to which AS 15, Employee Benefits, applies.

(d) financial instruments issued by the entity that meet the definition of an equity instrument in AS 31, Financial Instruments: Presentation (including options and warrants). However, the holder of such equity instruments should apply this Standard to those instruments, unless they meet the exception in (a) above.

(e) (i) rights and obligations arising under an insurance contract as defined in the Accounting Standard on Insurance Contracts[7], other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract in paragraph 8.6, or (ii) a contract that is within the scope of Accounting Standard on Insurance Contracts[8] because it contains a discretionary participation feature. However, this Standard applies to a derivative that is embedded in a contract within the scope of Accounting Standard on Insurance Contracts[9]if the derivative is not itself a contract within the scope of that Standard (see paragraphs 9–13 and Appendix A paragraphs A47–A53). Moreover, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may choose to apply either this Standard or Accounting Standard on Insurance Contracts[10]to such financial guarantee contracts (see Appendix A paragraphs A5 and A6). The issuer may make that choice contract by contract, but the choice made for each contract is irrevocable.

(f) contracts for contingent consideration in a business combination[11]. This exemption applies only to the acquirer.

(g) contracts between an acquirer and a vendor in a business combination to buy or sell an acquiree at a future date.

(h) loan commitments other than those loan commitments described in paragraph 3. An issuer of loan commitments should apply AS 29, Provision, Contingent Liabilities and Contingent Assets, to loan commitments that are not within the scope of this Standard. However, all loan commitments are subject to the derecognition provisions of this Standard (see paragraphs 15–46 and Appendix A paragraphs A59–A82).

(i) financial instruments, contracts and obligations under share-based payment transactions[12], except for contracts within the scope of paragraphs 4-6 of this Standard, to which this Standard applies.

---

[7] A separate Accounting Standard on *Insurance Contracts*, which is being formulated, will specify the requirements relating to insurance contracts.

[8] *ibid.*

[9] *ibid.*

[10] *ibid.*

[11] 'Business combination' is the bringing together of separate entities or businesses into one reporting entity.

At present, Accounting Standard (AS) 14, *Accounting for Amalgamations*, deals with accounting for contingent consideration in an amalgamation, which is a form of business combination.

[12] Employee share based payment, which is one of the share-based payment transactions, is accounted for as per the Guidance Note on Accounting for Employee Share-based Payments, issued by the ICAI. Further, some other pronouncements deal with other share-based payments, e.g., AS 10, *Accounting for Fixed Assets*.

(j) rights to receive payments as reimbursement of expenditure, the entity is required to make, to settle a liability that it recognises as a provision in accordance with AS 29, Provisions, Contingent Liabilities and Contingent Assets, or for which, in an earlier period, it recognised a provision in accordance with AS 29.

3. The following loan commitments are within the scope of this Standard (see Appendix A paragraphs A7–A12):

(a) loan commitments[13] that the entity designates as financial liabilities at fair value through profit or loss. An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination should apply this Standard to all its loan commitments in the same class.

(b) loan commitments that can be settled net in cash or by delivering or issuing another financial instrument. These loan commitments are derivatives. A loan commitment is not regarded as settled net merely because the loan is paid out in instalments (for example, a mortgage construction loan that is paid out in instalments in line with the progress of construction).

(c) commitments to provide a loan at a below-market interest rate. Paragraph 52(e) specifies the subsequent measurement of liabilities arising from these loan commitments.

4. This Standard should be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements.

5. There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:

(a) when the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;

(b) when the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);

(c) when, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and

(d) when the non-financial item that is the subject of the contract is readily convertible to cash.

A contract to which (b) or (c) applies is not entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements and, accordingly, is within the scope of this Standard. Other contracts to which paragraph 4 applies are evaluated to determine whether they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements and, accordingly, whether they are within the scope of this Standard.

[13] Loan commitment is firm commitment of an entity to provide credit under pre-specified terms and conditions.

6. A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, in accordance with paragraph 5 (a) or (d) is within the scope of this Standard. Such a contract cannot be entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements.

Definitions

7. The terms defined in AS 31, *Financial Instruments: Presentation* are used in this Standard with the meanings specified in paragraph 7 of AS 31. AS 31 defines the following terms:

- financial instrument
- financial asset
- financial liability
- equity instrument

  and provides guidance on applying those definitions.

8. The following terms are used in this Standard with the meanings specified:

Definition of a Derivative

8.1 A derivative is a financial instrument or other contract within the scope of this Standard (see paragraphs 2-6) 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.

Definitions of Four Categories of Financial Instruments

8.2 A financial asset or financial liability at fair value through profit or loss is a financial asset or financial liability that meets either of the following conditions.

(a) It is classified as 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; or

(iii) a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

(b) Upon initial recognition it is designated by the entity as at fair value through profit or loss. An entity may use this designation only when permitted by paragraph 11, or when doing so results in more relevant information, because either

(i) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from

measuring assets or liabilities or recognising the gains and losses on them on different bases (see Appendix A paragraphs A15-A18); or

(ii) a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel (as defined in AS 18, Related Party Disclosures), its board of directors or similar governing body and its chief executive officer. This would normally be relevant in case of a venture capital organisation, mutual fund, unit trust or similar entity whose business is investing in financial assets with a view to profiting from their total return in the form of interest or dividends and changes in fair value (see also Appendix A paragraphs A19-A22).

Accounting Standard (AS) 32, Financial Instruments: Disclosures[14]*, requires the entity to provide disclosures about financial assets and financial liabilities it has designated as at fair value through profit or loss, including how it has satisfied these conditions. For instruments qualifying in accordance with (ii) above, that disclosure includes a narrative description of how designation as at fair value through profit or loss is consistent with the entity's documented risk management or investment strategy.*

Investments in equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured (see paragraph 51(c) and Appendix A paragraphs A100 and A101), should not be designated as at fair value through profit or loss.

It should be noted that paragraphs 53, 54, 55 and Appendix A paragraphs A88-A102, which set out requirements for determining a reliable measure of the fair value of a financial asset or financial liability, apply equally to all items that are measured at fair value, whether by designation or otherwise, or whose fair value is disclosed.

8.3 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 (see Appendix A paragraphs A36-A45) 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.

An entity should not classify any financial assets as held to maturity if the entity has, during the current financial year or during the two preceding financial years, sold or reclassified more than an insignificant amount of held-to-maturity investments before maturity (more than insignificant in relation to the total amount of held-to-maturity investments) other than sales or reclassifications that:

(i) are so close to maturity or the financial asset's call date (for example, less than three months before maturity) that changes in the market rate of interest would not have a significant effect on the financial asset's fair value; or

(ii) occur after the entity has collected substantially all of the financial asset's original principal through scheduled payments or prepayments; or

[14] A separate Accounting Standard (AS) 32 on *Financial Instruments: Disclosures* is being formulated.

(iii) are attributable to an isolated event that is beyond the entity's control, is non-recurring and could not have been reasonably anticipated by the entity.

8.4 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.

An interest acquired in a pool of assets that are not loans or receivables (for example, an interest in a mutual fund or a similar fund) is not a loan or receivable.

8.5 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.

Definition of a financial guarantee contract

8.6 A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

Definitions Relating to Recognition and Measurement

8.7 The amortised cost of a financial asset or financial liability is the amount at which the financial asset or financial 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 minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

8.8 The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.

8.9 The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability (see Appendix A paragraphs A23-A27).

8.10 Derecognition is the removal of a previously recognised financial asset or financial liability from an entity's balance sheet.

8.11 Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction[15].

8.12 A regular way purchase or sale is a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.

[15] Paragraphs 53-55 and A88-A102 of Appendix A contain requirements for determining the fair value of a financial asset or financial liability.

8.13 Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see Appendix A paragraph A33). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

Definitions Relating to Hedge Accounting

8.14 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.

8.15 A forecast transaction is an uncommitted but anticipated future transaction.

8.16 Functional currency is the currency of the primary economic environment in which the entity operates.

8.17 A hedging instrument is (a) a designated derivative or (b) for a hedge of the risk of changes in foreign currency exchange rates only, a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item (paragraphs 81-86 and Appendix A paragraphs A114-A117 elaborate on the definition of a hedging instrument).

8.18 A hedged item is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged (paragraphs 87-94 and Appendix A paragraphs A118-A125 elaborate on the definition of hedged items).

8.19 Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument (see Appendix A paragraphs A129-A138).

Embedded Derivatives

9. An embedded derivative is 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. 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.

10. 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);

(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.

11. Notwithstanding paragraph 10, 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.

12. 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.

13. 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 applies and the hybrid (combined) instrument is designated as at fair value through profit or loss.

Recognition and Derecognition

Initial Recognition

14. 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 with respect to regular way purchases of financial assets.)

Derecognition of a Financial Asset

15. Before evaluating whether, and to what extent, derecognition is appropriate under paragraphs 16-22, 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 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.

16. 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.)

17. 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.

18. When an entity retains the contractual rights to receive the cash flows of a financial asset (the 'original asset'), but assumes a contractual obligation to pay those cash flows to one or more entities (the 'eventual recipients'), the entity treats the transaction as a transfer of a financial asset if, and only if, all of the following three conditions are met.

(a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. Short-term advances by the entity to the eventual recipients with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.

(b) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.

(c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents (as defined in AS 3, Cash Flow Statements) during the short settlement period from the collection date to the date of required remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients.

19. When an entity transfers a financial asset (see paragraph 17), it should evaluate the extent to which it retains the risks and rewards of ownership of the financial asset. In this case:

(a) if the entity transfers substantially all the risks and rewards of ownership of the financial asset, the entity should derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.

(b) if the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity should continue to recognise the financial asset.

(c) if the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset, the entity should determine whether it has retained control of the financial asset. In this case:

(i) if the entity has not retained control, it should derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.

(ii) if the entity has retained control, it should continue to recognise the financial asset to the extent of its continuing involvement in the financial asset (see paragraph 30).

20. The transfer of risks and rewards (see paragraph 19) is evaluated by comparing the entity's exposure, before and after the transfer, with the variability in the amounts and timing of the net cash flows of the transferred asset. An entity has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer (e.g., because the entity has sold a financial asset subject to an agreement to buy it back at a fixed price or the sale price plus a lender's return). An entity has transferred substantially all the risks and rewards of ownership of a financial asset if its exposure to such variability is no longer significant in relation to the total variability in the present value of the future net cash flows associated with the financial asset (e.g., because the entity has sold a financial asset subject only to an option to buy it back at its fair value at the time of repurchase or has transferred a fully proportionate share of the cash flows from a larger financial asset in an arrangement, such as a loan sub-participation, that meets the conditions in paragraph 18).

21. Often it will be obvious whether the entity has transferred or retained substantially all risks and rewards of ownership and there will be no need to perform any computations. In other cases, it will be necessary to compute and compare the entity's exposure to the variability in the present value of the future net cash flows before and after the transfer. The computation and comparison is made using as the discount rate an appropriate current market interest rate. All reasonably possible variability in net cash flows is considered, with greater weight being given to those outcomes that are more likely to occur.

22. Whether the entity has retained control (see paragraph 19(c)) of the transferred asset depends on the transferee's ability to sell the asset. If the transferee has the practical ability to sell the asset in its entirety to an unrelated party and is able to exercise that ability unilaterally and without needing to

impose additional restrictions on the transfer, the entity has not retained control. In all other cases, the entity has retained control.

23. In consolidated financial statements, paragraphs 15-22 and Appendix A paragraphs A57-A75 are applied at a consolidated level. Hence, an entity first consolidates all subsidiaries in accordance with AS 21 and then applies paragraphs 15-22 and Appendix A paragraphs A57-A75 to the resulting group.

Transfers that Qualify for Derecognition (see paragraph 19(a) and (c)(i))

24. If an entity transfers a financial asset in a transfer that qualifies for derecognition in its entirety and retains the right to service the financial asset for a fee, it should recognise either a servicing asset or a servicing liability for that servicing contract. If the fee to be received is not expected to compensate the entity adequately for performing the servicing, a servicing liability for the servicing obligation should be recognised at its fair value. If the fee to be received is expected to be more than adequate compensation for the servicing, a servicing asset should be recognised for the servicing right at an amount determined on the basis of an allocation of the carrying amount of the larger financial asset in accordance with paragraph 27.

25. If, as a result of a transfer, a financial asset is derecognised in its entirety but the transfer results in the entity obtaining a new financial asset or assuming a new financial liability, or a servicing liability, the entity should recognise the new financial asset, financial liability or servicing liability at fair value.

26. On derecognition of a financial asset in its entirety, the difference between:

(a) the carrying amount and
(b) the sum of (i) the consideration received (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss that had been recognised directly in an equity account, say, Investment Revaluation Reserve Account (see paragraph 61(b))

should be recognised in the statement of profit and loss.

27. If the transferred asset is part of a larger financial asset (e.g., when an entity transfers interest cash flows that are part of a debt instrument, see paragraph 15(a)) and the part transferred qualifies for derecognition in its entirety, the previous carrying amount of the larger financial asset should be allocated 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 transfer. For this purpose, a retained servicing asset should be treated as a part that continues to be recognised. The difference between:

(a) the carrying amount allocated to the part derecognised and
(b) the sum of (i) the consideration received for the part derecognised (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss allocated to it that had been recognised directly in the equity account (see paragraph 61(b))

should be recognised in the statement of profit and loss. A cumulative gain or loss that had been recognised in the equity account is allocated between the part that continues to be recognised and the part that is derecognised, based on the relative fair values of those parts.

28. When an entity allocates the previous carrying amount of a larger financial asset between the part that continues to be recognised and the part that is derecognised, the fair value of the part that continues to be recognised needs to be determined. When the entity has a history of selling parts similar to the part that continues to be recognised or other market transactions exist for such parts, recent prices of actual transactions provide the best estimate of its fair value. When there are no price

quotes or recent market transactions to support the fair value of the part that continues to be recognised, the best estimate of the fair value is the difference between the fair value of the larger financial asset as a whole and the consideration received from the transferee for the part that is derecognised.

Transfers that Do Not Qualify for Derecognition (see paragraph 19(b))

29. If a transfer does not result in derecognition because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the entity should continue to recognise the transferred asset in its entirety and should recognise a financial liability for the consideration received. In subsequent periods, the entity should recognise any income on the transferred asset and any expense incurred on the financial liability.

Continuing Involvement in Transferred Assets *(see paragraph 19(c)(ii))*

30. If an entity neither transfers nor retains substantially all the risks and rewards of ownership of a transferred asset, but retains control of the transferred asset, the entity continues to recognise the transferred asset to the extent of its continuing involvement. The extent of the entity's continuing involvement in the transferred asset is the extent to which it is exposed to changes in the value of the transferred asset. For example:

(a) when the entity's continuing involvement takes the form of guaranteeing the transferred asset, the extent of the entity's continuing involvement is the lower of (i) the carrying amount of the asset and (ii) the maximum amount of the consideration received that the entity could be required to repay ('the guarantee amount').

(b) when the entity's continuing involvement takes the form of a written or purchased option (or both) on the transferred asset, the extent of the entity's continuing involvement is the amount of the transferred asset that the entity may repurchase. However, in case of a written put option on an asset that is measured at fair value, the extent of the entity's continuing involvement is limited to the lower of the fair value of the transferred asset and the option exercise price (see paragraph A71).

(c) when the entity's continuing involvement takes the form of a cash-settled option or similar provision on the transferred asset, the extent of the entity's continuing involvement is measured in the same way as that which results from non-cash settled options as set out in (b) above.

31. When an entity continues to recognise an asset to the extent of its continuing involvement, the entity also recognises an associated liability. Despite the other measurement requirements in this Standard, the transferred asset and the associated liability are measured on a basis that reflects the rights and obligations that the entity has retained. The associated liability is measured in such a way that the net carrying amount of the transferred asset and the associated liability is:

(a) the amortised cost of the rights and obligations retained by the entity, if the transferred asset is measured at amortised cost; or

(b) equal to the fair value of the rights and obligations retained by the entity when measured on a stand-alone basis, if the transferred asset is measured at fair value.

32. The entity should continue to recognise any income arising on the transferred asset to the extent of its continuing involvement and should recognise any expense incurred on the associated liability.

33. For the purpose of subsequent measurement, recognised changes in the fair value of the transferred asset and the associated liability are accounted for consistently with each other in accordance with paragraph 61, and should not be offset.

34. If an entity's continuing involvement is in only a part of a financial asset (e.g., when an entity retains an option to repurchase part of a transferred asset, or retains a residual interest that does not result in the retention of substantially all the risks and rewards of ownership and the entity retains control), the entity allocates the previous carrying amount of the financial asset between the part it continues to recognise under continuing involvement, and the part it no longer recognises on the basis of the relative fair values of those parts on the date of the transfer. For this purpose, the requirements of paragraph 28 apply. The difference between:

(a) the carrying amount allocated to the part that is no longer recognised; and

(b) the sum of (i) the consideration received for the part no longer recognised and (ii) any cumulative gain or loss allocated to it that had been recognised directly in the appropriate equity account (see paragraph 61(b))

should be recognised in the statement of profit and loss. A cumulative gain or loss that had been recognised in the equity account is allocated between the part that continues to be recognised and the part that is no longer recognised on the basis of the relative fair values of those parts.

35. If the transferred asset is measured at amortised cost, the option in this Standard to designate a financial liability as at fair value through profit or loss is not applicable to the associated liability.

All Transfers

36. If a transferred asset continues to be recognised, the asset and the associated liability should not be offset. Similarly, the entity should not offset any income arising from the transferred asset with any expense incurred on the associated liability (see AS 31, Financial Instruments: Presentation, paragraph 72).

37. If a transferor provides non-cash collateral (such as debt or equity instruments) to the transferee, the accounting for the collateral by the transferor and the transferee depends on whether the transferee has the right to sell or repledge the collateral and on whether the transferor has defaulted. The transferor and transferee should account for the collateral as follows:

(a) If the transferee has the right by contract or custom to sell or repledge the collateral, then the transferor should reclassify that asset in its balance sheet (e.g., as a loaned asset, pledged equity instruments or repurchase receivable) separately from other assets.

(b) If the transferee sells collateral pledged to it, it should recognise the proceeds from the sale and a liability measured at fair value for its obligation to return the collateral.

(c) If the transferor defaults under the terms of the contract and is no longer entitled to redeem the collateral, it should derecognise the collateral, and the transferee should recognise the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognise its obligation to return the collateral.

(d) Except as provided in (c), the transferor should continue to carry the collateral as its asset, and the transferee should not recognise the collateral as an asset.

Regular Way Purchase or Sale of a Financial Asset

38. A regular way purchase or sale of financial assets should be recognised and derecognised using trade date accounting or settlement date accounting.

39. A regular way purchase or sale of financial assets is recognised using either trade date accounting or settlement date accounting as described in paragraphs 41 and 42. The method used is applied consistently for all purchases and sales of financial assets that belong to the same category of financial assets defined in paragraphs 8.2 to 8.5. For this purpose, assets that are held for trading form a separate category from assets designated at fair value through profit or loss.

40. A contract that requires or permits net settlement of the change in the value of the contract is not a regular way contract. Instead, such a contract is accounted for as a derivative in the period between the trade date and the settlement date.

41. The trade date is the date that an entity commits itself to purchase or sell an asset. Trade date accounting refers to (a) the recognition of an asset to be received and the liability to pay for it on the trade date, and (b) derecognition of an asset that is sold, recognition of any gain or loss on disposal and the recognition of a receivable from the buyer for payment on the trade date. Generally, interest does not start to accrue on the asset and corresponding liability until the settlement date when title passes.

42. The settlement date is the date on which an asset is delivered to or by an entity. Settlement date accounting refers to (a) the recognition of an asset on the day it is received by the entity, and (b) the derecognition of an asset and recognition of any gain or loss on disposal on the day that it is delivered by the entity. When settlement date accounting is applied, an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset. In other words, the change in value is not recognised for assets carried at cost or amortised cost; it is recognised in the statement of profit and loss for assets classified as financial assets at fair value through profit or loss; and it is recognised in the appropriate equity account for assets classified as available for sale.

Derecognition of a Financial Liability

43. 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.

44. 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.

45. 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.

46. 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.

Measurement

Initial Measurement of Financial Assets and Financial Liabilities

47. 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.

48. 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).

49. 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

50. 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:

(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.

These categories apply to measurement and profit or loss recognition under this Standard. The entity may use other descriptors for these categories or other categorisations when presenting information on the face of the financial statements. The entity should disclose in the notes the information required by AS 32 on *Financial Instruments: Disclosures*[16].

51. After initial recognition, an entity should measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal, except for the following financial assets:

(a) loans and receivables as defined in paragraph 8.4, which should be measured at amortised cost using the effective interest method. However, short-term receivables with no stated interest rate should not be measured at amortised cost if the effect of discounting is immaterial. Such short-term receivables should be measured at the original invoice amount;
(b) held-to-maturity investments as defined in paragraph 8.3, which should be measured at amortised cost using the effective interest method; and
(c) investments in equity instruments that do not have a quoted market price in an active market and whose fair value can not be reliably measured and derivatives that are linked to

[16] A separate Accounting Standard (AS) 32 on *Financial Instruments: Disclosures* is being formulated.

and must be settled by delivery of such unquoted equity instruments, which should be measured at cost (see Appendix A paragraphs A100 and A101).

Financial assets that are designated as hedged items are subject to measurement under the hedge accounting requirements in paragraphs 99-113. All financial assets except those measured at fair value through profit or loss are subject to review for impairment in accordance with paragraphs 64-79 and Appendix A paragraphs A104-A113.

Subsequent Measurement of Financial Liabilities

52. 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 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 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) 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.

Fair Value Measurement Considerations

53. In determining the fair value of a financial asset or a financial liability for the purpose of applying this Standard, AS 31, Financial Instruments: Presentation or AS 32 on Financial Instruments: Disclosures[17]*, an entity should apply paragraphs A88-A102 of Appendix A.*

54. The best evidence of fair value is quoted prices in an active market. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Valuation techniques include using recent arm's length market transactions between knowledgeable,

[17] A separate Accounting Standard (AS) 32 on *Financial Instruments: Disclosures* is being formulated.

willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique. The chosen valuation technique makes maximum use of market inputs and relies as little as possible on entity-specific inputs. It incorporates all factors that market participants would consider in setting a price and is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (i.e., without modification or repackaging) or based on any available observable market data.

55. The fair value of a financial liability with a demand feature (e.g., a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

Reclassifications

56. 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.

57. 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).

58. Whenever sales or reclassification of more than an insignificant amount of held-to-maturity investments do not meet any of the conditions in paragraph 8.3, any remaining held-to-maturity investments should be reclassified as available for sale. On such reclassification, the difference between their carrying amount and fair value should be accounted for in accordance with paragraph 61(b).

59. If a reliable measure becomes available for a financial asset or financial liability for which such a measure was previously not available, and the asset or liability is required to be measured at fair value if a reliable measure is available (see paragraphs 51(c) and 52), the asset or liability should be remeasured at fair value, and the difference between its carrying amount and fair value should be accounted for in accordance with paragraph 61.

60. If,

(a) as a result of a change in intention or ability; or
(b) in the rare circumstance that a reliable measure of fair value is no longer available (see paragraphs 51(c) and 52); or
(c) the 'two preceding financial years' referred to in paragraph 8.3 have passed,

it becomes appropriate to carry a financial asset or financial liability at cost or amortised cost rather than at fair value, the fair value carrying amount of the financial asset or the financial liability on that date becomes its new cost or amortised cost, as applicable. Any previous gain or loss on that asset that has been recognised directly in the appropriate equity account in accordance with paragraph 61(b) should be accounted for as follows:

(a) In the case of a financial asset with a fixed maturity, the gain or loss should be amortised to the statement of profit and loss over the remaining life of the held-to-maturity investment using the effective interest method. Any difference between the new amortised cost and maturity amount should also be amortised over the

remaining life of the financial asset using the effective interest method, similar to the amortisation of a premium and a discount. If the financial asset is subsequently impaired, any gain or loss that has been recognised directly in the appropriate equity account is recognised in the statement of profit and loss in accordance with paragraph 76.

(b) In the case of a financial asset that does not have a fixed maturity, the gain or loss should remain in the appropriate equity account until the financial asset is sold or otherwise disposed of, when it should be recognised in the statement profit and loss. If the financial asset is subsequently impaired any previous gain or loss that has been recognised directly in the appropriate equity account is recognised in the statement of profit and loss in accordance with paragraph 76.

Gains and Losses

61. 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 (see paragraphs 99-113), 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 (see paragraphs 76-79) and foreign exchange gains and losses (see Appendix A paragraph A103), 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 (see paragraph 8.9 and Appendix A paragraphs A23-A27) 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 (see AS 9, Revenue Recognition).

62. For financial assets and financial liabilities carried at amortised cost (see paragraphs 51 and 52), 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 (see paragraphs 87-94 and Appendix A paragraphs A118-A125) the accounting for the gain or loss should follow paragraphs 99-113.

63. If an entity recognises financial assets using settlement date accounting (see paragraphs 38-42), 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, as appropriate under paragraph 61.

Impairment and Uncollectibility of Financial Assets

64. 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 (for short-term receivables with no stated interest rate carried at original

invoice amount), paragraph 75 (for financial assets carried at cost) or paragraph 76 (for available-for-sale financial assets) to determine the amount of any impairment loss.

65. A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognised. Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the holder of the asset about the following loss events:

(a) significant financial difficulty of the issuer or obligor;
(b) a breach of contract, such as a default or delinquency in interest or principal payments;
(c) the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;
(d) it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
(e) an active market no longer exists for that financial asset because of financial difficulties; or
(f) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:
    (i) adverse changes in the payment status of borrowers in the group (e.g., an increased number of delayed payments or an increased number of credit card borrowers who have reached their credit limit and are paying the minimum monthly amount); or
    (ii) national or local economic conditions that correlate with defaults on the assets in the group (e.g., an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).

66. In case an active market no longer exists because an entity's financial instruments have ceased to be publicly traded is not evidence of impairment. A downgrade of an entity's credit rating is not, by itself, evidence of impairment, although it may be evidence of impairment when considered with other available information. A decline in the fair value of a financial asset below its cost or amortised cost is not necessarily evidence of impairment (for example, a decline in the fair value of an investment in a debt instrument that results from an increase in the risk-free interest rate).

67. In addition to the types of events in paragraph 65, objective evidence of impairment for an investment in an equity instrument includes information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates, and indicates that the cost of the investment in the equity instrument may not be recovered. A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment.

68. In some cases the observable data required to estimate the amount of an impairment loss on a financial asset may be limited or no longer fully relevant to current circumstances. For example, this may be the case when a borrower is in financial difficulties and there are few available historical data relating to similar borrowers. In such cases, an entity uses its experienced judgement to estimate the amount of any impairment loss. Similarly an entity uses its experienced judgement to adjust observable data for a group of financial assets to reflect current circumstances (see paragraph A109). The use of

reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

Financial Assets Carried at Amortised Cost

69. If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e., the effective interest rate computed at initial recognition). The carrying amount of the asset should be reduced either directly or through use of an allowance account[18]. The amount of the loss should be recognised in the statement of profit and loss.

70. An entity first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant (see paragraph 65). If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

71. If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the debtor's credit rating), the previously recognised impairment loss should be reversed either directly or by adjusting an allowance account. The reversal should not result in a carrying amount of the financial asset that exceeds what the amortised cost would have been had the impairment not been recognised at the date the impairment is reversed. The amount of the reversal should be recognised in the statement of profit and loss.

Short-term Receivables Carried at Original Invoice Amount

72. If there is objective evidence that an impairment loss on short-term receivables carried at original invoice amount has been incurred (i.e., some of the short-term receivables may not be recoverable), the amount of the loss is measured as the difference between the receivables' carrying amount and the undiscounted amount of estimated future cash flows (excluding future credit losses that have not been incurred). The carrying amount of the receivables should be reduced either directly or through use of an allowance account. The amount of the loss should be recognised in the statement of profit and loss.

73. An entity first assesses whether objective evidence of impairment exists individually for short-term receivables that are individually significant, and individually or collectively for short-term receivables that are not individually significant (see paragraph 65). If an entity determines that no objective evidence of impairment exists for an individually assessed short-term receivable, whether significant or not, it includes the receivable in a group of short-term receivables with similar credit risk characteristics and collectively assesses them for impairment. Short-term receivables that are individually assessed

[18] In line with the terminology prevalent internationally, the words 'allowance account' have been used in this Accounting Standard in the context of impairment of assets and doubtful debts. Hitherto, the term commonly used is 'provisions', e.g., provision for bad and doubtful debts. It may be noted that AS 29, *Provisions, Contingent Liabilities and Contingent Assets*, uses the term 'provisions' in the context of liabilities which can be measured only by using a substantial degree of estimation.

for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

74. If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the debtor's credit rating), the previously recognised impairment loss should be reversed either directly or by adjusting the allowance account. The reversal should not result in a carrying amount of the short-term receivable that exceeds what the amount would have been had the impairment not been recognised at the date the impairment is reversed. The amount of the reversal should be recognised in the statement of profit and loss.

Financial Assets Carried at Cost

75. If there is objective evidence that an impairment loss has been incurred on an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured, or on a derivative asset that is linked to and must be settled by delivery of such an unquoted equity instrument, the amount of the impairment loss is measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset (see paragraph 51(c) and Appendix A paragraphs A100 and A101). The amount of the loss should be recognised in the statement of profit and loss. Such impairment losses should not be reversed.

Available-for-Sale Financial Assets

76. When a decline in the fair value of an available-for-sale financial asset has been recognised directly in the appropriate equity account and there is objective evidence that the asset is impaired (see paragraph 65), the cumulative loss that had been recognised directly in the equity account should be removed from the equity account and recognised in the statement of profit and loss even though the financial asset has not been derecognised.

77. The amount of the cumulative loss that is removed from the equity account and recognised in the statement of profit and loss under paragraph 76 should be the difference between the acquisition cost (net of any principal repayment and amortisation) and current fair value, less any impairment loss on that financial asset previously recognised in the statement of profit and loss.

78. Impairment losses recognised in the statement of profit and loss for an investment in an equity instrument classified as available for sale should not be reversed through the statement of profit and loss. This is because in case of equity instruments classified as available for sale, reversals of impairment losses cannot be distinguished from other increases in fair value.

79. If, in a subsequent period, the fair value of a debt instrument classified as available for sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in the statement of profit and loss, the impairment loss should be reversed, with the amount of the reversal recognised in the statement of profit and loss.

Hedging

80. If there is a designated hedging relationship between a hedging instrument and a hedged item as described in paragraphs 95-98 and Appendix A paragraphs A126-A128, accounting for the gain or loss on the hedging instrument and the hedged item should follow paragraphs 99-113.

Hedging Instruments

Qualifying Instruments

81. This Standard does not restrict the circumstances in which a derivative may be designated as a hedging instrument provided the conditions in paragraph 98 are met, except for some written options (see Appendix A paragraph A114). However, a non-derivative financial asset or non-derivative financial liability may be designated as a hedging instrument only for a hedge of a foreign currency risk.

82. For hedge accounting purposes, only instruments that involve a party external to the reporting entity (i.e., external to the group, segment or individual entity that is being reported on) can be designated as hedging instruments. Although individual entities within a consolidated group or divisions within an entity may enter into hedging transactions with other entities within the group or divisions within the entity, any such intragroup transactions are eliminated on consolidation. Therefore, such hedging transactions do not qualify for hedge accounting in the consolidated financial statements of the group. However, they may qualify for hedge accounting in the individual or separate financial statements of individual entities within the group or in segment reporting provided that they are external to the individual entity or segment that is being reported on.

Designation of Hedging Instruments

83. There is normally a single fair value measure for a hedging instrument in its entirety, and the factors that cause changes in fair value are co-dependent. Thus, a hedging relationship is designated by an entity for a hedging instrument in its entirety. The only exceptions permitted are:

(a) separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option and excluding change in its time value; and

(b) separating the interest element and the spot price of a forward contract.

These exceptions are permitted because the intrinsic value of the option and the premium on the forward can generally be measured separately. A dynamic hedging strategy that assesses both the intrinsic value and time value of an option contract can qualify for hedge accounting.

84. A proportion of the entire hedging instrument, such as 50 per cent of the notional amount, may be designated as the hedging instrument in a hedging relationship. However, a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding.

85. A single hedging instrument may be designated as a hedge of more than one type of risk provided that (a) the risks hedged can be identified clearly; (b) the effectiveness of the hedge can be demonstrated; and (c) it is possible to ensure that there is specific designation of the hedging instrument and different risk positions.

86. Two or more derivatives, or proportions of them (or, in the case of a hedge of currency risk, two or more non-derivatives or proportions of them, or a combination of derivatives and non-derivatives or proportions of them), may be viewed in combination and jointly designated as the hedging instrument, including when the risk(s) arising from some derivatives offset(s) those arising from others. However, an interest rate collar or other derivative instrument that combines a written option and a purchased option does not qualify as a hedging instrument if it is, in effect, a net written option (for which a net premium is received). Similarly, two or more instruments (or proportions of them) may be designated as the hedging instrument only if none of them is a written option or a net written option.

Hedged Items

Qualifying Items

87. A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation. The hedged item can be (a) a single asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation, (b) a group of assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations with similar risk characteristics or (c) in a portfolio hedge of interest rate risk only, a portion of the portfolio of financial assets or financial liabilities that share the risk being hedged.

88. Unlike loans and receivables, a held-to-maturity investment cannot be a hedged item with respect to interest-rate risk or prepayment risk because designation of an investment as held-to-maturity requires an intention to hold the investment until maturity without regard to changes in the fair value or cash flows of such an investment attributable to changes in interest rates. However, a held-to-maturity investment can be a hedged item with respect to risks from changes in foreign currency exchange rates and credit risk.

89. For hedge accounting purposes, only assets, liabilities, firm commitments or highly probable forecast transactions that involve a party external to the entity can be designated as hedged items. It follows that hedge accounting can be applied to transactions between entities or segments in the same group only in the individual or separate financial statements of those entities or segments and not in the consolidated financial statements of the group. As an exception, the foreign currency risk of an intragroup monetary item (e.g., a payable/receivable between two subsidiaries) may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation in accordance with Accounting Standard (AS) 11, *The Effects of Changes in Foreign Exchange Rates*. In accordance with AS 11, foreign exchange rate gains and losses on intragroup monetary item are not fully eliminated on consolidation when the intragroup monetary item is transacted between two group entities that have different functional currencies[19]. In addition, the foreign currency risk of a highly probable forecast intragroup transaction may qualify as a hedged item in consolidated financial statements provided that the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss.

Designation of Financial Items as Hedged Items

90. If the hedged item is a financial asset or financial liability, it may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value (such as one or more selected contractual cash flows or portions of them or a percentage of the fair value) provided that effectiveness can be measured. For example, an identifiable and separately measurable portion of the interest rate exposure of an interest-bearing asset or interest-bearing liability may be designated as the hedged risk (such as a risk-free interest rate or benchmark interest rate component of the total interest rate exposure of a hedged financial instrument).

91. In a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only in such a hedge), the portion hedged may be designated in terms of an amount of a currency (e.g. an amount of rupees, dollars, euro, pounds or rand) rather than as individual assets (or liabilities). Although the portfolio may, for risk management purposes, include assets and liabilities, the amount designated is an amount of assets or an amount of liabilities. Designation of a net amount

[19] 'Functional currency' is the currency of the primary economic environment in which the entity operates.

including assets and liabilities is not permitted. The entity may hedge a portion of the interest rate risk associated with this designated amount. For example, in the case of a hedge of a portfolio containing prepayable assets, the entity may hedge the change in fair value that is attributable to a change in the hedged interest rate on the basis of expected, rather than contractual, repricing dates. When the portion hedged is based on expected repricing dates, the effect that changes in the hedged interest rate have on those expected repricing dates should be included when determining the change in the fair value of the hedged item. Consequently, if a portfolio that contains prepayable items is hedged with a non-prepayable derivative, ineffectiveness arises if the dates on which items in the hedged portfolio are expected to prepay are revised, or actual prepayment dates differ from those expected.

Designation of Non-Financial Items as Hedged Items

92. If the hedged item is a non-financial asset or non-financial liability, it should be designated as a hedged item (a) for foreign currency risks, or (b) in its entirety for all risks, because of the difficulty of isolating and measuring the appropriate portion of the cash flows or fair value changes attributable to specific risks other than foreign currency risks.

Designation of groups of items as hedged items

93. Similar assets or similar liabilities are aggregated and hedged as a group only if the individual assets or individual liabilities in the group share the risk exposure that is designated as being hedged. Furthermore, the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items.

94. Because an entity assesses hedge effectiveness by comparing the change in the fair value or cash flow of a hedging instrument (or group of similar hedging instruments) and a hedged item (or group of similar hedged items), comparing a hedging instrument with an overall net position (e.g., the net of all fixed rate assets and fixed rate liabilities with similar maturities), rather than with a specific hedged item, does not qualify for hedge accounting.

Hedge Accounting

95. Hedge accounting recognises the offsetting effects on profit or loss of changes in the fair values of the hedging instrument and the hedged item.

96. Hedging relationships are of three types:

(a) fair value hedge: 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.

(b) cash flow hedge: 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.

(c) hedge of a net investment in a foreign operation as defined in AS 11.

97. A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge.

98. A hedging relationship qualifies for hedge accounting under paragraphs 99-113 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 (see Appendix A paragraphs A129-A138) 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 (see paragraphs 51 and 52 and Appendix A paragraphs A100 and A101 for guidance on determining fair value).

(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.

Fair Value Hedges

99. 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

(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.

100. For a fair value hedge of the interest rate exposure of a portion of a portfolio of financial assets or financial liabilities (and only in such a hedge), the requirement in paragraph 99(b) may be met by presenting the gain or loss attributable to the hedged item either:

(a) in a single separate line item within assets, for those repricing time periods for which the hedged item is an asset; or

(b) in a single separate line item within liabilities, for those repricing time periods for which the hedged item is a liability.

The separate line items referred to in (a) and (b) above are presented next to financial assets or financial liabilities. Amounts included in these line items are removed from the balance sheet when the assets or liabilities to which they relate are derecognised.

101. If only particular risks attributable to a hedged item are hedged, recognised changes in the fair value of the hedged item unrelated to the hedged risk are recognised as set out in paragraph 61.

102. An entity should discontinue prospectively the hedge accounting specified in paragraph 99 if:

(a) the hedging instrument expires or is sold, terminated or exercised (for this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy);

(b) the hedge no longer meets the criteria for hedge accounting in paragraph 98; or

(c) the entity revokes the designation.

103. Any adjustment arising from paragraph 99(b) to the carrying amount of a hedged financial instrument for which the effective interest method is used (or, in the case of a portfolio hedge of interest rate risk, to the separate balance sheet line item described in paragraph 100) should be amortised to the statement of profit and loss. Amortisation may begin as soon as an adjustment exists and should begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged. The adjustment is based on a recalculated effective interest rate at the date amortisation begins. However, if, in the case of a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only in such a hedge), amortising using a recalculated effective interest rate is not practicable, the adjustment should be amortised using a straight-line method. The adjustment should be amortised fully by maturity of the financial instrument or, in the case of a portfolio hedge of interest rate risk, by expiry of the relevant repricing time period.

104. When an unrecognised firm commitment is designated as a hedged item, the subsequent cumulative change in the fair value of the firm commitment attributable to the hedged risk is recognised as an asset or liability with a corresponding gain or loss recognised in the statement of profit and loss (see paragraph 99(b)). The changes in the fair value of the hedging instrument are also recognised in the statement of profit and loss.

105. When an entity enters into a firm commitment to acquire an asset or assume a liability that is a hedged item in a fair value hedge, the initial carrying amount of the asset or liability that results from the entity meeting the firm commitment is adjusted to include the cumulative change in the fair value of the firm commitment attributable to the hedged risk that was recognised in the balance sheet.

Cash Flow Hedges

106. 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.

107. 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.

108. 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 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.

109. If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or a non-financial liability, or a forecast transaction for a non-financial asset or non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, then the entity should adopt (a) or (b) below:

(a) It reclassifies, i.e., recognises, the associated gains and losses that were recognised directly in the appropriate equity account in accordance with paragraph 106 into 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 depreciation expense or cost of sales 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.

(b) It removes the associated gains and losses that were recognised directly in the equity account in accordance with paragraph 106, and includes them in the initial cost or other carrying amount of the asset or liability.

110. An entity should adopt either (a) or (b) in paragraph 109 as its accounting policy and should apply it consistently to all hedges to which paragraph 109 relates.

111. For cash flow hedges other than those covered by paragraphs 108 and 109, amounts that had been recognised directly in the equity account should be reclassified into, i.e., recognised in, the statement of profit and loss in the same period or periods during which the hedged forecast transaction affects profit or loss (for example, when a forecast sale occurs).

112. In any of the following circumstances an entity should discontinue prospectively the hedge accounting specified in paragraphs 106-111:

(a) The hedging instrument expires or is sold, terminated or exercised (for this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy). In this case, the cumulative gain or loss on the hedging instrument that remains recognised directly in the appropriate equity account from the period when the hedge was effective (see paragraph 106(a)) should remain separately recognised in the equity account until the forecast transaction occurs. When the transaction occurs, paragraph 108, 109 or 111 applies, as the case may be.

(b) The hedge no longer meets the criteria for hedge accounting in paragraph 98. In this case, the cumulative gain or loss on the hedging instrument that remains recognised directly in the equity account from the period when the hedge was effective (see paragraph 106(a)) should remain so separately recognised in the equity account until the forecast transaction occurs. When the transaction occurs, paragraph 108, 109 or 111 applies, as the case may be.

(c) The forecast transaction is no longer expected to occur, in which case any related cumulative gain or loss on the hedging instrument that remains recognised directly in the equity account from the period when the hedge was effective (see paragraph 106(a)) should be recognised in the statement of profit and loss. A forecast transaction that is no longer highly probable (see paragraph 98(c)) may still be expected to occur.

(d) The entity revokes the designation. For hedges of a forecast transaction, the cumulative gain or loss on the hedging instrument that remains recognised directly in the equity account from the period when the hedge was effective (see paragraph 106(a)) should remain separately recognised in the equity account until the forecast transaction occurs or is no longer expected to occur. When the transaction occurs, paragraph 108, 109 or 111 applies, as the case may be. If the transaction is no longer expected to occur, the cumulative gain or loss that had been recognised directly in the equity account should be recognised in the statement of profit and loss.

Hedges of a Net Investment

113. 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.

Transitional Provisions

Designation and Measurement of Financial Assets and Financial Liabilities

114. On the date of this Standard becoming mandatory, an entity should change the designation and measurement of all its financial assets and financial liabilities existing on that date as per the requirements of this Standard. Any resulting gain or loss (as adjusted by any related tax expense/ benefit) should be adjusted against opening balance of revenue reserves and surplus except gains and/or losses relating to the financial instruments which as per the requirements of this Standard are recognised in an appropriate equity account, say, Investment Revaluation Reserve Account. Such gains and/or losses should be recognised in the said equity account.

Derecognition of Financial Assets and Financial Liabilities

115. The derecognition requirements in the Standard should be applied prospectively for transactions occurring on or after the date of this Standard becoming mandatory. An entity may, however, apply the derecognition requirements in the Standard retrospectively from a date

of the entity's choosing, provided that the information needed to apply this Standard to financial assets and financial liabilities derecognised as a result of past transactions was obtained at the time of initially accounting for those transactions.

116. The derecognition requirements in the Standard apply prospectively for transactions occurring on or after the date of this Standard becoming mandatory. This implies that if an entity has derecognised non-derivative financial assets or non-derivative financial liabilities under its previous accounting policy as a result of a transaction that occurred before the date of this Standard becoming mandatory, it should not recognise those assets and liabilities under Accounting Standards (unless they qualify for recognition as a result of a later transaction or event). This, however, does not prohibit an entity from applying the derecognition requirements in the Standard retrospectively from a date of the entity's choosing, provided that the information needed to apply this Standard to financial assets and financial liabilities derecognised as a result of past transactions was obtained at the time of initially accounting for those transactions.

Hedge Accounting

117. As required by the Standard, on the date of this Standard becoming mandatory, an entity should:

(a) measure all derivatives at fair value; and

(b) eliminate all deferred losses and gains, if any, arising on derivatives that under the previous accounting policy of the entity were reported as assets or liabilities. Any resulting gain or loss (as adjusted by any related tax expense/ benefit) should be adjusted against opening balance of revenue reserves and surplus.

118. On the date of this Standard becoming mandatory, an entity should not reflect in its financial statements a hedging relationship of a type that does not qualify for hedge accounting under this Standard (for example, hedging relationships where the hedging instrument is a cash instrument or written option; where the hedged item is a net position; or where the hedge covers interest risk in a held-to-maturity investment). However, if an entity designated a net position as a hedged item under its previous accounting policy, it may designate an individual item within that net position as a hedged item under Accounting Standards, provided that it does so on the date of this Standard becoming mandatory.

119. If, before the date of this Standard becoming mandatory, an entity had designated a transaction as a hedge but the hedge does not meet the conditions for hedge accounting in this Standard, the entity should apply paragraphs 102 and 112 to discontinue hedge accounting. Transactions entered into before the date of this Standard becoming mandatory should not be retrospectively designated as hedges.

Embedded Derivatives

120. 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, whichever is the later date.

Appendix A

Application of the Recognition and Measurement Principles Prescribed in the Accounting Standard

This appendix is an integral part of the Accounting Standard and explains the application of particular aspects of the Standard. References in this Appendix to various paragraph numbers of the Standard without any prefix refer to the relevant paragraph number(s) of the text of the Accounting Standard and those with prefix 'A' refer to the paragraph number(s) of this Appendix to the Accounting Standard.

Scope (paragraphs 2-6)

A1. Some contracts require a payment based on climatic, geological or other physical variables. (Those based on climatic variables are sometimes referred to as 'weather derivatives'.) If those contracts are not within the scope of Accounting Standard on *Insurance Contracts*[20] they are within the scope of this Standard.

A2. This Standard does not change the requirements relating to employee benefit plans that comply with Accounting Standard on *Accounting and Reporting by Retirement Benefit Plans*[21] and recognition of revenue arising from royalty agreements based on the volume of sales or service revenues that are accounted for under AS 9.

A3. Sometimes, an entity makes what it views as a 'strategic investment' in equity instruments issued by another entity, with the intention of establishing or maintaining a long-term operating relationship with the entity in which the investment is made. The investor entity uses AS 23 to determine whether the equity method of accounting is appropriate for such an investment in the consolidated financial statements. Similarly, the investor entity uses AS 27 to determine whether proportionate consolidation is appropriate for such an investment in the consolidated financial statements. If neither the equity method nor proportionate consolidation is appropriate in the consolidated financial statements, the entity applies this Standard to that strategic investment in the consolidated financial statements. In such a case, it is not appropriate to apply AS 23 or AS 27, as the case may be, to that investment in separate financial statements also. Accordingly, the entity applies this Standard to that investment in the separate financial statements also.

A4. This Standard applies to the financial assets and financial liabilities of insurers, other than rights and obligations arising under an insurance contract and financial instruments that paragraph 2(e) excludes because they arise under contracts within the scope of Accounting Standard on *Insurance Contracts*[22].

A5. Financial guarantee contracts may have various legal forms, such as a guarantee, some types of letter of credit, a credit default contract or an insurance contract. Their accounting treatment does not depend on their legal form. The following are examples of the appropriate treatment (see paragraph 2(e)):

(a) Although a financial guarantee contract meets the definition of an insurance contract in Accounting Standard on *Insurance Contracts*[23]if the risk transferred is significant, the issuer applies this Standard. Nevertheless, if the issuer has previously asserted explicitly that it regards

[20] A separate Accounting Standard on *Insurance Contracts*, which is being formulated, will specify the requirements relating to insurance contracts.
[21] A separate Accounting Standard on *Accounting and Reporting by Retirement Benefit Plan* will specify the requirements relating to accounting and reporting retirement by retirement benefit plans.
[22] See footnote 20.
[23] *ibid*.

such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may chose to apply either this Standard or Accounting Standard on *Insurance Contracts*[24]to such financial guarantee contracts. If this Standard applies, paragraph 47 requires the issuer to recognise a financial guarantee contract initially at fair value. If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's length transaction, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary. Subsequently, unless the financial guarantee contract was designated at inception as at fair value through profit or loss or unless paragraphs 29–37 and A70–A75 apply (when a transfer of a financial asset does not qualify for derecognition or the continuing involvement approach applies), the issuer measures it at the higher of:

(i) the amount determined in accordance with AS 29; and

(ii) the amount initially recognised less, when appropriate, cumulative amortisation recognised, if any.

(b) Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a guarantee is one that requires payments in response to changes in a specified credit rating or credit index. Such guarantees are not financial guarantee contracts, as defined in this Standard, and are not insurance contracts, as defined in Accounting Standard on *Insurance Contracts*[25]. Such guarantees are derivatives and the issuer applies this Standard to them.

(c) If a financial guarantee contract was issued in connection with the sale of goods, the issuer applies AS 9 (Revised)[26] in determining when it recognises the revenue from the guarantee and from the sale of goods.

A6. Assertions that an issuer regards contracts as insurance contracts are typically found throughout the issuer's communications with customers and regulators, contracts, business documentation and financial statements. Furthermore, insurance contracts are often subject to accounting requirements that are distinct from the requirements for other types of transaction, such as contracts issued by banks or commercial companies. In such cases, an issuer's financial statements typically include a statement that the issuer has used those accounting requirements.

A7. Loan commitments are firm commitments to provide credit under pre-specified terms and conditions. Since a commitment to make a loan at a specified rate of interest during a fixed period of time is, in effect, a written option for the potential borrower to obtain a loan at a specified rate and, therefore, meets the definition of a derivative, the issue has been raised as to whether loan commitments of a bank are derivatives or not to be accounted for at fair value under this Standard.

A8. To simplify accounting for the holders and issuers of loan commitments, particular loan commitments have been excluded from the scope of this Standard. The effect of the exclusion is that an entity does not recognise and measure changes in fair value of these loan commitments that result from changes in market interest rates or credit spreads. This is consistent with the measurement of the loan that results if the holder of the loan commitment exercises its right to obtain financing, because changes in market interest rates do not affect the measurement of an asset measured at amortised cost (assuming it is not designated in a category other than loans and receivables).

---

[24] *ibid*.

[25] *ibid*.

[26] AS 9 is presently under revision.

A9. However, this Standard permits an entity to measure a loan commitment at fair value with changes in fair value recognised in the statement of profit and loss on the basis of designation at inception of the loan commitment as a financial liability through profit or loss. This may be appropriate, for example, if the entity manages risk exposures related to loan commitments on a fair value basis.

A10. A loan commitment is excluded from the scope of this Standard only if it cannot be settled net. If the value of a loan commitment can be settled net in cash or another financial instrument, including when the entity has a past practice of selling the resulting loan assets shortly after origination, it is difficult to justify its exclusion from the requirement in this Standard to measure at fair value similar instruments that meet the definition of a derivative.

A11. In case an entity that has a past practice of selling the assets resulting from its loan commitments shortly after their origination, it applies this Standard to all its loan commitments in the same class. However, this does not require or permit the application of this Standard to other loan commitments of the entity.

A12. The commitments to provide a loan at a below-market interest rate should be initially measured at fair value. After initial recognition, such loans are measured at the higher of:

(a) the amount determined in accordance with AS 29; and

(b) the amount initially recognised less, where appropriate, cumulative amortisation recognised, if any.

It may be noted that without such a requirement, liabilities that result from such commitments might not be recognised in the balance sheet, because in many cases no cash consideration is received.

Definitions (paragraphs 7 and 8)

Designation as at Fair Value through Profit or Loss

A13. Paragraph 8.2 of this Standard allows an entity to designate a financial asset, a financial liability, or a group of financial instruments (financial assets, financial liabilities or both) as at fair value through profit or loss provided that doing so results in more relevant information.

A14. The decision of an entity to designate a financial asset or financial liability as at fair value through profit or loss is similar to an accounting policy choice (although, unlike an accounting policy choice, it is not required to be applied consistently to all similar transactions). When an entity has such a choice, Accounting Standard (AS) 5, *Accounting Policies, Changes in Accounting Estimates and Errors*[27] requires the chosen policy to result in the financial statements providing reliable and more relevant information about the effects of transactions, other events and conditions on the entity's financial position, financial performance or cash flows. In the case of designation as at fair value through profit or loss, paragraph 8.2 sets out the two circumstances when the requirement for more relevant information will be met. Accordingly, to choose such designation in accordance with paragraph 8.2, the entity needs to demonstrate that it falls within one (or both) of these two circumstances.

Paragraph 8.2(b)(i): Designation eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise

A15. Under this Standard, measurement of a financial asset or financial liability and classification of recognised changes in its value are determined by the item's classification and whether the item is part of a designated hedging relationship. Those requirements can create a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') when, for example, in the absence

[27] AS 5 is presently under revision.

of designation as at fair value through profit or loss, a financial asset would be classified as available for sale (with most changes in fair value recognised directly in the appropriate equity account) and a liability the entity considers related would be measured at amortised cost (with changes in fair value not recognised). In such circumstances, an entity may conclude that its financial statements would provide more relevant information if both the asset and the liability were classified as at fair value through profit or loss.

A16. The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through profit or loss only if it meets the principle in paragraph 8.2(b)(i).

(a) An entity has liabilities whose cash flows are contractually based on the performance of assets that would otherwise be classified as available for sale. For example, an insurer may have liabilities containing a discretionary participation feature that pay benefits based on realised and/or unrealised investment returns of a specified pool of the insurer's assets. If the measurement of those liabilities reflects current market prices, classifying the assets as at fair value through profit or loss means that changes in the fair value of the financial assets are recognised in the statement of profit and loss in the same period as related changes in the value of the liabilities.

(b) An entity has liabilities under insurance contracts whose measurement incorporates current information (as permitted by Accounting Standard on *Insurance Contracts*[28]), and financial assets it considers related that would otherwise be classified as available for sale or measured at amortised cost.

(c) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other. However, only some of the instruments would be measured at fair value through profit or loss (i.e., derivatives, or instruments classified as held for trading). It may also be the case that the requirements for hedge accounting are not met, say, because the requirements for effectiveness in paragraph 98 are not met.

(d) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other and the entity does not qualify for hedge accounting because none of the instruments is a derivative. Furthermore, in the absence of hedge accounting there is a significant inconsistency in the recognition of gains and losses. For example:

    (i) the entity has financed a portfolio of fixed rate assets that would otherwise be classified as available for sale by issuing fixed rate bonds/ debentures whose changes in fair value tend to offset each other. Reporting both the assets and the bonds/ debentures at fair value through profit or loss corrects the inconsistency that would otherwise arise from measuring the assets at fair value with changes reported in the appropriate equity account and the bonds/ debentures at amortised cost.

    (ii) the entity has financed a specified group of loans by issuing traded bonds/ debentures whose changes in fair value tend to offset each other. If, in addition, the entity regularly buys and sells the bonds/ debentures but rarely, if ever, buys and sells the loans, reporting both the loans and the bonds/ debentures at fair value through profit or loss eliminates the inconsistency in the timing of recognition of gains and losses that would otherwise result

[28] A separate Accounting Standard on *Insurance Contracts*, which is being formulated, will specify the requirements relating to insurance contracts.

from measuring them both at amortised cost and recognising a gain or loss each time a bond/ debenture is repurchased.

A17. In cases such as those described in the preceding paragraph, to designate, at initial recognition, the financial assets and financial liabilities not otherwise so measured as at fair value through profit or loss may eliminate or significantly reduce the measurement or recognition inconsistency and produce more relevant information. For practical purposes, the entity need not enter into all of the assets and liabilities giving rise to the measurement or recognition inconsistency at exactly the same time. A reasonable delay is permitted provided that each transaction is designated as at fair value through profit or loss at its initial recognition and, at that time, any remaining transactions are expected to occur.

A18. It would not be acceptable to designate only some of the financial assets and financial liabilities giving rise to the inconsistency as at fair value through profit or loss if to do so would not eliminate or significantly reduce the inconsistency and would therefore not result in more relevant information. However, it would be acceptable to designate only some of a number of similar financial assets or similar financial liabilities if doing so achieves a significant reduction (and possibly a greater reduction than other allowable designations) in the inconsistency. For example, assume an entity has a number of similar financial liabilities that sum to ₹ 100 and a number of similar financial assets that sum to ₹ 50 but are measured on a different basis. The entity may significantly reduce the measurement inconsistency by designating at initial recognition all of the assets but only some of the liabilities (for example, individual liabilities with a combined total of ₹ 45) as at fair value through profit or loss. However, because designation as at fair value through profit or loss can be applied only to the whole of a financial instrument, the entity in this example must designate one or more liabilities in their entirety. It could not designate either a component of a liability (e.g., changes in value attributable to only one risk, such as changes in a benchmark interest rate) or a proportion (i.e., percentage) of a liability.

Paragraph 8.2(b)(ii): A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy

A19. An entity may manage and evaluate the performance of a group of financial assets, financial liabilities or both in such a way that measuring that group at fair value through profit or loss results in more relevant information. The focus in this instance is on the way the entity manages and evaluates performance, rather than on the nature of its financial instruments.

A20. The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through profit or loss only if it meets the principle in paragraph 8.2(b)(ii).

(a) The entity is a venture capital organisation, mutual fund, unit trust or similar entity whose business is investing in financial assets with a view to profiting from their total return in the form of interest or dividends and changes in fair value. AS 23 and AS 27 allow such investments to be excluded from their scope provided they are measured at fair value through profit or loss[29]. An entity may apply the same accounting policy to other investments managed on a total return basis but over which its influence is insufficient for them to be within the scope of AS 23 or AS 27.

(b) The entity has financial assets and financial liabilities that share one or more risks and those risks are managed and evaluated on a fair value basis in accordance with a documented policy of

[29] It may be noted that AS 23 and AS 27, at present, do not make this exclusion from their scope. Limited Revisions have also been made to AS 23 and AS 27 to provide for the same.

asset and liability management. An example could be an entity that has issued 'structured products' containing multiple embedded derivatives and manages the resulting risks on a fair value basis using a mix of derivative and non-derivative financial instruments. A similar example could be an entity that originates fixed interest rate loans and manages the resulting benchmark interest rate risk using a mix of derivative and non-derivative financial instruments.

(c) The entity is an insurer that holds a portfolio of financial assets, manages that portfolio so as to maximise its total return (i.e., interest or dividends and changes in fair value), and evaluates its performance on that basis. The portfolio may be held to back specific liabilities, equity or both. If the portfolio is held to back specific liabilities, the condition in paragraph 8.2(b)(ii) may be met for the assets regardless of whether the insurer also manages and evaluates the liabilities on a fair value basis. The condition in paragraph 8.2(b)(ii) may be met when the insurer's objective is to maximise total return on the assets over the longer term even if amounts paid to holders of participating contracts depend on other factors such as the amount of gains realised in a shorter period (e.g., a year) or are subject to the insurer's discretion.

A21. As noted above, this condition relies on the way the entity manages and evaluates performance of the group of financial instruments under consideration. Accordingly, (subject to the requirement of designation at initial recognition) an entity that designates financial instruments as at fair value through profit or loss on the basis of this condition should so designate all eligible financial instruments that are managed and evaluated together.

A22. Documentation of the entity's strategy need not be extensive but should be sufficient to demonstrate compliance with paragraph 8.2(b)(ii). Such documentation is not required for each individual item, but may be on a portfolio basis. For example, if the performance management system for a department—as approved by the entity's key management personnel, its board of directors or similar governing body or its chief executive officer—clearly demonstrates that its performance is evaluated on a total return basis, no further documentation is required to demonstrate compliance with paragraph 8.2(b)(ii).

Effective Interest Rate

A23. When calculating the effective interest rate, an entity should estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but should not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity should use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

A24. In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. Entities include such incurred credit losses in the estimated cash flows when computing the effective interest rate.

A25. When applying the effective interest method, an entity generally amortises any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the instrument. However, a shorter period is used if this is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate. This will be the case when the variable to which the fees, points paid or received, transaction costs, premiums or discounts relate is repriced to market rates before the expected maturity of the instrument.

In such a case, the appropriate amortisation period is the period to the next such repricing date. For example, if a premium or discount on a floating rate instrument reflects interest that has accrued on the instrument since interest was last paid, or changes in market rates since the floating interest rate was reset to market rates, it will be amortised to the next date when the floating interest is reset to market rates. This is because the premium or discount relates to the period to the next interest reset date because, at that date, the variable to which the premium or discount relates (i.e., interest rates) is reset to market rates. If, however, the premium or discount results from a change in the credit spread over the floating rate specified in the instrument, or other variables that are not reset to market rates, it is amortised over the expected life of the instrument.

A26. For floating rate financial assets and floating rate financial liabilities, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. If a floating rate financial asset or floating rate financial liability is recognised initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability.

A27. If an entity revises its estimates of payments or receipts, the entity adjusts the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The adjustment is recognised as income or expense in the statement of profit and loss.

Derivatives

A28. Typical examples of derivatives are futures and forward, swap and option contracts. A derivative usually has a notional amount, which is an amount of currency, a number of shares, a number of units of weight or volume or other units specified in the contract. However, a derivative instrument does not require the holder or writer to invest or receive the notional amount at the inception of the contract. Alternatively, a derivative could require a fixed payment or payment of an amount that can change (but not proportionally with a change in the underlying) as a result of some future event that is unrelated to a notional amount. For example, a contract may require a fixed payment of ₹ 1,000, if six-month MIBOR increases by 100 basis points. Such a contract is a derivative even though a notional amount is not specified.

A29. The definition of a derivative in this Standard includes contracts that are settled gross by delivery of the underlying item (e.g., a forward contract to purchase a fixed rate debt instrument). An entity may have a contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument or by exchanging financial instruments (e.g., a contract to buy or sell a commodity at a fixed price at a future date). Such a contract is within the scope of this Standard unless it was entered into and continues to be held for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (see paragraphs 4-6).

A30. One of the defining characteristics of a derivative is that it has 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. An option contract meets that definition because the premium is less than the investment that would be required to obtain the underlying financial instrument to which the option is linked. A currency swap that requires an initial exchange of different currencies of equal fair values meets the definition because it has a zero initial net investment.

A31. A regular way purchase or sale gives rise to a fixed price commitment between trade date and settlement date that meets the definition of a derivative. However, because of the short duration of the

commitment it is not recognised as a derivative financial instrument. Rather, this Standard provides for special accounting for such regular way contracts (see paragraphs 38-42).

A32. The definition of a derivative refers to non-financial variables that are not specific to a party to the contract. These include an index of earthquake losses in a particular region and an index of temperatures in a particular city. Non-financial variables specific to a party to the contract include the occurrence or non-occurrence of a fire that damages or destroys an asset of a party to the contract. A change in the fair value of a non-financial asset is specific to the owner if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific non-financial asset held (a non-financial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car's physical condition, the change in that residual value is specific to the owner of the car.

Transaction Costs

A33. Transaction costs include fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

Financial Assets and Financial Liabilities Held for Trading

A34. Trading generally reflects active and frequent buying and selling, and financial instruments held for trading generally are used with the objective of generating a profit from short-term fluctuations in price or dealer's margin.

A35. Financial liabilities held for trading include:

(a) derivative liabilities that are not accounted for as hedging instruments;

(b) obligations to deliver financial assets borrowed by a short seller (i.e., an entity that sells financial assets it has borrowed and does not yet own);

(c) financial liabilities that are incurred with an intention to repurchase them in the near term (e.g., a quoted debt instrument that the issuer may buy back in the near term depending on changes in its fair value); and

(d) financial liabilities that are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking.

The fact that a liability is used to fund trading activities does not in itself make that liability one that is held for trading.

Held-to-Maturity Investments

A36. An entity does not have a positive intention to hold to maturity an investment in a financial asset with a fixed maturity if:

(a) the entity intends to hold the financial asset for an undefined period;

(b) the entity stands ready to sell the financial asset (other than if a situation arises that is non-recurring and could not have been reasonably anticipated by the entity) in response to changes in market interest rates or risks, liquidity needs, changes in the availability of and the yield on alternative investments, changes in financing sources and terms or changes in foreign currency risk; or

(c) the issuer has a right to settle the financial asset at an amount significantly below its amortised cost.

A37. A debt instrument with a variable interest rate can satisfy the criteria for a held-to-maturity investment. Equity instruments cannot be held-to-maturity investments either because they have an indefinite life (such as equity shares) or because the amounts the holder may receive can vary in a manner that is not predetermined (such as for share options, warrants and similar rights). With respect to the definition of held-to-maturity investments, fixed or determinable payments and fixed maturity mean that a contractual arrangement defines the amounts and dates of payments to the holder, such as interest and principal payments. A significant risk of non-payment does not preclude classification of a financial asset as held to maturity as long as its contractual payments are fixed or determinable and the other criteria for that classification are met. If the terms of a perpetual debt instrument provide for interest payments for an indefinite period, the instrument cannot be classified as held to maturity because there is no maturity date.

A38. The criteria for classification as a held-to-maturity investment are met for a financial asset that is callable by the issuer if the holder intends and is able to hold it until it is called or until maturity and the holder would recover substantially all of its carrying amount. The call option of the issuer, if exercised, simply accelerates the asset's maturity. However, if the financial asset is callable on a basis that would result in the holder not recovering substantially all of its carrying amount, the financial asset cannot be classified as a held-to-maturity investment. The entity considers any premium paid and capitalised transaction costs in determining whether the carrying amount would be substantially recovered.

A39. A financial asset that is puttable (i.e., the holder has the right to require that the issuer repay or redeem the financial asset before maturity) cannot be classified as a held-to-maturity investment because paying for a put feature in a financial asset is inconsistent with expressing an intention to hold the financial asset until maturity.

A40. For most financial assets, fair value is a more appropriate measure than amortised cost. The held-to-maturity classification is an exception, but only if the entity has a positive intention and the ability to hold the investment to maturity. When an entity's actions cast doubt on its intention and ability to hold such investments to maturity, paragraph 8.3 precludes the use of the held-to-maturity classification for a reasonable period of time.

A41. A disaster scenario that is only remotely possible, such as a run on a bank or a similar situation affecting an insurer, is not something that is assessed by an entity in deciding whether it has the positive intention and ability to hold an investment to maturity.

A42. Sales before maturity could satisfy the condition in paragraph 8.3—and therefore not raise a question about the entity's intention to hold other investments to maturity—if they are attributable to any of the following:

(a) a significant deterioration in the issuer's creditworthiness. For example, a sale following a downgrade in a credit rating by an external rating agency would not necessarily raise a question about the entity's intention to hold other investments to maturity if the downgrade provides evidence of a significant deterioration in the issuer's creditworthiness judged by reference to the credit rating at initial recognition. Similarly, if an entity uses internal ratings for assessing exposures, changes in those internal ratings may help to identify issuers for which there has been a significant deterioration in creditworthiness, provided the entity's approach to assigning internal ratings and changes in those ratings give a consistent, reliable and objective measure of the credit quality of the issuers. If there is evidence that a financial asset is impaired (see paragraphs 64 and 65), the deterioration in creditworthiness is often regarded as significant.

(b) a change in tax law that eliminates or significantly reduces the tax-exempt status of interest on the held-to-maturity investment (but not a change in tax law that revises the marginal tax rates applicable to interest income).

(c) a major business combination or major disposition (such as a sale of a segment) that necessitates the sale or transfer of held-to-maturity investments to maintain the entity's existing interest rate risk position or credit risk policy (although the business combination is an event within the entity's control, the changes to its investment portfolio to maintain an interest rate risk position or credit risk policy may be consequential rather than anticipated).

(d) a change in statutory or regulatory requirements significantly modifying either what constitutes a permissible investment or the maximum level of particular types of investments, thereby causing an entity to dispose of a held-to-maturity investment.

(e) a significant increase in the industry's regulatory capital requirements that causes the entity to downsize by selling held-to-maturity investments.

(f) a significant increase in the risk weights of held-to-maturity investments used for regulatory risk-based capital purposes.

A43. An entity does not have a demonstrated ability to hold to maturity an investment in a financial asset with a fixed maturity if:

(a) it does not have the financial resources available to continue to finance the investment until maturity; or

(b) it is subject to an existing legal or other constraint that could frustrate its intention to hold the financial asset to maturity. (However, an issuer's call option does not necessarily frustrate an entity's intention to hold a financial asset to maturity—see paragraph A38.)

A44. Circumstances other than those described in paragraphs A36-A43 can indicate that an entity does not have a positive intention or the ability to hold an investment to maturity.

A45. An entity assesses its intention and ability to hold its held-to-maturity investments to maturity not only when those financial assets are initially recognised, but also at each subsequent balance sheet date.

Loans and Receivables

A46. Any non-derivative financial asset with fixed or determinable payments (including loan assets, trade receivables, investments in debt instruments and deposits held in banks) could potentially meet the definition of loans and receivables. However, a financial asset that is quoted in an active market (such as a quoted debt instrument, see paragraph A90) does not qualify for classification as a loan or receivable. Financial assets that do not meet the definition of loans and receivables may be classified as held-to-maturity investments if they meet the conditions for that classification (see paragraphs 8.3 and A36-A45). On initial recognition of a financial asset that would otherwise be classified as a loan or receivable, an entity may designate it as a financial asset at fair value through profit or loss, or available for sale.

Embedded Derivatives (paragraphs 9-13)

A47. If a host contract has no stated or predetermined maturity and represents a residual interest in the net assets of an entity, then its economic characteristics and risks are those of an equity instrument, and an embedded derivative would need to possess equity characteristics related to the same entity to be regarded as closely related. If the host contract is not an equity instrument and meets

the definition of a financial instrument, then its economic characteristics and risks are those of a debt instrument.

A48. An embedded non-option derivative (such as an embedded forward or swap) is separated from its host contract on the basis of its stated or implied substantive terms, so as to result in it having a fair value of zero at initial recognition. An embedded option-based derivative (such as an embedded put, call, cap, floor or swaption) is separated from its host contract on the basis of the stated terms of the option feature. The initial carrying amount of the host instrument is the residual amount after separating the embedded derivative.

A49. Generally, multiple embedded derivatives in a single instrument are treated as a single compound embedded derivative. However, embedded derivatives that are classified as equity (see AS 31, *Financial Instruments: Presentation* are accounted for separately from those classified as assets or liabilities. In addition, if an instrument has more than one embedded derivative and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other.

A50. The economic characteristics and risks of an embedded derivative are not closely related to the host contract (paragraph 10(a)) in the following examples. In these examples, assuming the conditions in paragraph 10(b) and (c) are met, an entity accounts for the embedded derivative separately from the host contract.

(a) A put option embedded in an instrument that enables the holder to require the issuer to reacquire the instrument for an amount of cash or other assets that varies on the basis of the change in an equity or commodity price or index is not closely related to a host debt instrument.

(b) A call option embedded in an equity instrument that enables the issuer to reacquire that equity instrument at a specified price is not closely related to the host equity instrument from the perspective of the holder (from the issuer's perspective, the call option is an equity instrument provided it meets the conditions for that classification under AS 31, in which case it is excluded from the scope of this Standard).

(c) An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension. If an entity issues a debt instrument and the holder of that debt instrument writes a call option on the debt instrument to a third party, the issuer regards the call option as extending the term to maturity of the debt instrument provided the issuer can be required to participate in or facilitate the remarketing of the debt instrument as a result of the call option being exercised.

(d) Equity-indexed interest or principal payments embedded in a host debt instrument or insurance contract—by which the amount of interest or principal is indexed to the value of equity instruments—are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.

(e) Commodity-indexed interest or principal payments embedded in a host debt instrument or insurance contract—by which the amount of interest or principal is indexed to the price of a commodity (such as gold)—are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.

(f) An equity conversion feature embedded in a convertible debt instrument is not closely related to the host debt instrument from the perspective of the holder of the instrument (from the issuer's perspective, the equity conversion option is an equity instrument and excluded from the scope of this Standard provided it meets the conditions for that classification under AS 31).

(g) A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless the option's exercise price is approximately equal on each exercise date to the amortised cost of the host debt instrument or the carrying amount of the host insurance contract. From the perspective of the issuer of a convertible debt instrument with an embedded call or put option feature, the assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element under AS 31.

(h) Credit derivatives that are embedded in a host debt instrument and allow one party (the 'beneficiary') to transfer the credit risk of a particular reference asset, which it may not own, to another party (the 'guarantor') are not closely related to the host debt instrument. Such credit derivatives allow the guarantor to assume the credit risk associated with the reference asset without directly owning it.

A51. An example of a hybrid instrument is a financial instrument that gives the holder a right to put the financial instrument back to the issuer in exchange for an amount of cash or other financial assets that varies on the basis of the change in an equity or commodity index that may increase or decrease (a 'puttable instrument'). Unless the issuer on initial recognition designates the puttable instrument as a financial liability at fair value through profit or loss, it is required to separate an embedded derivative (i.e., the indexed principal payment) under paragraph 10 because the host contract is a debt instrument under paragraph A47 and the indexed principal payment is not closely related to a host debt instrument under paragraph A50(a). Because the principal payment can increase and decrease, the embedded derivative is a non-option derivative whose value is indexed to the underlying variable.

A52. In the case of a puttable instrument that can be put back at any time for cash equal to a proportionate share of the net asset value of an entity (such as units of an open-ended mutual fund or some unit-linked investment products), the effect of separating an embedded derivative and accounting for each component is to measure the combined instrument at the redemption amount that is payable at the balance sheet date if the holder exercised its right to put the instrument back to the issuer.

A53. The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract in the following examples. In these examples, an entity does not account for the embedded derivative separately from the host contract.

(a) An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt contract or insurance contract is closely related to the host contract unless the combined instrument can be settled in such a way that the holder would not recover substantially all of its recognised investment or the embedded derivative could at least double the holder's initial rate of return on the host contract and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract.

(b) An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the contract is issued, and the cap or floor is not leveraged in relation to the host contract. Similarly, provisions included in a contract to purchase or sell an asset (e.g., a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money at inception and are not leveraged.

(c) An embedded foreign currency derivative that provides a stream of principal or interest payments that are denominated in a foreign currency and is embedded in a host debt instrument (e.g., a dual

currency bond) is closely related to the host debt instrument. Such a derivative is not separated from the host instrument because AS 11 requires foreign currency gains and losses on monetary items to be recognised in the statement of profit and loss.

(d) An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument (such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:

(i) the functional currency of any substantial party to that contract;

(ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or

(iii) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (e.g., a relatively stable and liquid currency that is commonly used in local business transactions or external trade).

(e) An embedded prepayment option in an interest-only or principal-only strip is closely related to the host contract provided the host contract (i) initially resulted from separating the right to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative, and (ii) does not contain any terms not present in the original host debt contract.

(f) An embedded derivative in a host lease contract is closely related to the host contract if the embedded derivative is (i) an inflation-related index such as an index of lease payments to a consumer price index (provided that the lease is not leveraged and the index relates to inflation in the entity's own economic environment), (ii) contingent rentals based on related sales or (iii) contingent rentals based on variable interest rates.

(g) A unit-linking feature embedded in a host financial instrument or host insurance contract is closely related to the host instrument or host contract if the unit-denominated payments are measured at current unit values that reflect the fair values of the assets of the fund. A unit-linking feature is a contractual term that requires payments denominated in units of an internal or external investment fund.

(h) A derivative embedded in an insurance contract is closely related to the host insurance contract if the embedded derivative and host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately (i.e., without considering the host contract).

Instruments containing Embedded Derivatives

A54. When an entity becomes a party to a hybrid (combined) instrument that contains one or more embedded derivatives, paragraph 10 requires the entity to identify any such embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently. These requirements can be more complex, or result in less reliable measures, than measuring the entire instrument at fair value through profit or loss. For that reason this Standard permits the entire instrument to be designated as at fair value through profit or loss.

A55. Such designation may be used whether paragraph 10 requires the embedded derivatives to be separated from the host contract or prohibits such separation. However, paragraph 11 would not justify designating the hybrid (combined) instrument as at fair value through profit or loss in the cases set out in paragraph 11(a) and (b) because doing so would not reduce complexity or increase reliability.

Reassessment of Embedded Derivatives

A56. An entity should assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity first becomes a party to the contract. Subsequent reassessment is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract, in which case reassessment is required. An entity determines whether a modification to cash flows is significant by considering the extent to which the expected future cash flows associated with the embedded derivative, the host contract or both have changed and whether the change is significant relative to the previously expected cash flows on the contract.

Recognition and Derecognition (paragraphs 14-46)

Initial Recognition (paragraph 14)

A57. As a consequence of the principle in paragraph 14, an entity recognises all of its contractual rights and obligations under derivatives in its balance sheet as assets and liabilities, respectively, except for derivatives that prevent a transfer of financial assets from being accounted for as a sale (see paragraph A72). If a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset (see paragraph A73).

A58. The following are examples of applying the principle in paragraph 14:

(a) unconditional receivables and payables are recognised as assets or liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash.

(b) assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognised until at least one of the parties has performed under the agreement. For example, an entity that receives a firm order does not generally recognise an asset (and the entity that places the order does not recognise a liability) at the time of the commitment but, rather, delays recognition until the ordered goods or services have been shipped, delivered or rendered. If a firm commitment to buy or sell non-financial items is within the scope of this Standard under paragraphs 4-6, its net fair value is recognised as an asset or liability on the commitment date (see (c) below). In addition, if a previously unrecognised firm commitment is designated as a hedged item in a fair value hedge, any change in the net fair value attributable to the hedged risk is recognised as an asset or liability after the inception of the hedge (see paragraphs 104 and 105).

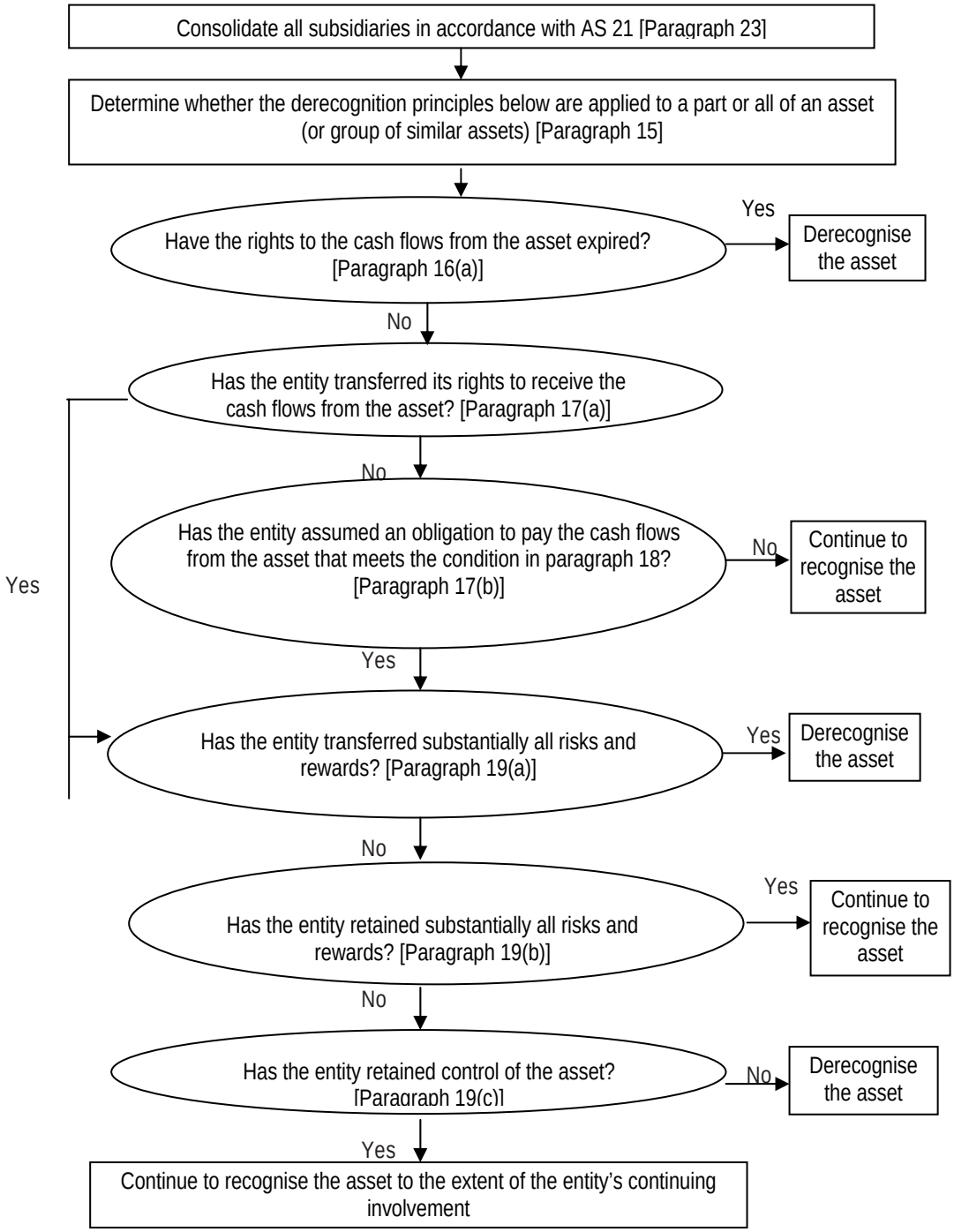
(c) a forward contract that is within the scope of this Standard (see paragraphs 2-6) is recognised as an asset or a liability on the commitment date, rather than on the date on which settlement takes place. When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero. If the net fair value of the right and obligation is not zero, the contract is recognised as an asset or liability.

(d) option contracts that are within the scope of this Standard (see paragraphs 2-6) are recognised as assets or liabilities when the holder or writer becomes a party to the contract.

(e) planned future transactions, no matter how likely, are not assets and liabilities because the entity has not become a party to a contract.

Derecognition of a Financial Asset (paragraphs 15-37)

A59. The following flow chart illustrates the evaluation of whether and to what extent a financial asset is derecognised.



Arrangements under which an entity retains the contractual rights to receive the cash flows of a financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients (paragraph 17(b))

A60. The situation described in paragraph 17(b) (when an entity 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) occurs, for example, if the entity is a special purpose entity or trust, and issues to investors beneficial interests in the underlying financial assets that it owns and provides servicing of those financial assets. In that case, the financial assets qualify for derecognition if the conditions in paragraphs 18 and 19 are met.

A61. In applying paragraph 18, the entity could be, for example, the originator of the financial asset, or it could be a group that includes a consolidated special purpose entity that has acquired the financial asset and passes on cash flows to unrelated third party investors.

Evaluation of the transfer of risks and rewards of ownership (paragraph 19)

A62. Examples of when an entity has transferred substantially all the risks and rewards of ownership are:

(a) an unconditional sale of a financial asset;
(b) a sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase; and
(c) sale of a financial asset together with a put or call option that is deeply out of the money (i.e., an option that is so far out of the money it is highly unlikely to go into the money before expiry).

A63. Examples of when an entity has retained substantially all the risks and rewards of ownership are:

(a) a sale and repurchase transaction (e.g., REPO transactions) where the repurchase price is a fixed price or the sale price plus a lender's return;
(b) a securities lending agreement;
(c) a sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity;
(d) a sale of a financial asset together with a deep in-the-money put or call option (i.e., an option that is so far in the money that it is highly unlikely to go out of the money before expiry); and
(e) a sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.

A64. If an entity determines that as a result of the transfer, it has transferred substantially all the risks and rewards of ownership of the transferred asset, it does not recognise the transferred asset again in a future period, unless it reacquires the transferred asset in a new transaction.

Evaluation of the transfer of control

A65. An entity has not retained control of a transferred asset if the transferee has the practical ability to sell the transferred asset. An entity has retained control of a transferred asset if the transferee does not have the practical ability to sell the transferred asset. A transferee has the practical ability to sell the transferred asset if it is traded in an active market because the transferee could repurchase the transferred asset in the market if it needs to return the asset to the entity. For example, a transferee may have the practical ability to sell a transferred asset if the transferred asset is subject to an option that allows the entity to repurchase it, but the transferee can readily obtain the transferred asset in the market if the option is exercised. A transferee does not have the practical ability to sell the transferred asset if the entity retains such an option and the transferee cannot readily obtain the transferred asset in the market if the entity exercises its option.

A66. The transferee has the practical ability to sell the transferred asset only if the transferee can sell the transferred asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without imposing additional restrictions on the transfer. The critical question is what the transferee is able to do in practice, not what contractual rights the transferee has concerning what it can do with the transferred asset or what contractual prohibitions exist. In particular:

(a) a contractual right to dispose of the transferred asset has little practical effect if there is no market for the transferred asset; and

(b) an ability to dispose of the transferred asset has little practical effect if it cannot be exercised freely. For that reason:

   (i) the transferee's ability to dispose of the transferred asset must be independent of the actions of others (i.e., it must be a unilateral ability); and

   (ii) the transferee must be able to dispose of the transferred asset without needing to attach restrictive conditions or 'strings' to the transfer (e.g., conditions about how a loan asset is serviced or an option giving the transferee the right to repurchase the asset).

A67. That the transferee is unlikely to sell the transferred asset does not, of itself, mean that the transferor has retained control of the transferred asset. However, if a put option or guarantee constrains the transferee from selling the transferred asset, then the transferor has retained control of the transferred asset. For example, if a put option or guarantee is sufficiently valuable it constrains the transferee from selling the transferred asset because the transferee would, in practice, not sell the transferred asset to a third party without attaching a similar option or other restrictive conditions. Instead, the transferee would hold the transferred asset so as to obtain payments under the guarantee or put option. Under these circumstances the transferor has retained control of the transferred asset.

Transfers that Qualify for Derecognition

A68. An entity may retain the right to a part of the interest payments on transferred assets as compensation for servicing those assets. The part of the interest payments that the entity would give up upon termination or transfer of the servicing contract is allocated to the servicing asset or servicing liability. The part of the interest payments that the entity would not give up is an interest-only strip receivable. For example, if the entity would not give up any interest upon termination or transfer of the servicing contract, the entire interest spread is an interest-only strip receivable. For the purposes of applying paragraph 27, the fair values of the servicing asset and interest-only strip receivable are used to allocate the carrying amount of the receivable between the part of the asset that is derecognised and the part that continues to be recognised. If there is no servicing fee specified or the fee to be received is not expected to compensate the entity adequately for performing the servicing, a liability for the servicing obligation is recognised at fair value.

A69. In estimating the fair values of the part that continues to be recognised and the part that is derecognised for the purposes of applying paragraph 27, an entity applies the fair value measurement requirements in paragraphs 53-55 and A88-A102 in addition to paragraph 28.

Transfers that Do Not Qualify for Derecognition

A70. The following is an application of the principle outlined in paragraph 29. If a guarantee provided by the entity for default losses on the transferred asset prevents a transferred asset from being derecognised because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the transferred asset continues to be recognised in its entirety and the consideration received is recognised as a liability.

Continuing Involvement in Transferred Assets

A71. The following are examples of how an entity measures a transferred asset and the associated liability under paragraph 30.

All assets

(a) If a guarantee provided by an entity to pay for default losses on a transferred asset prevents the transferred asset from being derecognised to the extent of the continuing involvement, the transferred asset at the date of the transfer is measured at the lower of (i) the carrying amount of the asset and (ii) the maximum amount of the consideration received in the transfer that the entity could be required to repay ('the guarantee amount'). The associated liability is initially measured at the guarantee amount plus the fair value of the guarantee (which is normally the consideration received for the guarantee). Subsequently, the initial fair value of the guarantee is recognised in the statement of profit and loss on a time proportion basis (see AS 9 (revised)[30]) and the carrying value of the asset is reduced by any impairment losses.

Assets measured at amortised cost

(b) If a put option obligation written by an entity or call option right held by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at amortised cost, the associated liability is measured at its cost (i.e., the consideration received) adjusted for the amortisation of any difference between that cost and the amortised cost of the transferred asset at the expiration date of the option. For example, assume that the amortised cost and carrying amount of the asset on the date of the transfer is ₹ 98 and that the consideration received is ₹ 95. The amortised cost of the asset on the option exercise date will be ₹ 100. The initial carrying amount of the associated liability is ₹ 95 and the difference between ₹ 95 and ₹ 100 is recognised in the statement of profit and loss using the effective interest method. If the option is exercised, any difference between the carrying amount of the associated liability and the exercise price is recognised in the statement of profit and loss.

Assets measured at fair value

(c) If a call option right retained by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at fair value, the asset continues to be measured at its fair value. The associated liability is measured at (i) the option exercise price less the time value of the option if the option is in or at the money, or (ii) the fair value of the transferred asset less the time value of the option if the option is out of the money. The adjustment to the measurement of the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the call option right. For example, if the fair value of the underlying asset is ₹ 80, the option exercise price is ₹ 95 and the time value of the option is ₹ 5, the carrying amount of the associated liability is ₹ 75 (₹ 80 - ₹ 5) and the carrying amount of the transferred asset is ₹ 80 (i.e., its fair value).

(d) If a put option written by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at fair value, the associated liability is measured at the option exercise price plus the time value of the option. The measurement of the asset at fair value is limited to the lower of the fair value and the option exercise price because the entity has no right to increases in the fair value of the transferred asset above the exercise price of the option. This ensures that the net carrying amount of the asset and the associated liability is the fair value of the put option obligation. For example, if the fair value of the underlying asset is ₹ 120, the option exercise price is ₹ 100 and the

[30] AS 9 is presently under revision.

time value of the option is ₹ 5, the carrying amount of the associated liability is ₹ 105 (₹ 100 + ₹ 5) and the carrying amount of the asset is ₹ 100 (in this case the option exercise price).

(e) If a collar, in the form of a purchased call and written put, prevents a transferred asset from being derecognised and the entity measures the asset at fair value, it continues to measure the asset at fair value. The associated liability is measured at (i) the sum of the call exercise price and fair value of the put option less the time value of the call option, if the call option is in or at the money, or (ii) the sum of the fair value of the asset and the fair value of the put option less the time value of the call option if the call option is out of the money. The adjustment to the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the options held and written by the entity. For example, assume an entity transfers a financial asset that is measured at fair value while simultaneously purchasing a call with an exercise price of ₹ 120 and writing a put with an exercise price of ₹ 80. Assume also that the fair value of the asset is ₹ 100 at the date of the transfer. The time value of the put and call are ₹ 1 and ₹ 5 respectively. In this case, the entity recognises an asset of ₹ 100 (the fair value of the asset) and a liability of ₹ 96 [(₹ 100 + ₹ 1) – ₹ 5]. This gives a net asset value of ₹ 4, which is the fair value of the options held and written by the entity.

All Transfers

A72. To the extent that a transfer of a financial asset does not qualify for derecognition, the transferor's contractual rights or obligations related to the transfer are not accounted for separately as derivatives if recognising both the derivative and either the transferred asset or the liability arising from the transfer would result in recognising the same rights or obligations twice. For example, a call option retained by the transferor may prevent a transfer of financial assets from being accounted for as a sale. In that case, the call option is not separately recognised as a derivative asset.

A73. To the extent that a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset. The transferee derecognises the cash or other consideration paid and recognises a receivable from the transferor. If the transferor has both a right and an obligation to reacquire control of the entire transferred asset for a fixed amount (such as under a repurchase agreement), the transferee may account for its receivable as a loan or receivable.

Examples

A74. The following examples illustrate the application of the derecognition principles of this Standard.

(a) *Repurchase agreements and securities lending.* If a financial asset is sold under an agreement to repurchase it at a fixed price or at the sale price plus a lender's return or if it is loaned under an agreement to return it to the transferor, it is not derecognised because the transferor retains substantially all the risks and rewards of ownership. If the transferee obtains the right to sell or pledge the asset, the transferor reclassifies the asset on its balance sheet, for example, as a loaned asset or repurchase receivable.

(b) *Repurchase agreements and securities lending—assets that are substantially the same*. If a financial asset is sold under an agreement to repurchase the same or substantially the same asset at a fixed price or at the sale price plus a lender's return or if a financial asset is borrowed or loaned under an agreement to return the same or substantially the same asset to the transferor, it is not derecognised because the transferor retains substantially all the risks and rewards of ownership.

(c) *Repurchase agreements and securities lending—right of substitution*. If a repurchase agreement at a fixed repurchase price or a price equal to the sale price plus a lender's return, or a similar securities lending transaction, provides the transferee with a right to substitute assets that are similar and of equal fair value to the transferred asset at the repurchase date, the asset sold or lent under a

repurchase or securities lending transaction is not derecognised because the transferor retains substantially all the risks and rewards of ownership.

(d) *Repurchase right of first refusal at fair value.* If an entity sells a financial asset and retains only a right of first refusal to repurchase the transferred asset at fair value in case the transferee subsequently sells it, the entity derecognises the asset because it has transferred substantially all the risks and rewards of ownership.

(e) *Wash sale transaction.* The repurchase of a financial asset shortly after it has been sold is sometimes referred to as a wash sale. Such a repurchase does not preclude derecognition provided that the original transaction met the derecognition requirements. However, if an agreement to sell a financial asset is entered into concurrently with an agreement to repurchase the same asset at a fixed price or the sale price plus a lender's return, then the asset is not derecognised.

(f) *Put options and call options that are deeply in the money.* If a transferred financial asset can be called back by the transferor and the call option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership. Similarly, if the financial asset can be put back by the transferee and the put option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership.

(g) *Put options and call options that are deeply out of the money.* A financial asset that is transferred subject only to a deep out-of-the-money put option held by the transferee or a deep out-of-the-money call option held by the transferor is derecognised. This is because the transferor has transferred substantially all the risks and rewards of ownership.

(h) *Readily obtainable assets subject to a call option that is neither deeply in the money nor deeply out of the money*. If an entity holds a call option on an asset that is readily obtainable in the market and the option is neither deeply in the money nor deeply out of the money, the asset is derecognised. This is because the entity (i) has neither retained nor transferred substantially all the risks and rewards of ownership, and (ii) has not retained control. However, if the asset is not readily obtainable in the market, derecognition is precluded to the extent of the amount of the asset that is subject to the call option because the entity has retained control of the asset.

(i) A not readily obtainable asset subject to a put option written by an entity that is neither deeply in the money nor deeply out of the money. If an entity transfers a financial asset that is not readily obtainable in the market, and writes a put option that is not deeply out of the money, the entity neither retains nor transfers substantially all the risks and rewards of ownership because of the written put option. The entity retains control of the asset if the put option is sufficiently valuable to prevent the transferee from selling the asset, in which case the asset continues to be recognised to the extent of the transferor's continuing involvement (see paragraph A67). The entity transfers control of the asset if the put option is not sufficiently valuable to prevent the transferee from selling the asset, in which case the asset is derecognised.

(j) *Assets subject to a fair value put or call option or a forward repurchase agreement.* A transfer of a financial asset that is subject only to a put or call option or a forward repurchase agreement that has an exercise or repurchase price equal to the fair value of the financial asset at the time of repurchase results in derecognition because of the transfer of substantially all the risks and rewards of ownership.

(k) *Cash settled call or put options.* An entity evaluates the transfer of a financial asset that is subject to a put or call option or a forward repurchase agreement that will be settled net in cash to determine whether it has retained or transferred substantially all the risks and rewards of ownership. If the entity has not retained substantially all the risks and rewards of ownership of the transferred asset, it

determines whether it has retained control of the transferred asset. That the put or the call or the forward repurchase agreement is settled net in cash does not automatically mean that the entity has transferred control (see paragraphs A67 and (g), (h) and (i) above).

(l) *Removal of accounts provision.* A removal of accounts provision is an unconditional repurchase (call) option that gives an entity the right to reclaim assets transferred subject to some restrictions. Provided that such an option results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership, it precludes derecognition only to the extent of the amount subject to repurchase (assuming that the transferee cannot sell the assets). For example, if the carrying amount and proceeds from the transfer of loan assets are ₹ 100,000 and any individual loan could be called back but the aggregate amount of loans that could be repurchased could not exceed ₹ 10,000, ₹ 90,000 of the loans would qualify for derecognition.

(m) *Clean-up calls.* An entity, which may be a transferor, that services transferred assets may hold a clean-up call to purchase remaining transferred assets when the amount of outstanding assets falls to a specified level at which the cost of servicing those assets becomes burdensome in relation to the benefits of servicing. Provided that such a clean-up call results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership and the transferee cannot sell the assets, it precludes derecognition only to the extent of the amount of the assets that is subject to the call option.

(n) *Subordinated retained interests and credit guarantees.* An entity may provide the transferee with credit enhancement by subordinating some or all of its interest retained in the transferred asset. Alternatively, an entity may provide the transferee with credit enhancement in the form of a credit guarantee that could be unlimited or limited to a specified amount. If the entity retains substantially all the risks and rewards of ownership of the transferred asset, the asset continues to be recognised in its entirety. If the entity retains some, but not substantially all, of the risks and rewards of ownership and has retained control, derecognition is precluded to the extent of the amount of cash or other assets that the entity could be required to pay.

(o) *Total return swaps.* An entity may sell a financial asset to a transferee and enter into a total return swap with the transferee, whereby all of the interest payment cash flows from the underlying asset are remitted to the entity in exchange for a fixed payment or variable rate payment and any increases or declines in the fair value of the underlying asset are absorbed by the entity. In such a case, derecognition of all of the asset is prohibited.

(p) *Interest rate swaps.* An entity may transfer to a transferee a fixed rate financial asset and enter into an interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount that is equal to the principal amount of the transferred financial asset. The interest rate swap does not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on payments being made on the transferred asset.

(q) A*mortising interest rate swaps.* An entity may transfer to a transferee a fixed rate financial asset that is paid off over time, and enter into an amortising interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount. If the notional amount of the swap amortises so that it equals the principal amount of the transferred financial asset outstanding at any point in time, the swap would generally result in the entity retaining substantial prepayment risk, in which case the entity either continues to recognise all of the transferred asset or continues to recognise the transferred asset to the extent of its continuing involvement. Conversely, if the amortisation of the notional amount of the swap is not linked to the principal amount outstanding of the transferred asset, such a swap would not result in the entity retaining prepayment risk on the asset. Hence, it would not preclude derecognition of the transferred asset provided the payments on the swap are not conditional

on interest payments being made on the transferred asset and the swap does not result in the entity retaining any other significant risks and rewards of ownership on the transferred asset.

A75. This paragraph illustrates the application of the continuing involvement approach when the entity's continuing involvement is in a part of a financial asset.

Assume an entity has a portfolio of prepayable loans whose coupon and effective interest rate is 10 per cent and whose principal amount and amortised cost is ₹ 10,000. It enters into a transaction in which, in return for a payment of ₹ 9,115, the transferee obtains the right to ₹ 9,000 of any collections of principal plus interest thereon at 9.5 per cent. The entity retains rights to ₹ 1,000 of any collections of principal plus interest thereon at 10 per cent, plus the excess spread of 0.5 per cent on the remaining ₹ 9,000 of principal. Collections from prepayments are allocated between the entity and the transferee proportionately in the ratio of 1:9, but any defaults are deducted from the entity's interest of ₹ 1,000 until that interest is exhausted. The fair value of the loans at the date of the transaction is ₹ 10,100 and the estimated fair value of the excess spread of 0.5 per cent is ₹ 40.

The entity determines that it has transferred some significant risks and rewards of ownership (for example, significant prepayment risk) but has also retained some significant risks and rewards of ownership (because of its subordinated retained interest) and has retained control. It therefore applies the continuing involvement approach.

To apply this Standard, the entity analyses the transaction as (a) a retention of a fully proportionate retained interest of ₹ 1,000, plus (b) the subordination of that retained interest to provide credit enhancement to the transferee for credit losses.

The entity calculates that ₹ 9,090 (90 per cent × ₹ 10,100) of the consideration received of ₹ 9,115 represents the consideration for a fully proportionate 90 per cent share. The remainder of the consideration received (₹ 25) represents consideration received for subordinating its retained interest to provide credit enhancement to the transferee for credit losses. In addition, the excess spread of 0.5 per cent represents consideration received for the credit enhancement. Accordingly, the total consideration received for the credit enhancement is ₹ 65 (₹ 25 + ₹ 40).

The entity calculates the gain or loss on the sale of the 90 per cent share of cash flows. Assuming that separate fair values of the 90 per cent part transferred and the 10 per cent part retained are not available at the date of the transfer, the entity allocates the carrying amount of the asset in accordance with paragraph 28 as follows:

Estimated	Percentage Fair Value	Allocated	Carrying Amount
Portion transferred	9,090	90%	9,000
Portion retained	1,010	10%	1,000
Total	10,100		10,000

The entity computes its gain or loss on the sale of the 90 per cent share of the cash flows by deducting the allocated carrying amount of the portion transferred from the consideration received, i.e., ₹ 90 (₹ 9,090 - ₹ 9,000). The carrying amount of the portion retained by the entity is ₹ 1,000.

In addition, the entity recognises the continuing involvement that results from the subordination of its retained interest for credit losses. Accordingly, it recognises an asset of ₹ 1,000 (the maximum amount of the cash flows it would not receive under the subordination), and an associated liability of ₹ 1,065 (which is the maximum amount of the cash flows it would not receive under the subordination, i.e., ₹ 1,000 plus the fair value of the subordination of ₹ 65).

The entity uses all of the above information to account for the transaction as follows:

	Debit	Credit
Original asset	–	9,000
Asset recognised for subordination or the residual interest	1,000	–
Asset for the consideration received in the form of excess spread	40	–
Profit or loss (gain on transfer)	–	90
Liability	–	1,065
Cash received	9,115	–
Total	10,155	10,155

Immediately following the transaction, the carrying amount of the asset is ₹ 2,040 comprising ₹ 1,000, representing the allocated cost of the portion retained, and ₹ 1,040, representing the entity's additional continuing involvement from the subordination of its retained interest for credit losses (which includes the excess spread of ₹ 40).

In subsequent periods, the entity recognises the consideration received for the credit enhancement (₹ 65) on a time proportion basis, accrues interest on the recognised asset using the effective interest method and recognises any credit impairment on the recognised assets. As an example of the latter, assume that in the following year there is a credit impairment loss on the underlying loans of ₹ 300. The entity reduces its recognised asset by ₹ 600 (₹ 300 relating to its retained interest and ₹ 300 relating to the additional continuing involvement that arises from the subordination of its retained interest for credit losses), and reduces its recognised liability by ₹ 300. The net result is a charge to the statement of profit and loss for credit impairment of ₹ 300.

Derecognition of a Financial Liability (paragraphs 43-46)

A76. A financial liability (or part of it) is extinguished when the debtor either:

(a) discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or

(b) is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (If the debtor has given a guarantee this condition may still be met.)

A77. If an issuer of a debt instrument repurchases that instrument, the debt is extinguished even if the issuer is a market maker in that instrument or intends to resell it in the near term.

A78. Payment to a third party, including a trust (sometimes called 'in-substance defeasance'), does not, by itself, relieve the debtor of its primary obligation to the creditor, in the absence of legal release.

A79. If a debtor pays a third party to assume an obligation and notifies its creditor that the third party has assumed its debt obligation, the debtor does not derecognise the debt obligation unless the condition in paragraph A76(b) is met. If the debtor pays a third party to assume an obligation and obtains a legal release from its creditor, the debtor has extinguished the debt. However, if the debtor agrees to make payments on the debt to the third party or direct to its original creditor, the debtor recognises a new debt obligation to the third party. For example, suppose Entity A which owes ₹ 1,000,000 to Entity B agrees to pay ₹ 1,000,000 to Entity C at a future date to assume its obligation to Entity B. Entity B legally releases Entity A from any further obligation under the debt. As desired by Entity C, Entity A agrees to make payment to Entity B on behalf of Entity C. In this case, Entity A derecognises its obligation to pay ₹ 1,000,000 to Entity B and recognises a new obligation to pay this amount to Entity C.

A80. Although legal release, whether judicially or by the creditor, results in derecognition of a liability, the entity recognises a new liability if the derecognition criteria in paragraphs 15-37 are not met for the financial assets transferred. If those criteria are not met, the transferred assets are not derecognised, and the entity recognises a new liability relating to the transferred assets.

A81. For the purpose of paragraph 44, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.

A82. In some cases, a creditor releases a debtor from its present obligation to make payments, but the debtor assumes a guarantee obligation to pay if the party assuming primary responsibility defaults. In this circumstance the debtor:

(a) recognises a new financial liability based on the fair value of its obligation for the guarantee; and

(b) recognises a gain or loss based on the difference between (i) any proceeds paid and (ii) the carrying amount of the original financial liability less the fair value of the new financial liability.

Measurement (paragraphs 47-79)

Initial Measurement of Financial Assets and Financial Liabilities (paragraph 47)

A83. The fair value of a financial instrument on initial recognition is normally the transaction price (i.e., the fair value of the consideration given or received, see also paragraph A95). However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated, using a valuation technique (see paragraphs A93-A99). For example, the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset.

A84. If an entity originates a loan that bears an off-market interest rate (e.g., 5 per cent when the market rate for similar loans is 8 per cent), and receives an up-front fee as compensation, the entity recognises the loan at its fair value, i.e., net of the fee it receives. The entity accretes the discount to the statement of profit and loss using the effective interest rate method.

Example Illustrating Paragraph A84

Entity S lends ₹ 1,000,000 to Entity A. The loan carries interest at 5% per annum payable annually and is payable in full after a period of five years, even though the market rate for similar loans is 8%. To compensate entity S for the below market rate of interest, entity A pays an origination fees of ₹ 120,000 to entity S. There are no other directly related payments by either party.

Entity S recognises the loan at its fair value, i.e., net present value of interest ₹ 50,000 to be received each year for next five years and repayment of principal ₹ 1,000,000 to be received at the end of five years. The fair value of loan computed in this manner comes out to be ₹ 880,000 which is the same amount as the loan amount net of fees received. Entity S recognises interest on loan using the effective interest rate method computed as below:

Year	Balance Outstanding	Interest income @ 8% p.a.	Total	Cash received	Balance at end
1	880,000	70,400	950,400	50,000	900,400
2	900,400	72,032	972,432	50,000	922,432
3	922,432	73,795	996,227	50,000	946,227
4	946,227	75,698	1,021,925	50,000	971,925
5	971,925	78,075	1,050,000	1,000,000 + 50,000 = 1,050,000	Nil

Subsequent Measurement of Financial Assets (paragraphs 50 and 51)

A85. If a financial instrument that was previously recognised as a financial asset is measured at fair value and its fair value falls below zero, it is a financial liability measured in accordance with paragraph 52.

A86. The following example illustrates the accounting for transaction costs on the initial and subsequent measurement of an available-for-sale financial asset. An asset is acquired for ₹ 100 plus a purchase commission of ₹ 2. Initially, the asset is recognised at ₹ 102. The next financial reporting date occurs one day later, when the quoted market price of the asset is ₹ 100. If the asset were sold, a commission of ₹ 3 would be paid. On that date, the asset is measured at ₹ 100 (without regard to the possible commission on sale) and a loss of ₹ 2 is recognised in the appropriate equity account. If the available-for-sale financial asset has fixed or determinable payments, the transaction costs are amortised to the statement of profit and loss using the effective interest method. If the available-for-sale financial asset does not have fixed or determinable payments, the transaction costs are recognised in the statement of profit and loss when the asset is derecognised or becomes impaired.

A87. Instruments that are classified as loans and receivables are measured at amortised cost without regard to the entity's intention to hold them to maturity. However, short-term receivables with no stated interest rate are not measured at the amortised cost if the effect of discounting is immaterial. Such short-term receivables are measured at the original invoice amount.

Fair Value Measurement Considerations (paragraphs 53-55)

A88. Underlying the definition of fair value is a presumption that an entity is a going concern without any intention or need to liquidate, to curtail materially the scale of its operations or to undertake a transaction on adverse terms. Fair value is not, therefore, the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale. However, fair value reflects the credit quality of the instrument.

A89. This Standard uses the terms 'bid price' and 'asking price' (sometimes referred to as 'current offer price') in the context of quoted market prices, and the term 'the bid-ask spread' to include only transaction costs. Other adjustments to arrive at fair value (e.g., for counterparty credit risk) are not included in the term 'bid-ask spread'.

Active Market: Quoted Price

A90. A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from a reliable source, such as, an exchange, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. Fair value is defined in terms of a price agreed by a willing buyer and a willing seller in an arm's length transaction. The objective of determining fair value for a financial instrument that is traded in an active market is to arrive at the price at which a transaction would occur at the measurement date in that instrument (i.e., without modifying or repackaging the instrument) in the most advantageous active market to which the entity has immediate access. However, the entity adjusts the

price in the more advantageous market to reflect any differences in counterparty credit risk between instruments traded in that market and the one being valued. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used to measure the financial asset or financial liability.

A91. The appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the asking price. When an entity has assets and liabilities with offsetting market risks, it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate. When current bid and asking prices are unavailable, the price of the most recent transaction provides evidence of the current fair value as long as there has not been a significant change in economic circumstances since the time of the transaction. If conditions have changed since the time of the transaction (e.g., a change in the risk-free interest rate following the most recent price quote for a corporate bond), the fair value reflects the change in conditions by reference to current prices or rates for similar financial instruments, as appropriate. Similarly, if the entity can demonstrate that the last transaction price is not fair value (e.g., because it reflected the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale), that price is adjusted. The fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price. If a published price quotation in an active market does not exist for a financial instrument in its entirety, but active markets exist for its component parts, fair value is determined on the basis of the relevant market prices for the component parts.

A92. If a rate (rather than a price) is quoted in an active market, the entity uses that market-quoted rate as an input into a valuation technique to determine fair value. If the market-quoted rate does not include credit risk or other factors that market participants would include in valuing the instrument, the entity adjusts for those factors.

No Active Market: Valuation Technique

A93. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. Valuation techniques include using:

(a) recent arm's length market transactions between knowledgeable, willing parties, if such transactions are available;

(b) if available, reference to the current fair value of another instrument that is substantially the same;

(c) discounted cash flow analysis; and

(d) option pricing models.

If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.

A94. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Fair value is estimated on the basis of the results of a valuation technique that makes maximum use of market inputs, and relies as little as possible on entity-specific inputs. A valuation technique would be expected to arrive at a realistic estimate of the fair value if (a) it reasonably reflects how the market could be expected to price the instrument and (b) the inputs to the valuation technique reasonably represent market expectations and measures of the risk-return factors inherent in the financial instrument.

A95. Therefore, a valuation technique (a) incorporates all factors that market participants would consider in arriving at a price and (b) is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (i.e., without modification or repackaging) or based on any available observable market data. An entity obtains market data consistently in the same market where the instrument was originated or purchased. The best evidence of the fair value of a financial instrument at initial recognition is the transaction price (i.e., the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e., without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets.

A96. The subsequent measurement of the financial asset or financial liability and the subsequent recognition of gains and losses should be consistent with the requirements of this Standard. The application of paragraph A95 may result in no gain or loss being recognised on the initial recognition of a financial asset or financial liability. In such a case, this Standard requires that a gain or loss should be recognised after the initial recognition only to the extent that it arises from a change in a factor (including time) that market participants would consider in arriving at a price.

A97. The initial acquisition or origination of a financial asset or incurrence of a financial liability is a market transaction that provides a foundation for estimating the fair value of the financial instrument. In particular, if the financial instrument is a debt instrument (such as a loan), its fair value can be determined by reference to the market conditions that existed at its acquisition or origination date and current market conditions or interest rates currently charged by the entity or by others for similar debt instruments (i.e., similar remaining maturity, cash flow pattern, currency, credit risk, collateral and interest basis). Alternatively, provided there is no change in the credit risk of the debtor and applicable credit spreads after the origination of the debt instrument, an estimate of the current market interest rate may be derived by using a benchmark interest rate reflecting a better credit quality than the underlying debt instrument, holding the credit spread constant, and adjusting for the change in the benchmark interest rate from the origination date. If conditions have changed since the most recent market transaction, the corresponding change in the fair value of the financial instrument being valued is determined by reference to current prices or rates for similar financial instruments, adjusted as appropriate, for any differences from the instrument being valued.

A98. The same information may not be available at each measurement date. For example, at the date that an entity makes a loan or acquires a debt instrument that is not actively traded, the entity has a transaction price that is also a market price. However, no new transaction information may be available at the next measurement date and, although the entity can determine the general level of market interest rates, it may not know what level of credit or other risk market participants would consider in pricing the instrument on that date. An entity may not have information from recent transactions to determine the appropriate credit spread over the basic interest rate to use in determining a discount rate for a present value computation. It would be reasonable to assume, in the absence of evidence to the contrary, that no changes have taken place in the spread that existed at the date the loan was made. However, the entity would be expected to make reasonable efforts to determine whether there is evidence that there has been a change in such factors. When evidence of a change exists, the entity would consider the effects of the change in determining the fair value of the financial instrument.

A99. In applying discounted cash flow analysis, an entity uses one or more discount rates equal to the prevailing rates of return for financial instruments having substantially the same terms and characteristics, including the credit quality of the instrument, the remaining term over which the

contractual interest rate is fixed, the remaining term to repayment of the principal and the currency in which payments are to be made. Short-term receivables and payables with no stated interest rate are measured at the original invoice amount if the effect of discounting is immaterial.

No Active Market: Equity Instruments

A100. The fair value of investments in equity instruments that do not have a quoted market price in an active market and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 51(c) and 52) is reliably measurable if (a) the variability in the range of reasonable fair value estimates is not significant for that instrument or (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.

A101. There are many situations in which the variability in the range of reasonable fair value estimates of investments in equity instruments that do not have a quoted market price and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 51(c) and 52) is likely not to be significant. Normally it is possible to estimate the fair value of a financial asset that an entity has acquired from an outside party. However, if the range of reasonable fair value estimates is significant and the probabilities of the various estimates cannot be reasonably assessed, an entity is precluded from measuring the instrument at fair value.

Inputs to Valuation Techniques

A102. An appropriate technique for estimating the fair value of a particular financial instrument would incorporate observable market data about the market conditions and other factors that are likely to affect the instrument's fair value. The fair value of a financial instrument will be based on one or more of the following factors:

(a) *The time value of money (i.e., interest at the basic or risk-free rate).* Basic interest rates can usually be derived from observable government bond prices and are often quoted in financial publications. These rates typically vary with the expected dates of the projected cash flows along a yield curve of interest rates for different time horizons. For practical reasons, an entity may use a well-accepted and readily observable general rate, such as LIBOR or a swap rate, as the benchmark rate. (Because a rate such as LIBOR is not the risk-free interest rate, the credit risk adjustment appropriate to the particular financial instrument is determined on the basis of its credit risk in relation to the credit risk in this benchmark rate.) In some countries, the central government's bonds may carry a significant credit risk and may not provide a stable benchmark basic interest rate for instruments denominated in that currency. Some entities in these countries may have a better credit standing and a lower borrowing rate than the central government. In such a case, basic interest rates may be more appropriately determined by reference to interest rates for the highest rated corporate bonds issued in the currency of that jurisdiction.

(b) *Credit risk.* The effect on fair value of credit risk (i.e., the premium over the basic interest rate for credit risk) may be derived from observable market prices for traded instruments of different credit quality or from observable interest rates charged by lenders for loans of various credit ratings.

(c) *Foreign currency exchange prices.* Active currency exchange markets exist for most major currencies, and prices are quoted daily in financial publications.

(d) *Commodity prices.* There are observable market prices for many commodities.

(e) *Equity prices.* Prices (and indexes of prices) of traded equity instruments are readily observable in some markets. Present value based techniques may be used to estimate the current market price of equity instruments for which there are no observable prices.

(f) *Volatility (i.e., magnitude of future changes in price of the financial instrument or other item).* Measures of the volatility of actively traded items can normally be reasonably estimated on the basis of historical market data or by using volatilities implied in current market prices.

(g) *Prepayment risk and surrender risk.* Expected prepayment patterns for financial assets and expected surrender patterns for financial liabilities can be estimated on the basis of historical data. (The fair value of a financial liability that can be surrendered by the counterparty cannot be less than the present value of the surrender amount—see paragraph 55.)

(h) *Servicing costs for a financial asset or a financial liability.* Costs of servicing can be estimated using comparisons with current fees charged by other market participants. If the costs of servicing a financial asset or financial liability are significant and other market participants would face comparable costs, the issuer would consider them in determining the fair value of that financial asset or financial liability. It is likely that the fair value at inception of a contractual right to future fees equals the origination costs paid for them, unless future fees and related costs are out of line with market comparables.

The above factors are merely indicative in nature and are not intended to be exhaustive. An entity also considers the other relevant factors, if any, in determination of fair value of a financial instrument.

Gains and Losses (paragraphs 61-63)

A103. An entity applies AS 11 to financial assets and financial liabilities that are monetary items in accordance with AS 11 and denominated in a foreign currency. Under AS 11, any foreign exchange gains and losses on monetary assets and monetary liabilities are recognised in the statement of profit and loss. An exception is a monetary item that is designated as a hedging instrument in either a cash flow hedge (see paragraphs 106-112) or a hedge of a net investment in a non-integral foreign operation (see paragraph 113). For the purpose of recognising foreign exchange gains and losses under AS 11, a monetary available-for-sale financial asset is treated as if it were carried at amortised cost in the foreign currency. Accordingly, for such a financial asset, exchange differences resulting from changes in amortised cost are recognised in the statement of profit and loss and other changes in carrying amount are recognised in accordance with paragraph 61(b). For available-for-sale financial assets that are not monetary items under AS 11 (for example, equity instruments), the gain or loss including any related foreign exchange component is recognised directly in the appropriate equity account under paragraph 61(b). If there is a hedging relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in the foreign currency component of those financial instruments are recognised in the statement of profit and loss.

Impairment and Uncollectibility of Financial Assets (paragraphs 64-79)

Financial Assets Carried at Amortised Cost (paragraphs 69-71)

A104. Impairment of a financial asset carried at amortised cost is measured using the financial instrument's original effective interest rate because discounting at the current market rate of interest would, in effect, impose fair value measurement on financial assets that are otherwise measured at amortised cost. If the terms of a loan, receivable or held-to-maturity investment are renegotiated or otherwise modified because of financial difficulties of the borrower or issuer, impairment is measured using the original effective interest rate before the modification of terms. Cash flows relating to short-term receivables are not discounted if the effect of discounting is immaterial. If a loan, receivable or held-to-maturity investment has a variable interest rate, the discount rate for measuring any impairment loss under paragraph 69 is the current effective interest rate(s) determined under the contract. As a practical expedient, a creditor may measure impairment of a financial asset carried at amortised cost on the basis of an instrument's fair value using an observable market price. The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash

flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

A105. The process for estimating impairment considers all credit exposures, not only those of low credit quality. For example, if an entity uses an internal credit grading system it considers all credit grades, not only those reflecting a severe credit deterioration.

A106. Uncertainties surrounding the amount to be recognised as impairment loss are dealt with by various means according to the circumstances. The process for estimating the amount of an impairment loss may result either in a single amount or in a range of possible amounts. In the latter case, the entity recognises an impairment loss equal to the best estimate within the range taking into account all relevant information available before the financial statements are issued about conditions existing at the balance sheet date. In a range of possible outcomes, the best estimate of loss is determined by using 'expected value' statistical method of valuation which weighs all possible outcomes by their associated probabilities. Under this method, the best estimate of loss will be different depending on whether the probability of a loss of a given amount is, for example, 60 per cent or 90 per cent. Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the mid-point of the range is used as the best estimate.

A107. For the purpose of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics that are indicative of the debtors' ability to pay all amounts due according to the contractual terms (for example, on the basis of a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status and other relevant factors). The characteristics chosen are relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated. However, loss probabilities and other loss statistics differ at a group level between (a) assets that have been individually evaluated for impairment and found not to be impaired and (b) assets that have not been individually evaluated for impairment, with the result that a different amount of impairment may be required. If an entity does not have a group of assets with similar risk characteristics, it does not make the additional assessment.

A108. Impairment losses recognised on a group basis represent an interim step pending the identification of impairment losses on individual assets in the group of financial assets that are collectively assessed for impairment. As soon as information is available that specifically identifies losses on individually impaired assets in a group, those assets are removed from the group.

A109. Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group. Entities that have no entity-specific loss experience or insufficient experience, use peer group experience for comparable groups of financial assets. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. Estimates of changes in future cash flows reflect and are directionally consistent with changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of incurred losses in the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

A110. As an example of applying paragraph A109, an entity may determine, on the basis of historical experience, that one of the main causes of default on credit card loans is the death of the borrower. The entity may observe that the death rate is unchanged from one year to the next. On this basis, the

entity concludes that some of the borrowers in its group of credit card loans may have died in that year, indicating that an impairment loss has occurred on those loans, even if, at the year-end, the entity is not yet aware which specific borrowers have died. It would be appropriate for an impairment loss to be recognised for these 'incurred but not reported' losses. However, it would not be appropriate to recognise an impairment loss for deaths that are expected to occur in a future period, because the necessary loss event (the death of the borrower) has not yet occurred.

A111. When using historical loss rates in estimating future cash flows, it is important that information about historical loss rates is applied to groups that are defined in a manner consistent with the groups for which the historical loss rates were observed. Therefore, the method used should enable each group to be associated with information about past loss experience in groups of assets with similar credit risk characteristics and relevant observable data that reflect current conditions.

A112. Formula-based approaches or statistical methods may be used to determine impairment losses in a group of financial assets (e.g., for smaller balance loans) as long as they are consistent with the requirements in paragraphs 69-71 and A107-A111. Any model used would incorporate the effect of the time value of money, consider the cash flows for all of the remaining life of an asset (not only the next year), consider the age of the loans within the portfolio and not give rise to an impairment loss on initial recognition of a financial asset.

Interest Income After Impairment Recognition

A113. Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is thereafter recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

Hedging (paragraphs 80-113)

Hedging Instruments (paragraphs 81-86)

Qualifying Instruments (paragraphs 81 and 82)

A114. The potential loss on an option that an entity writes could be significantly greater than the potential gain in value of a related hedged item. In other words, a written option is not effective in reducing the profit or loss exposure of a hedged item. Therefore, a written option does not qualify as a hedging instrument unless it is designated as an offset to a purchased option, including one that is embedded in another financial instrument (for example, a written call option used to hedge a callable liability). In contrast, a purchased option has potential gains equal to or greater than losses and therefore has the potential to reduce profit or loss exposure from changes in fair values or cash flows. Accordingly, it can qualify as a hedging instrument.

A115. A held-to-maturity investment carried at amortised cost may be designated as a hedging instrument in a hedge of foreign currency risk.

A116. An investment in an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured or a derivative that is linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 51(c) and 52) cannot be designated as a hedging instrument.

A117. An entity's own equity instruments are not financial assets or financial liabilities of the entity and therefore cannot be designated as hedging instruments.

Hedged Items (paragraphs 87-94)

Qualifying Items (paragraphs 87-89)

A118. A firm commitment to acquire a business in a business combination cannot be a hedged item, except for foreign exchange risk, because the other risks being hedged cannot be specifically identified and measured. These other risks are general business risks.

A119. An investment accounted for using the equity method of accounting or using the proportionate consolidation cannot be a hedged item in a fair value hedge because the equity method and the proportionate consolidation recognises in the consolidated statement of profit and loss the investor's share of the associate's profit or loss and the venturer's share of the jointly controlled entity's profit or loss, respectively, rather than changes in the investment's fair value. For a similar reason, an investment in a consolidated subsidiary cannot be a hedged item in a fair value hedge because consolidation recognises in the consolidated statement of profit and loss the subsidiary's profit or loss, rather than changes in the investment's fair value. A hedge of a net investment in a foreign operation is different because it is a hedge of the foreign currency exposure, not a fair value hedge of the change in the value of the investment.

A120. Paragraph 89 states that in consolidated financial statements the foreign currency risk of a highly probable forecast intragroup transaction may qualify as a hedged item in a cash flow hedge, provided the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss. For this purpose an entity can be a parent, subsidiary, associate, joint venture or branch. If the foreign currency risk of a forecast intragroup transaction does not affect consolidated profit or loss, the intragroup transaction cannot qualify as a hedged item. This is usually the case for royalty payments, interest payments or management charges between members of the same group unless there is a related external transaction. However, when the foreign currency risk of a forecast intragroup transaction will affect consolidated profit or loss, the intragroup transaction can qualify as a hedged item. An example is forecast sales or purchases of inventories between members of the same group if there is an onward sale of the inventory to a party external to the group. Similarly, a forecast intragroup sale of plant and equipment from the group entity that manufactured it to a group entity that will use the plant and equipment in its operations may affect consolidated profit or loss. This could occur, for example, because the plant and equipment will be depreciated by the purchasing entity and the amount initially recognised for the plant and equipment may change if the forecast intragroup transaction is denominated in a currency other than the functional currency of the purchasing entity.

A121. If a hedge of a forecast intragroup transaction qualifies for hedge accounting, any gain or loss that is recognised directly in the appropriate equity account in accordance with paragraph 106(a) should be reclassified into, i.e., recognised in, the statement of profit and loss in the same period or periods during which the foreign currency risk of the hedged transaction affects consolidated profit or loss.

Designation of Financial Items as Hedged Items (paragraphs 90 and 91)

A122. If a portion of the cash flows of a financial asset or financial liability is designated as the hedged item, that designated portion must be less than the total cash flows of the asset or liability. For example, in the case of a liability whose effective interest rate is below LIBOR, an entity cannot designate (a) a portion of the liability equal to the principal amount plus interest at LIBOR and (b) a negative residual portion. However, the entity may designate all of the cash flows of the entire financial asset or financial liability as the hedged item and hedge them for only one particular risk (e.g., only for changes that are attributable to changes in LIBOR). For example, in the case of a financial liability

whose effective interest rate is 100 basis points below LIBOR, an entity can designate as the hedged item the entire liability (i.e., principal plus interest at LIBOR minus 100 basis points) and hedge the change in the fair value or cash flows of that entire liability that is attributable to changes in LIBOR. The entity may also choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph A124.

A123. In addition, if a fixed rate financial instrument is hedged some time after its origination and interest rates have changed in the meantime, the entity can designate a portion equal to a benchmark rate that is higher than the contractual rate paid on the item. The entity can do so provided that the benchmark rate is less than the effective interest rate calculated on the assumption that the entity had purchased the instrument on the day it first designates the hedged item. For example, assume an entity originates a fixed rate financial asset of ₹ 100 that has an effective interest rate of 6 per cent at a time when LIBOR is 4 per cent. It begins to hedge that asset some time later when LIBOR has increased to 8 per cent and the fair value of the asset has decreased to ₹ 90. The entity calculates that if it had purchased the asset on the date it first designates it as the hedged item for its then fair value of ₹ 90, the effective yield would have been 9.5 per cent. Because LIBOR is less than this effective yield, the entity can designate a LIBOR portion of 8 per cent that consists partly of the contractual interest cash flows and partly of the difference between the current fair value (i.e., ₹ 90) and the amount repayable on maturity (i.e., ₹ 100).

Designation of Non-Financial Items as Hedged Items (paragraph 92)

A124. Changes in the price of an ingredient or component of a non-financial asset or non-financial liability generally do not have a predictable, separately measurable effect on the price of the item that is comparable to the effect of, say, a change in market interest rates on the price of a bond. Thus, a non-financial asset or non-financial liability is a hedged item only in its entirety or for foreign exchange risk. If there is a difference between the terms of the hedging instrument and the hedged item (such as for a hedge of the forecast purchase of Brazilian coffee using a forward contract to purchase Colombian coffee on otherwise similar terms), the hedging relationship nonetheless can qualify as a hedge relationship provided all the conditions in paragraph 98 are met, including that the hedge is expected to be highly effective. For this purpose, the amount of the hedging instrument may be greater or less than that of the hedged item if this improves the effectiveness of the hedging relationship. For example, a regression analysis could be performed to establish a statistical relationship between the hedged item (e.g., a transaction in Brazilian coffee) and the hedging instrument (e.g., a transaction in Colombian coffee). If there is a valid statistical relationship between the two variables (i.e., between the unit prices of Brazilian coffee and Colombian coffee), the slope of the regression line can be used to establish the hedge ratio that will maximise expected effectiveness. For example, if the slope of the regression line is 1.02, a hedge ratio based on 0.98 quantities of hedged items to 1.00 quantities of the hedging instrument maximises expected effectiveness. However, the hedging relationship may result in ineffectiveness that is recognised in the statement of profit and loss during the term of the hedging relationship.

Designation of Groups of Items as Hedged Items (paragraphs 93 and 94)

A125. A hedge of an overall net position (e.g., the net of all fixed rate assets and fixed rate liabilities with similar maturities), rather than of a specific hedged item, does not qualify for hedge accounting. However, almost the same effect on profit or loss of hedge accounting for this type of hedging relationship can be achieved by designating as the hedged item part of the underlying items. For example, if a bank has ₹ 100 of assets and ₹ 90 of liabilities with risks and terms of a similar nature and hedges the net ₹ 10 exposure, it can designate as the hedged item ₹ 10 of those assets. This designation can be used if such assets and liabilities are fixed rate instruments, in which case it is a fair

value hedge, or if they are variable rate instruments, in which case it is a cash flow hedge. Similarly, if an entity has a firm commitment to make a purchase in a foreign currency of ₹ 100 and a firm commitment to make a sale in the foreign currency of ₹ 90, it can hedge the net amount of ₹ 10 by acquiring a derivative and designating it as a hedging instrument associated with ₹ 10 of the firm purchase commitment of ₹ 100.

Hedge Accounting (paragraphs 95-113)

A126. An example of a fair value hedge is a hedge of exposure to changes in the fair value of a fixed rate debt instrument as a result of changes in interest rates. Such a hedge could be entered into by the issuer or by the holder.

A127. An example of a cash flow hedge is the use of a swap to change floating rate debt to fixed rate debt (i.e., a hedge of a future transaction where the future cash flows being hedged are the future interest payments).

A128. A hedge of a firm commitment (e.g., a hedge of the change in fuel price relating to an unrecognised contractual commitment by an electric utility to purchase fuel at a fixed price) is a hedge of an exposure to a change in fair value. Accordingly, such a hedge is a fair value hedge. However, under paragraph 97 a hedge of the foreign currency risk of a firm commitment could alternatively be accounted for as a cash flow hedge.

Assessing Hedge Effectiveness

A129. A hedge is regarded as highly effective only if both of the following conditions are met:

(a) At the inception of the hedge and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. Such an expectation can be demonstrated in various ways, including a comparison of past changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk with past changes in the fair value or cash flows of the hedging instrument, or by demonstrating a high statistical correlation between the fair value or cash flows of the hedged item and those of the hedging instrument. The entity may choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph A124.

(b) The actual results of the hedge are within a range of 80-125 per cent. For example, if actual results are such that the loss on the hedging instrument is ₹ 120 and the gain on the cash instrument is ₹ 100, offset can be measured by 120 / 100, which is 120 per cent, or by 100 / 120, which is 83 per cent. In this example, assuming the hedge meets the condition in (a), the entity would conclude that the hedge has been highly effective.

A130. Effectiveness is assessed, at a minimum, at the time an entity prepares its annual or interim financial statements.

A131. This Standard does not specify a single method for assessing hedge effectiveness. The method an entity adopts for assessing hedge effectiveness depends on its risk management strategy. For example, if the entity's risk management strategy is to adjust the amount of the hedging instrument periodically to reflect changes in the hedged position, the entity needs to demonstrate that the hedge is expected to be highly effective only for the period until the amount of the hedging instrument is next adjusted. In some cases, an entity adopts different methods for different types of hedges. An entity's documentation of its hedging strategy includes its procedures for assessing effectiveness. Those procedures state whether the assessment includes all of the gain or loss on a hedging instrument or whether the instrument's time value is excluded.

A132. If an entity hedges less than 100 per cent of the exposure on an item, such as 85 per cent, it should designate the hedged item as being 85 per cent of the exposure and should measure ineffectiveness based on the change in that designated 85 per cent exposure. However, when hedging the designated 85 per cent exposure, the entity may use a hedge ratio of other than one to one if that improves the expected effectiveness of the hedge, as explained in paragraph A124.

A133. If the principal terms of the hedging instrument and of the hedged asset, liability, firm commitment or highly probable forecast transaction are the same, the changes in fair value and cash flows attributable to the risk being hedged may be likely to offset each other fully, both when the hedge is entered into and afterwards. For example, an interest rate swap is likely to be an effective hedge if the notional and principal amounts, term, repricing dates, dates of interest and principal receipts and payments, and basis for measuring interest rates are the same for the hedging instrument and the hedged item. In addition, a hedge of a highly probable forecast purchase of a commodity with a forward contract is likely to be highly effective if:

(a) the forward contract is for the purchase of the same quantity of the same commodity at the same time and location as the hedged forecast purchase;
(b) the fair value of the forward contract at inception is zero; and
(c) either the change in the discount or premium on the forward contract is excluded from the assessment of effectiveness and is recognised in the statement of profit and loss or the change in expected cash flows on the highly probable forecast transaction is based on the forward price for the commodity.

A134. Sometimes the hedging instrument offsets only part of the hedged risk. For example, a hedge would not be fully effective if the hedging instrument and hedged item are denominated in different currencies that do not move in tandem. Also, a hedge of interest rate risk using a derivative would not be fully effective if part of the change in the fair value of the derivative is attributable to the counterparty's credit risk.

A135. To qualify for hedge accounting, the hedge must relate to a specific identified and designated risk, and not merely to the entity's general business risks, and must ultimately affect the entity's profit or loss. A hedge of the risk of obsolescence of a physical asset or the risk of expropriation of property by a government is not eligible for hedge accounting; effectiveness cannot be measured because those risks are not measurable reliably.

A136. In the case of interest rate risk, hedge effectiveness may be assessed by preparing a maturity schedule for financial assets and financial liabilities that shows the net interest rate exposure for each time period, provided that the net exposure is associated with a specific asset or liability (or a specific group of assets or liabilities or a specific portion of them) giving rise to the net exposure, and hedge effectiveness is assessed against that asset or liability.

A137. In assessing the effectiveness of a hedge, an entity generally considers the time value of money. The fixed interest rate on a hedged item need not exactly match the fixed interest rate on a swap designated as a fair value hedge. Nor does the variable interest rate on an interest-bearing asset or liability need to be the same as the variable interest rate on a swap designated as a cash flow hedge. A swap's fair value derives from its net settlements. The fixed and variable rates on a swap can be changed without affecting the net settlement if both are changed by the same amount.

A138. If an entity does not meet hedge effectiveness criteria, the entity discontinues hedge accounting from the last date on which compliance with hedge effectiveness was demonstrated. However, if the entity identifies the event or change in circumstances that caused the hedging relationship to fail the effectiveness criteria, and demonstrates that the hedge was effective before the event or change in

circumstances occurred, the entity discontinues hedge accounting from the date of the event or change in circumstances.

Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk

A139. For a fair value hedge of interest rate risk associated with a portfolio of financial assets or financial liabilities, an entity would meet the requirements of this Standard if it complies with the procedures set out in (a)-(i) and paragraphs A140-A157 below.

(a) As part of its risk management process the entity identifies a portfolio of items whose interest rate risk it wishes to hedge. The portfolio may comprise only assets, only liabilities or both assets and liabilities. The entity may identify two or more portfolios (e.g., the entity may group its available-for-sale assets into a separate portfolio), in which case it applies the guidance below to each portfolio separately.

(b) The entity analyses the portfolio into repricing time periods based on expected, rather than contractual, repricing dates. The analysis into repricing time periods may be performed in various ways including scheduling cash flows into the periods in which they are expected to occur, or scheduling notional principal amounts into all periods until repricing is expected to occur.

(c) On the basis of this analysis, the entity decides the amount it wishes to hedge. The entity designates as the hedged item an amount of assets or liabilities (but not a net amount) from the identified portfolio equal to the amount it wishes to designate as being hedged. This amount also determines the percentage measure that is used for testing effectiveness in accordance with paragraph A151(b).

(d) The entity designates the interest rate risk it is hedging. This risk could be a portion of the interest rate risk in each of the items in the hedged position, such as a benchmark interest rate (e.g., LIBOR).

(e) The entity designates one or more hedging instruments for each repricing time period.

(f) Using the designations made in (c)-(e) above, the entity assesses at inception and in subsequent periods, whether the hedge is expected to be highly effective during the period for which the hedge is designated.

(g) Periodically, the entity measures the change in the fair value of the hedged item (as designated in (c)) that is attributable to the hedged risk (as designated in (d)), on the basis of the expected repricing dates determined in (b). Provided that the hedge is determined actually to have been highly effective when assessed using the entity's documented method of assessing effectiveness, the entity recognises the change in fair value of the hedged item as a gain or loss in the statement of profit and loss and in one of two line items in the balance sheet as described in paragraph 100. The change in fair value need not be allocated to individual assets or liabilities.

(h) The entity measures the change in fair value of the hedging instrument(s) (as designated in (e)) and recognises it as a gain or loss in the statement of profit and loss. The fair value of the hedging instrument(s) is recognised as an asset or liability in the balance sheet.

(i) Any ineffectiveness[31] will be recognised in the statement of profit and loss as the difference between the change in fair value referred to in (g) and that referred to in (h).

A140. This approach is described in more detail below. The approach is applied only to a fair value hedge of the interest rate risk associated with a portfolio of financial assets or financial liabilities.

A141. The portfolio identified in paragraph A139(a) could contain assets and liabilities. Alternatively, it could be a portfolio containing only assets, or only liabilities. The portfolio is used to determine the

[31] The same materiality considerations apply in this context as apply throughout Accounting Standards.

amount of the assets or liabilities the entity wishes to hedge. However, the portfolio is not itself designated as the hedged item.

A142. In applying paragraph A139(b), the entity determines the expected repricing date of an item as the earlier of the dates when that item is expected to mature or to reprice to market rates. The expected repricing dates are estimated at the inception of the hedge and throughout the term of the hedge, based on historical experience and other available information, including information and expectations regarding prepayment rates, interest rates and the interaction between them. Entities that have no entity-specific experience or insufficient experience use peer group experience for comparable financial instruments. These estimates are reviewed periodically and updated in the light of experience. In the case of a fixed rate item that is prepayable, the expected repricing date is the date on which the item is expected to prepay unless it reprices to market rates on an earlier date. For a group of similar items, the analysis into time periods based on expected repricing dates may take the form of allocating a percentage of the group, rather than individual items, to each time period. An entity may apply other methodologies for such allocation purposes. For example, it may use a prepayment rate multiplier for allocating amortising loans to time periods based on expected repricing dates. However, the methodology for such an allocation should be in accordance with the entity's risk management procedures and objectives.

A143. As an example of the designation set out in paragraph A139(c), if in a particular repricing time period an entity estimates that it has fixed rate assets of ₹ 100 and fixed rate liabilities of ₹ 80 and decides to hedge all of the net position of ₹ 20, it designates as the hedged item assets in the amount of ₹ 20 (a portion of the assets)[32]. The designation is expressed as an 'amount of a currency' (e.g., an amount of dollars, euro, pounds or rand) rather than as individual assets. It follows that all of the assets (or liabilities) from which the hedged amount is drawn—i.e., all of the ₹ 100 of assets in the above example—must be:

(a) items whose fair value changes in response to changes in the interest rate being hedged; and
(b) items that could have qualified for fair value hedge accounting if they had been designated as hedged individually. In particular, because the Standard[33] specifies that the fair value of a financial liability with a demand feature (such as demand deposits and some types of time deposits) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid, such an item cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the holder can demand payment. In the above example, the hedged position is an amount of assets. Hence, such liabilities are not a part of the designated hedged item, but are used by the entity to determine the amount of the asset that is designated as being hedged. If the position the entity wished to hedge was an amount of liabilities, the amount representing the designated hedged item must be drawn from fixed rate liabilities other than liabilities that the entity can be required to repay in an earlier time period, and the percentage measure used for assessing hedge effectiveness in accordance with paragraph A151(b) would be calculated as a percentage of these other liabilities. For example, assume that an entity estimates that in a particular repricing time period it has fixed rate liabilities of ₹ 100, comprising ₹ 40 of demand deposits and ₹ 60 of liabilities with no demand feature, and ₹ 70 of fixed rate assets. If the entity decides to hedge all of the net position of ₹ 30, it designates as the hedged item liabilities of ₹ 30 or 50 per cent[34] of the liabilities with no demand feature.

---

[32] The Standard permits an entity to designate any amount of the available qualifying assets or liabilities, i.e., in this example any amount of assets between Rs. 0 and Rs. 100.
[33] See Paragraph 52.
[34] Rs. 30 / (Rs. 100 – Rs. 40) = 50 per cent

A144. The entity also complies with the other designation and documentation requirements set out in paragraph 98(a). For a portfolio hedge of interest rate risk, this designation and documentation specifies the entity's policy for all of the variables that are used to identify the amount that is hedged and how effectiveness is measured, including the following:

(a) which assets and liabilities are to be included in the portfolio hedge and the basis to be used for removing them from the portfolio.

(b) how the entity estimates repricing dates, including what interest rate assumptions underlie estimates of prepayment rates and the basis for changing those estimates. The same method is used for both the initial estimates made at the time an asset or liability is included in the hedged portfolio and for any later revisions to those estimates.

(c) the number and duration of repricing time periods.

(d) how often the entity will test effectiveness and which of the two methods in paragraph A151 it will use.

(e) the methodology used by the entity to determine the amount of assets or liabilities that are designated as the hedged item and, accordingly, the percentage measure used when the entity tests effectiveness using the method described in paragraph A151(b).

(f) when the entity tests effectiveness using the method described in paragraph A151(b), whether the entity will test effectiveness for each repricing time period individually, for all time periods in aggregate, or by using some combination of the two.

The policies specified in designating and documenting the hedging relationship should be in accordance with the entity's risk management procedures and objectives. Changes in policies should not be made arbitrarily. They should be justified on the basis of changes in market conditions and other factors and be founded on and consistent with the entity's risk management procedures and objectives.

A145. The hedging instrument referred to in paragraph A139(e) may be a single derivative or a portfolio of derivatives all of which contain exposure to the hedged interest rate risk designated in paragraph A139(d) (e.g., a portfolio of interest rate swaps all of which contain exposure to LIBOR). Such a portfolio of derivatives may contain offsetting risk positions. However, it may not include written options or net written options, because the Standard[35] does not permit such options to be designated as hedging instruments (except when a written option is designated as an offset to a purchased option). If the hedging instrument hedges the amount designated in paragraph A139(c) for more than one repricing time period, it is allocated to all of the time periods that it hedges. However, the whole of the hedging instrument must be allocated to those repricing time periods because the Standard[36] does not permit a hedging relationship to be designated for only a portion of the time period during which a hedging instrument remains outstanding.

A146. When the entity measures the change in the fair value of a prepayable item in accordance with paragraph A139(g), a change in interest rates affects the fair value of the prepayable item in two ways: it affects the fair value of the contractual cash flows and the fair value of the prepayment option that is contained in a prepayable item. Paragraph 90 of the Standard permits an entity to designate a portion of a financial asset or financial liability, sharing a common risk exposure, as the hedged item, provided effectiveness can be measured. For prepayable items, paragraph 91 permits this to be achieved by designating the hedged item in terms of the change in the fair value that is attributable to changes in the designated interest rate on the basis of expected, rather than contractual, repricing dates. However,

[35] See paragraphs 86 and A114
[36] See paragraph 84

the effect that changes in the hedged interest rate have on those expected repricing dates should be included when determining the change in the fair value of the hedged item. Consequently, if the expected repricing dates are revised (e.g., to reflect a change in expected prepayments), or if actual repricing dates differ from those expected, ineffectiveness will arise as described in paragraph A151. Conversely, changes in expected repricing dates that (a) clearly arise from factors other than changes in the hedged interest rate, (b) are uncorrelated with changes in the hedged interest rate and (c) can be reliably separated from changes that are attributable to the hedged interest rate (e.g., changes in prepayment rates clearly arising from a change in demographic factors or tax regulations rather than changes in interest rate) are excluded when determining the change in the fair value of the hedged item, because they are not attributable to the hedged risk. If there is uncertainty about the factor that gave rise to the change in expected repricing dates or the entity is not able to separate reliably the changes that arise from the hedged interest rate from those that arise from other factors, the change is assumed to arise from changes in the hedged interest rate.

A147. The Standard does not specify the techniques used to determine the amount referred to in paragraph A139(g), namely the change in the fair value of the hedged item that is attributable to the hedged risk. If statistical or other estimation techniques are used for such measurement, management must expect the result to approximate closely that which would have been obtained from measurement of all the individual assets or liabilities that constitute the hedged item. It is not appropriate to assume that changes in the fair value of the hedged item equal changes in the value of the hedging instrument.

A148. Paragraph 100 requires that if the hedged item for a particular repricing time period is an asset, the change in its value is presented in a separate line item within assets. Conversely, if the hedged item for a particular repricing time period is a liability, the change in its value is presented in a separate line item within liabilities. These are the separate line items referred to in paragraph A139(g). Specific allocation to individual assets (or liabilities) is not required.

A149. Paragraph A139(i) notes that ineffectiveness arises to the extent that the change in the fair value of the hedged item that is attributable to the hedged risk differs from the change in the fair value of the hedging derivative. Such a difference may arise for a number of reasons, including:

(a) actual repricing dates being different from those expected, or expected repricing dates being revised;

(b) items in the hedged portfolio becoming impaired or being derecognised;

(c) the payment dates of the hedging instrument and the hedged item being different; and

(d) other causes (e.g., when a few of the hedged items bear interest at a rate below the benchmark rate for which they are designated as being hedged, and the resulting ineffectiveness is not so great that the portfolio as a whole fails to qualify for hedge accounting).

Such ineffectiveness[37] should be identified and recognised in the statement of profit and loss.

A150. Generally, the effectiveness of the hedge will be improved:

(a) if the entity schedules items with different prepayment characteristics in a way that takes account of the differences in prepayment behaviour.

(b) when the number of items in the portfolio is larger. When only a few items are contained in the portfolio, relatively high ineffectiveness is likely if one of the items prepays earlier or later than expected. Conversely, when the portfolio contains many items, the prepayment behaviour can be predicted more accurately.

[37] The same materiality considerations apply in this context as apply throughout Accounting Standards.

(c) when the repricing time periods used are narrower (e.g., 1-month as opposed to 3-month repricing time periods). Narrower repricing time periods reduces the effect of any mismatch between the repricing and payment dates (within the repricing time period) of the hedged item and those of the hedging instrument.

(d) the greater the frequency with which the amount of the hedging instrument is adjusted to reflect changes in the hedged item (e.g., because of changes in prepayment expectations).

A151. An entity tests effectiveness periodically. If estimates of repricing dates change between one date on which an entity assesses effectiveness and the next, it should calculate the amount of effectiveness either:

(a) as the difference between the change in the fair value of the hedging instrument (see paragraph A139(h)) and the change in the value of the entire hedged item that is attributable to changes in the hedged interest rate (including the effect that changes in the hedged interest rate have on the fair value of any embedded prepayment option); or

(b) using the following approximation. The entity:

  (i) calculates the percentage of the assets (or liabilities) in each repricing time period that was hedged, on the basis of the estimated repricing dates at the last date it tested effectiveness.
  (ii) applies this percentage to its revised estimate of the amount in that repricing time period to calculate the amount of the hedged item based on its revised estimate.
  (iii) calculates the change in the fair value of its revised estimate of the hedged item that is attributable to the hedged risk and presents it as set out in paragraph A139(g).
  (iv) recognises ineffectiveness equal to the difference between the amount determined in (iii) and the change in the fair value of the hedging instrument (see paragraph A139(h)).

A152. When measuring effectiveness, the entity distinguishes revisions to the estimated repricing dates of existing assets (or liabilities) from the origination of new assets (or liabilities), with only the former giving rise to ineffectiveness. All revisions to estimated repricing dates (other than those excluded in accordance with paragraph A146), including any reallocation of existing items between time periods, are included when revising the estimated amount in a time period in accordance with paragraph A151(b)(ii) and hence when measuring effectiveness. Once ineffectiveness has been recognised as set out above, the entity establishes a new estimate of the total assets (or liabilities) in each repricing time period, including new assets (or liabilities) that have been originated since it last tested effectiveness, and designates a new amount as the hedged item and a new percentage as the hedged percentage. The procedures set out in paragraph A151(b) are then repeated at the next date it tests effectiveness.

A153. Items that were originally scheduled into a repricing time period may be derecognised because of earlier than expected prepayment or write offs caused by impairment or sale. When this occurs, the amount of change in fair value included in the separate line item referred to in paragraph A139(g) that relates to the derecognised item is removed from the balance sheet, and included in the gain or loss that arises on derecognition of the item. For this purpose, it is necessary to know the repricing time period(s) into which the derecognised item was scheduled, because this determines the repricing time period(s) from which to remove it and hence the amount to remove from the separate line item referred to in paragraph A139(g). When an item is derecognised, if it can be determined in which time period it was included, it is removed from that time period. If not, it is removed from the earliest time period if the derecognition resulted from higher than expected prepayments, or allocated to all time periods containing the derecognised item on a systematic and rational basis if the item was sold or became impaired.

A154. In addition, any amount relating to a particular time period that has not been derecognised when the time period expires is recognised in the statement of profit and loss at that time (see paragraph 100). For example, assume an entity schedules items into three repricing time periods. At the previous redesignation, the change in fair value reported in the single line item on the balance sheet was an asset of ₹ 25. That amount represents amounts attributable to periods 1, 2 and 3 of ₹ 7, ₹ 8 and ₹ 10, respectively. At the next redesignation, the assets attributable to period 1 have been either realised or rescheduled into other periods. Therefore, ₹ 7 is derecognised from the balance sheet and recognised in the statement of profit and loss. ₹ 8 and ₹ 10 are now attributable to periods 1 and 2, respectively. These remaining periods are then adjusted, as necessary, for changes in fair value as described in paragraph A139(g).

A155. As an illustration of the requirements of the previous two paragraphs, assume that an entity scheduled assets by allocating a percentage of the portfolio into each repricing time period. Assume also that it scheduled ₹ 100 into each of the first two time periods. When the first repricing time period expires, ₹ 110 of assets are derecognised because of expected and unexpected repayments. In this case, all of the amount contained in the separate line item referred to in paragraph A139(g) that relates to the first time period is removed from the balance sheet, plus 10 per cent of the amount that relates to the second time period.

A156. If the hedged amount for a repricing time period is reduced without the related assets (or liabilities) being derecognised, the amount included in the separate line item referred to in paragraph A139(g) that relates to the reduction should be amortised in accordance with paragraph 103.

A157. An entity may wish to apply the approach set out in paragraphs A139-A156 to a portfolio hedge that had previously been accounted for as a cash flow hedge in accordance with this Standard. Such an entity would revoke the previous designation of a cash flow hedge in accordance with paragraph 112(d), and apply the requirements set out in that paragraph. It would also redesignate the hedge as a fair value hedge and apply the approach set out in paragraphs A139-A156 prospectively to subsequent accounting periods.

Appendix B

Illustrative Example

This example accompanies, but is not part of, AS 30. The purpose of this example is to illustrate application of hedge accounting principles of AS 30 to hedge the interest rate risk of a portfolio comprising assets and liabilities.

Facts

IE1. On 1 January 20x7, Entity A identifies a portfolio comprising assets and liabilities whose interest rate risk it wishes to hedge. The liabilities include demandable deposit liabilities that the depositor may withdraw at any time without notice. For risk management purposes, the entity views all of the items in the portfolio as fixed rate items.

IE2. For risk management purposes, Entity A analyses the assets and liabilities in the portfolio into repricing time periods based on expected repricing dates. The entity uses monthly time periods and schedules items for the next five years (i.e., it has 60 separate monthly time periods)[38] The assets in the portfolio are prepayable assets that Entity A allocates into time periods based on the expected

[38] In this Example principal cash flows have been scheduled into time periods but the related interest cash flows have been included when calculating the change in the fair value of the hedged item. Other methods of scheduling assets and liabilities are also possible. Also, in this Example, monthly repricing time periods have been used. An entity may choose narrower or wider time periods.

prepayment dates, by allocating a percentage of all of the assets, rather than individual items, into each time period. The portfolio also includes demandable liabilities that the entity expects, on a portfolio basis, to repay between one month and five years and, for risk management purposes, are scheduled into time periods on this basis. On the basis of this analysis, Entity A decides what amount it wishes to hedge in each time period.

IE3. This example deals only with the repricing time period expiring in three months' time, i.e., the time period maturing on 31 March 20x7 (a similar procedure would be applied for each of the other 59 time periods). Entity A has scheduled assets of ₹ 100 million and liabilities of ₹ 80 million into this time period. All of the liabilities are repayable on demand.

IE4. Entity A decides, for risk management purposes, to hedge the net position of ₹ 20 million and accordingly enters into an interest rate swap[39] on 1 January 20x7 to pay a fixed rate and receive LIBOR, with a notional principal amount of ₹ 20 million and a fixed life of three months.

IE5. This Example makes the following simplifying assumptions:

(a) the coupon on the fixed leg of the swap is equal to the fixed coupon on the asset;

(b) the coupon on the fixed leg of the swap becomes payable on the same dates as the interest payments on the asset; and

(c) the interest on the variable leg of the swap is the overnight LIBOR rate. As a result, the entire fair value change of the swap arises from the fixed leg only, because the variable leg is not exposed to changes in fair value due to changes in interest rates.

In cases when these simplifying assumptions do not hold, greater ineffectiveness will arise. (The ineffectiveness arising from (a) could be eliminated by designating as the hedged item a portion of the cash flows on the asset that are equivalent to the fixed leg of the swap.)

IE6. It is also assumed that Entity A tests effectiveness on a monthly basis.

IE7. The fair value of an equivalent non-prepayable asset of ₹ 20 million, ignoring changes in value that are not attributable to interest rate movements, at various times during the period of the hedge is as follows:

	1 Jan 20x7	31 Jan 20x7	1 Feb 20x7	28 Feb 20x7	31 Mar 20x7
Fair value (asset) (₹)	20,000,000	20,047,408	20,047,408	20,023,795	Nil

IE8. The fair value of the swap at various times during the period of the hedge is as follows.

	1 Jan 20x7	31 Jan 20x7	1 Feb 20x7	28 Feb 20x7	31 Mar 20x7
Fair value (asset) (₹)	Nil	(47,408)	(47,408)	(23,795)	Nil

Accounting Treatment

IE9. On 1 January 20x7, Entity A designates as the hedged item an amount of ₹ 20 million of assets in the three-month time period. It designates as the hedged risk the change in the value of the hedged item (i.e., the ₹ 20 million of assets) that is attributable to changes in LIBOR. It also complies with the other designation requirements set out in paragraphs 98(d) and Appendix A paragraph A144 of the Standard.

[39] The Example uses a swap as the hedging instrument. An entity may use forward rate agreements or other derivatives as hedging instruments.

IE10. Entity A designates as the hedging instrument the interest rate swap described in paragraph IE4.

End of month 1 (31 January 20x7)

IE11. On 31 January 20x7 (at the end of month 1) when Entity A tests effectiveness, LIBOR has decreased. Based on historical prepayment experience, Entity A estimates that, as a consequence, prepayments will occur faster than previously estimated. As a result it re-estimates the amount of assets scheduled into this time period (excluding new assets originated during the month) as ₹ 96 million.

IE12. The fair value of the designated interest rate swap with a notional principal of ₹ 20 million is (₹ 47,408)[40] (the swap is a liability).

IE13. Entity A computes the change in the fair value of the hedged item, taking into account the change in estimated prepayments, as follows.

(a) First, it calculates the percentage of the initial estimate of the assets in the time period that was hedged. This is 20 per cent (₹ 20 million / ₹ 100 million).

(b) Second, it applies this percentage (20 per cent) to its revised estimate of the amount in that time period (₹ 96 million) to calculate the amount that is the hedged item based on its revised estimate. This is ₹ 19.2 million.

(c) Third, it calculates the change in the fair value of this revised estimate of the hedged item (₹ 19.2 million) that is attributable to changes in LIBOR. This is ₹ 45,511 (₹ 47,408[41] x (₹ 19.2 million / ₹ 20 million)).

IE14. Entity A makes the following accounting entries relating to this time period:

Dr	Cash	₹ 172,097	
Cr	Statement of profit and loss (interest income)[42]		₹ 172,097
To recognise the interest received on the hedged amount (₹ 19.2 million).			
Dr	Statement of profit and loss (interest expense)	₹ 179,268	
	Cr Statement of profit and loss (interest income)		₹ 179,268
	Cr Cash		Nil
To recognise the interest received and paid on the swap designated as the hedging instrument.			
Dr	Statement of profit and loss (loss)	₹ 47,408	
	Cr Derivative liability		₹ 47,408
To recognise the change in the fair value of the swap.			
Dr	Separate balance sheet line item	₹ 45,511	
	Cr Statement of profit and loss (gain)		₹ 45,511
To recognise the change in the fair value of the hedged amount.			

IE15. The net result on profit or loss (excluding interest income and interest expense) is to recognise a loss of (₹ 1,897). This represents ineffectiveness in the hedging relationship that arises from the change in estimated prepayment dates.

[40] See paragraph IE8.
[41] i.e., Rs. 20,047,408 – Rs. 20,000,000. See paragraph IE7.
[42] This Example does not show how amounts of interest income and interest expense are calculated.

Beginning of month 2

IE16. On 1 February 20x7 Entity A sells a proportion of the assets in the various time periods. Entity A calculates that it has sold $8^1/_3$ per cent of the entire portfolio of assets. Because the assets were allocated into time periods by allocating a percentage of the assets (rather than individual assets) into each time period, Entity A determines that it cannot ascertain into which specific time periods the sold assets were scheduled. Hence it uses a systematic and rational basis of allocation. Based on the fact that it sold a representative selection of the assets in the portfolio, Entity A allocates the sale proportionately over all time periods.

IE17. On this basis, Entity A computes that it has sold $8^1/_3$ per cent of the assets allocated to the three-month time period, i.e., ₹ 8 million ($8^1/_3$ per cent of ₹ 96 million). The proceeds received are ₹ 8,018,400, equal to the fair value of the assets[43]. On derecognition of the assets, Entity A also removes from the separate balance sheet line item an amount that represents the change in the fair value of the hedged assets that it has now sold. This is $8^1/_3$ per cent of the total line item balance of ₹ 45,511, i.e., ₹ 3,793.

IE18. Entity A makes the following accounting entries to recognise the sale of the asset and the removal of part of the balance in the separate balance sheet line item.

Dr	Cash	₹ 8,018,400	
	Cr Asset		₹ 8,000,000
	Cr Separate balance sheet line		₹ 3,793
	Cr Statement of profit and loss (gain)		₹ 14,607
To recognise the sale of the asset at fair value and to recognise a gain on sale.			

Because the change in the amount of the assets is not attributable to a change in the hedged interest rate no ineffectiveness arises.

IE19. Entity A now has ₹ 88 million of assets and ₹ 80 million of liabilities in this time period. Hence the net amount Entity A wants to hedge is now ₹ 8 million and, accordingly, it designates ₹ 8 million as the hedged amount.

IE20. Entity A decides to adjust the hedging instrument by designating only a proportion of the original swap as the hedging instrument. Accordingly, it designates as the hedging instrument ₹ 8 million or 40 per cent of the notional amount of the original swap with a remaining life of two months and a fair value of ₹ 18,963.[44] It also complies with the other designation requirements in paragraphs 98(a) and A144 of the Standard. The ₹ 12 million of the notional amount of the swap that is no longer designated as the hedging instrument is either classified as held for trading with changes in fair value recognised in the statement of profit and loss, or is designated as the hedging instrument in a different hedge.[45]

IE21. As at 1 February 20x7 and after accounting for the sale of assets, the separate balance sheet line item is ₹ 41,718 (₹ 45,511 – ₹ 3,793), which represents the cumulative change in fair value of ₹ 17.6[46] million of assets. However, as at 1 February 20x7, Entity A is hedging only ₹ 8 million of assets

[43] The amount realised on sale of the asset is the fair value of a prepayable asset, which is less than the fair value of the equivalent non-prepayable asset shown in paragraph IE7.

[44] Rs. 47,408 x 40 per cent

[45] The entity could instead enter into an offsetting swap with a notional principal of Rs. 12 million to adjust its position and designate as the hedging instrument all Rs. 20 million of the existing swap and all Rs. 12 million of the new offsetting swap.

[46] Rs. 19.2 million – ($8^1/_3$ % x Rs. 19.2 million)

that have a cumulative change in fair value of ₹ 18,963.[47] The remaining separate balance sheet line item of ₹ 22,755[48] relates to an amount of assets that Entity A still holds but is no longer hedging. Accordingly Entity A amortises this amount over the remaining life of the time period, i.e., it amortises ₹ 22,755 over two months.

IE22. Entity A determines that it is not practicable to use a method of amortisation based on a recalculated effective yield and hence uses a straight-line method.

End of month 2 (28 February 20x7)

IE23. On 28 February 20x7 when Entity A next tests effectiveness, LIBOR is unchanged. Entity A does not revise its prepayment expectations. The fair value of the designated interest rate swap with a notional principal of ₹ 8 million is (₹ 9,518)[49] (the swap is a liability). Also, Entity A calculates the fair value of the ₹ 8 million of the hedged assets as at 28 February 20x7 as ₹ 8,009,518[50].

IE24. Entity A makes the following accounting entries relating to the hedge in this time period:

Dr	Cash	₹ 71,707	
	Cr Statement of profit and loss (interest income)		₹ 71,707
To recognise the interest received on the hedged amount (₹ 8 million).			
Dr	Statement of profit and loss (interest expense)	₹ 71,707	
	Cr Statement of profit and loss (interest income)		₹ 62,115
	Cr Cash		₹ 9,592
To recognise the interest received and paid on the portion of the swap designated as the hedging instrument (₹ 8 million).			
Dr	Derivative liability	₹ 9,445	
	Cr Statement of profit and loss (gain)		₹ 9,445
To recognise the change in the fair value of the portion of the swap designated as the hedging instrument (₹ 8 million) (₹ 9,518 – ₹ 18,963).			
Dr	Statement of profit and loss (loss)	₹ 9,445	
	Cr Separate balance sheet line item		₹ 9,445
To recognise the change in the fair value of the hedged amount (₹ 8,009,518 – ₹ 8,018,963).			

IE25. The net effect on profit or loss (excluding interest income and interest expense) is nil reflecting that the hedge is fully effective.

IE26. Entity A makes the following accounting entry to amortise the line item balance for this time period:

Dr	Statement of profit and loss (loss)	₹ 11,378	
	Cr Separate balance sheet line item		₹ 11,378[51]
To recognise the amortisation charge for the period.			

[47] Rs. 41,718 x (Rs. 8 million / Rs. 17.6 million)
[48] Rs. 41,718 – Rs. 18,963
[49] Rs. 23,795 [see paragraph IE8] x (Rs. 8 million / Rs. 20 million)
[50] Rs. 20,023,795 [see paragraph IE7] x (Rs. 8 million / Rs. 20 million)
[51] Rs. 22,755 / 2

End of month 3

IE27. During the third month there is no further change in the amount of assets or liabilities in the three-month time period. On 31 March 20x7 the assets and the swap mature and all balances are recognised in the statement of profit and loss.

IE28. Entity A makes the following accounting entries relating to this time period:

Dr	Cash	₹ 8,071,707	
	Cr Asset (balance sheet)		₹ 8,000,000
	Cr Statement of profit and loss (interest income)		₹ 71,707
To recognise the interest and cash received on maturity of the hedged amount (₹ 8 million).			

Dr	Statement of profit and loss (interest expense)	₹ 71,707	
	Cr Statement of profit and loss (interest income)		₹ 62,115
	Cr Cash		₹ 9,592
To recognise the interest received and paid on the portion of the swap designated as the hedging instrument (₹ 8 million).			

Dr	Derivative liability	₹ 9,518	
	Cr Statement of profit and loss (gain)		₹ 9,518
To recognise the expiry of the portion of the swap designated as the hedging instrument (₹ 8 million).			

Dr	Statement of profit and loss (loss)	₹ 9,518	
	Cr Separate balance sheet line item		₹ 9,518
To remove the remaining line item balance on expiry of the time period.			

IE29. The net effect on profit or loss (excluding interest income and interest expense) is nil reflecting that the hedge is fully effective.

IE30. Entity A makes the following accounting entry to amortise the line item balance for this time period:

Dr	Statement of profit and loss (loss)	₹ 11,377	
	Cr Separate balance sheet line item		₹ 11,377[52]
To recognise the amortisation charge for the period.			

Summary

IE31. The tables below summarise:

(a) changes in the separate balance sheet line item;

(b) the fair value of the derivative;

(c) the profit or loss effect of the hedge for the entire three-month period of the hedge; and

[52] ₹ 22,755 / 2

(d) interest income and interest expense relating to the amount designated as hedged.

Description	1 Jan 20x7 ₹	31 Jan 20x7 ₹	1 Feb 20x7 ₹	28 Feb 20x7 ₹	31 Mar 20x7 ₹
Amount of asset hedged	20,000,000	19,200,000	8,000,000	8,000,000	8,000,000
(a) Changes in the separate balance sheet line item					
Brought forward:					
Balance to be amortised	Nil	Nil	Nil	22,755	11,377
Remaining balance	Nil	Nil	45,511	18,963	9,518
Less: Adjustment on sale of asset	Nil	Nil	(3,793)	Nil	Nil
Adjustment for change in fair value of the hedged asset	Nil	45,511	Nil	(9,445)	(9,518)
Amortisation	Nil	Nil	Nil	(11,378)	(11,377)
Carried forward:					
Balance to be amortised	Nil	Nil	22,755	11,377	Nil
Remaining balance	Nil	45,511	18,963	9,518	Nil
(b) The fair value of the derivative					
	1 Jan 20x7	31 Jan 20x7	1 Feb 20x7	28 Feb 20x7	31 Mar 20x7
₹ 20,000,000	Nil	47,408	-	-	-
₹ 12,000,000	Nil	-	28,445	No longer designated as the hedging instrument	
₹ 8,000,000	Nil	-	18,963	9,518	Nil
Total	Nil	47,408	47,408	9,518	Nil
(c) Profit or loss effect of the hedge					
	1 Jan 20x7	31 Jan 20x7	1 Feb 20x7	28 Feb 20x7	31 Mar 20x7
Change in line item: asset	Nil	45,511	N/A	(9,445)	(9,518)
Change in derivative fair value	Nil	(47,408)	N/A	9,445	9,518
Net effect	Nil	(1,897)	N/A	Nil	Nil
Amortisation	Nil	Nil	N/A	(11,378)	(11,377)
In addition, there is a gain on sale of assets of ₹ 14,607 at 1 February 20x7.					
(d) Interest income and interest expense relating to the amount designated as hedged					
Profit or loss recognised for the amount hedged	1 Jan 20x7	31 Jan 20x7	1 Feb 20x7	28 Feb 20x7	31 Mar 20x7
Interest income					
- on the asset	Nil	172,097	N/A	71,707	71,707
- on the swap	Nil	179,268	N/A	62,115	62,115
Interest expense					
- on the swap	Nil	(179,268)	N/A	(71,707)	(71,707)

Appendix C

Guidance on Implementing AS 30

Financial Instruments: Recognition and Measurement

Guidance on Implementing AS 30

Financial Instruments: Recognition and Measurement

This guidance accompanies, but is not part of, AS 30.

Section A: Scope

A.1 Practice of settling net: forward contract to purchase a commodity

Entity XYZ enters into a fixed price forward contract to purchase one million kilograms of copper in accordance with its expected usage requirements. The contract permits XYZ to take physical delivery of the copper at the end of twelve months or to pay or receive a net settlement in cash, based on the change in fair value of copper. Is the contract accounted for as a derivative?

While such a contract meets the definition of a derivative, it is not necessarily accounted for as a derivative. The contract is a derivative instrument because there is no initial net investment, the contract is based on the price of copper, and it is to be settled at a future date. However, if XYZ intends to settle the contract by taking delivery and has no history for similar contracts of settling net in cash or of taking delivery of the copper and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin, the contract is not accounted for as a derivative under AS 30. Instead, it is accounted for as an executory contract.

A.2 Option to put a non-financial asset

Entity XYZ owns an office building. XYZ enters into a put option with an investor that permits XYZ to put the building to the investor for ₹ 150 million. The current value of the building is ₹ 175million. The option expires in five years. The option, if exercised, may be settled through

physical delivery or net cash, at XYZ's option. How do both XYZ and the investor account for the option?

XYZ's accounting depends on XYZ's intention and past practice for settlement. Although the contract meets the definition of a derivative, XYZ does not account for it as a derivative if XYZ intends to settle the contract by delivering the building if XYZ exercises its option and there is no past practice of settling net (paragraph 4 and Appendix A paragraph A29 of AS 30).

The investor, however, cannot conclude that the option was entered into to meet the investor's expected purchase, sale or usage requirements because the investor does not have the ability to require delivery (paragraph 6 of AS 30.). In addition, the option may be settled net in cash. Therefore, the investor has to account for the contract as a derivative. Regardless of past practices, the investor's intention does not affect whether settlement is by delivery or in cash. The investor has written an option, and a written option in which the holder has a choice of physical settlement or net cash settlement can never satisfy the normal delivery requirement for the exemption from AS 30 because the option writer does not have the ability to require delivery.

However, if the contract were a forward contract rather than an option, and if the contract required physical delivery and the reporting entity had no past practice of settling net in cash or of taking delivery of the building and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin, the contract would not be accounted for as a derivative.

Section B: Definitions

B.1 Definition of a financial instrument: gold bullion

Is gold bullion a financial instrument (like cash) or is it a commodity?

It is a commodity. Although bullion is highly liquid, there is no contractual right to receive cash or another financial asset inherent in bullion.

B.2 Definition of a derivative: examples of derivatives and underlyings

What are examples of common derivative contracts and the identified underlying?

AS 30 defines a derivative as follows:

"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."

Type of Contract	Main Pricing-Settlement Variable (Underlying Variable)
Interest Rate Swap	Interest rates
Currency Swap (Foreign Exchange Swap)	Currency rates
Commodity Swap	Commodity prices

Equity Swap	Equity prices (equity of another entity)
Credit Swap	Credit rating, credit index or credit price
Total Return Swap	Total fair value of the reference asset and interest rates
Purchased or Written Treasury Bond Option (call or put)	Interest rates
Purchased or Written Currency Option (call or put)	Currency rates
Purchased or Written Commodity Option (call or put)	Commodity prices
Currency Futures	Currency rates
Commodity Futures	Commodity prices
Interest Rate Forward Linked to Government Debt (Treasury Forward)	Interest rates
Currency Forward	Currency rates
Commodity Forward	Commodity prices
Equity Forward	Equity prices (equity of another entity)

The above list provides examples of contracts that normally qualify as derivatives under AS 30. The list is not exhaustive. Any contract that has an underlying may be a derivative. Moreover, even if an instrument meets the definition of a derivative contract, special provisions of AS 30 may apply, for example, if it is a weather derivative (see Appendix A paragraph A1 of AS 30.) or a contract to buy or sell a non-financial item such as commodity (see paragraph 4 and Appendix A paragraph A29 of AS 30.). Therefore, an entity must evaluate the contract to determine whether the other characteristics of a derivative are present and whether special provisions apply.

B.3 Definition of a derivative: settlement at a future date, interest rate swap with net or gross settlement

For the purpose of determining whether an interest rate swap is a derivative financial instrument under AS 30, does it make a difference whether the parties pay the interest payments to each other (gross settlement) or settle on a net basis?

No. The definition of a derivative does not depend on gross or net settlement.

To illustrate: Entity ABC enters into an interest rate swap with a counterparty (XYZ) that requires ABC to pay a fixed rate of 8 per cent and receive a variable amount based on three-month LIBOR, reset on a quarterly basis. The fixed and variable amounts are determined based on a ₹ 100 million notional amount. ABC and XYZ do not exchange the notional amount. ABC pays or receives a net cash amount each quarter based on the difference between 8 per cent and three-month LIBOR. Alternatively, settlement may be on a gross basis.

The contract meets the definition of a derivative regardless of whether there is net or gross settlement because its value changes in response to changes in an underlying variable (LIBOR), there is no initial net investment, and settlements occur at future dates.

B.4 Definition of a derivative: prepaid interest rate swap (fixed rate payment obligation prepaid at inception or subsequently)

If a party prepays its obligation under a *pay-fixed, receive-variable* interest rate swap at inception, is the swap a derivative financial instrument?

Yes.

To illustrate: Entity S enters into a ₹ 100 million notional amount five-year pay-fixed, receive-variable interest rate swap with Counterparty C. The interest rate of the variable part of the swap is reset on a

quarterly basis to three-month LIBOR. The interest rate of the fixed part of the swap is 10 per cent per year. Entity S prepays its fixed obligation under the swap of ₹ 50 million (₹ 100 million X 10 per cent X 5 years) at inception, discounted using market interest rates, while retaining the right to receive interest payments on the ₹ 100 million reset quarterly based on three-month LIBOR over the life of the swap.

The initial net investment in the interest rate swap is significantly less than the notional amount on which the variable payments under the variable leg will be calculated. The contract requires 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, such as a variable rate bond. Therefore, the contract fulfils the "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" provision of AS 30. Even though Entity S has no future performance obligation, the ultimate settlement of the contract is at a future date and the value of the contract changes in response to changes in the LIBOR index. Accordingly, the contract is regarded as a derivative contract.

Would the answer change if the fixed rate payment obligation is prepaid subsequent to initial recognition?

If the fixed leg is prepaid during the term, that would be regarded as a termination of the old swap and an origination of a new instrument that is evaluated under AS 30.

B.5 Definition of a derivative: prepaid pay-variable, receive-fixed interest rate swap

If a party prepays its obligation under a pay-variable, receive-fixed interest rate swap at inception of the contract or subsequently, is the swap a derivative financial instrument?

No. A prepaid pay-variable, receive-fixed interest rate swap is not a derivative if it is prepaid at inception and it is no longer a derivative if it is prepaid after inception because it provides a return on the prepaid (invested) amount comparable to the return on a debt instrument with fixed cash flows. The prepaid amount fails the "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" criterion of a derivative.

To illustrate: Entity S enters into a ₹ 100 million notional amount five-year pay-variable, receive-fixed interest rate swap with Counterparty C. The variable leg of the swap is reset on a quarterly basis to three-month LIBOR. The fixed interest payments under the swap are calculated as 10 per cent times the swap's notional amount, i.e., ₹ 10 million per year. Entity S prepays its obligation under the variable leg of the swap at inception at current market rates, while retaining the right to receive fixed interest payments of 10 per cent on ₹ 100 million per year.

The cash inflows under the contract are equivalent to those of a financial instrument with a fixed annuity stream since Entity S knows it will receive ₹ 10 million per year over the life of the swap. Therefore, all else being equal, the initial investment in the contract should equal that of other financial instruments that consist of fixed annuities. Thus, the initial net investment in the pay-variable, receive-fixed interest rate swap is equal to the investment required in a non-derivative contract that has a similar response to changes in market conditions. For this reason, the instrument fails the "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" criterion of AS 30. Therefore, the contract is not accounted for as a derivative under AS 30. By discharging the obligation to pay variable interest rate payments, Entity S in effect provides a loan to Counterparty C.

B.6 Definition of a derivative: offsetting loans

Entity A makes a five-year fixed rate loan to Entity B, while B at the same time makes a five-year variable rate loan for the same amount to A. There are no transfers of principal at inception of the two loans, since A and B have a netting agreement. Is this a derivative under AS 30?

Yes. This meets the definition of a derivative (that is to say, there is an underlying variable, 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 future settlement). The contractual effect of the loans is the equivalent of an interest rate swap arrangement with no initial net investment. Non-derivative transactions are aggregated and treated as a derivative when the transactions result, in substance, in a derivative. Indicators of this would include:

- they are entered into at the same time and in contemplation of one another
- they have the same counterparty
- they relate to the same risk
- there is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.

The same answer would apply if Entity A and Entity B did not have a netting agreement, because the definition of a derivative instrument in paragraph 8.1 of AS 30 does not require net settlement.

B.7 Definition of a derivative: option not expected to be exercised

The definition of a derivative in paragraph 8.1 of AS 30 requires that the instrument "is settled at a future date". Is this criterion met even if an option is expected not to be exercised, for example, because it is out of the money?

Yes. An option is settled upon exercise or at its maturity. Expiry at maturity is a form of settlement even though there is no additional exchange of consideration.

B.8 Definition of a derivative: foreign currency contract based on sales volume

Entity XYZ, whose functional currency is the Indian Rupees, sells products in France denominated in Euro. XYZ enters into a contract with an investment bank to convert Euro to Indian Rupees at a fixed exchange rate. The contract requires XYZ to remit Euro based on its sales volume in France in exchange for Indian Rupees at a fixed exchange rate of 55.00. Is that contract a derivative?

Yes. The contract has two underlying variables (the foreign exchange rate and the volume of sales), 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 a payment provision. AS 30 does not exclude from its scope derivatives that are based on sales volume.

B.9 Definition of a derivative: prepaid forward

An entity enters into a forward contract to purchase shares in one year at the forward price. It prepays at inception based on the current price of the shares. Is the forward contract a derivative?

No. The forward contract fails the "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" test for a derivative.

To illustrate: Entity XYZ enters into a forward contract to purchase one million equity shares of T in one year. The current market price of T is ₹ 50 per share; the one-year forward price of T is ₹ 55 per share. XYZ is required to prepay the forward contract at inception with a ₹ 50 million payment. The initial investment in the forward contract of ₹ 50 million is less than the notional amount applied to the underlying, one million shares at the forward price of ₹ 55 per share, i.e., ₹ 55 million. However, the initial net investment approximates the investment that would be required for other types of contracts that would be expected to have a similar response to changes in market factors because T's shares could be purchased at inception for the same price of ₹ 50. Accordingly, the prepaid forward contract does not meet the initial net investment criterion of a derivative instrument.

B.10Definition of a derivative: initial net investment

Many derivative instruments, such as futures contracts and exchange traded written options, require margin accounts. Is the margin account part of the initial net investment?

No. The margin account is not part of the initial net investment in a derivative instrument. Margin accounts are a form of collateral for the counterparty or clearing house and may take the form of cash, securities or other specified assets, typically liquid assets. Margin accounts are separate assets that are accounted for separately.

B.11 Definition of held for trading: portfolio with a recent actual pattern of short-term profit taking

The definition of a financial asset or financial liability held for trading states that "a financial asset or financial liability is classified as held for trading if it is ... 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". What is a 'portfolio' for the purposes of applying this definition?

Although the term 'portfolio' is not explicitly defined in AS 30, the context in which it is used suggests that a portfolio is a group of financial assets or financial liabilities that are managed as part of that group (paragraph 8.2 of AS 30). If there is evidence of a recent actual pattern of short-term profit taking on financial instruments included in such a portfolio, those financial instruments qualify as held for trading even though an individual financial instrument may in fact be held for a longer period of time.

B.12 Definition of held for trading: balancing a portfolio

Entity A has an investment portfolio of debt and equity instruments. The documented portfolio management guidelines specify that the equity exposure of the portfolio should be limited to between 30 and 50 per cent of total portfolio value. The investment manager of the portfolio is authorised to balance the portfolio within the designated guidelines by buying and selling equity and debt instruments. Is Entity A permitted to classify the instruments as available for sale?

It depends on Entity A's intentions and past practice. If the portfolio manager is authorised to buy and sell instruments to balance the risks in a portfolio, but there is no intention to trade and there is no past practice of trading for short-term profit, the instruments can be classified as available for sale. If the portfolio manager actively buys and sells instruments to generate short-term profits, the financial instruments in the portfolio are classified as held for trading.

B.13 Definition of held-to-maturity financial assets: index-linked principal

Entity A purchases a five-year equity-index-linked note with an original issue price of ₹ 10 at a market price of ₹ 12 at the time of purchase. The note requires no interest payments before

maturity. At maturity, the note requires payment of the original issue price of ₹ 10 plus a supplemental redemption amount that depends on whether a specified share price index exceeds a predetermined level at the maturity date. If the share index does not exceed or is equal to the predetermined level, no supplemental redemption amount is paid. If the share index exceeds the predetermined level, the supplemental redemption amount equals the product of 1.15 and the difference between the level of the share index at maturity and the level of the share index when the note was issued divided by the level of the share index at the time of issue. Entity A has the positive intention and ability to hold the note to maturity. Can Entity A classify the note as a held-to-maturity investment?

Yes. The note can be classified as a held-to-maturity investment because it has a fixed payment of ₹ 10 and fixed maturity and Entity A has the positive intention and ability to hold it to maturity (paragraph 8.3 of AS 30). However, the equity index feature is a call option not closely related to the debt host, which must be separated as an embedded derivative under paragraph 10 of AS 30. The purchase price of ₹ 12 is allocated between the host debt instrument and the embedded derivative. For example, if the fair value of the embedded option at acquisition is ₹ 4, the host debt instrument is measured at ₹ 8 on initial recognition. In this case, the discount of ₹ 2 that is implicit in the host bond (principal of ₹ 10 minus the original carrying amount of ₹ 8) is amortised to the statement of profit and loss over the term to maturity of the note using the effective interest method.

B.14 Definition of held-to-maturity financial assets: index-linked interest

Can a bond with a fixed payment at maturity and a fixed maturity date be classified as a held-to-maturity investment if the bond's interest payments are indexed to the price of a commodity or equity, and the entity has the positive intention and ability to hold the bond to maturity?

Yes. However, the commodity-indexed or equity-indexed interest payments result in an embedded derivative that is separated and accounted for as a derivative at fair value (paragraph 10 of AS 30). Paragraph 12 of AS 30 is not applicable since it should be straightforward to separate the host debt investment (the fixed payment at maturity) from the embedded derivative (the index-linked interest payments).

B.15 Definition of held-to-maturity financial assets: sale following rating downgrade

Would a sale of a held-to-maturity investment following a downgrade of the issuer's credit rating by a rating agency raise a question about the entity's intention to hold other investments to maturity?

Not necessarily. A downgrade is likely to indicate a decline in the issuer's creditworthiness. AS 30 specifies that a sale due to a significant deterioration in the issuer's creditworthiness could satisfy the condition in AS 30 and therefore not raise a question about the entity's intention to hold other investments to maturity. However, the deterioration in creditworthiness must be significant judged by reference to the credit rating at initial recognition. Also, the rating downgrade must not have been reasonably anticipated when the entity classified the investment as held to maturity in order to meet the condition in AS 30. A credit downgrade of a notch within a class or from one rating class to the immediately lower rating class could often be regarded as reasonably anticipated. If the rating downgrade in combination with other information provides evidence of impairment, the deterioration in creditworthiness often would be regarded as significant.

B.16Definition of held-to-maturity financial assets: permitted sales

Would sales of held-to-maturity financial assets due to a change in management compromise the classification of other financial assets as held to maturity?

Yes. A change in management is not identified under Appendix A paragraph A42 of AS 30 as an instance where sales or transfers from held-to-maturity do not compromise the classification as held to maturity. Sales in response to such a change in management would, therefore, call into question the entity's intention to hold investments to maturity.

To illustrate: Entity X has a portfolio of financial assets that is classified as held to maturity. In the current period, at the direction of the Board of Directors, the senior management team has been replaced. The new management wishes to sell a portion of the held-to-maturity financial assets in order to carry out an expansion strategy designated and approved by the Board. Although the previous management team had been in place since the entity's inception and Entity X had never before undergone a major restructuring, the sale nevertheless calls into question Entity X's intention to hold remaining held-to-maturity financial assets to maturity.

B.17 Definition of held-to-maturity investments: sales in response to entity-specific capital requirements

In some cases, a regulator may set *entity-specific* capital requirements that are based on an assessment of the risk in that particular entity. Appendix A paragraph A42(e) of AS 30 indicates that an entity that sells held-to-maturity investments in response to an unanticipated significant increase by the regulator in the *industry's* capital requirements may do so under AS 30 without necessarily raising a question about its intention to hold other investments to maturity. Would sales of held-to-maturity investments that are due to a significant increase in *entity-specific* capital requirements imposed by regulators (i.e., capital requirements applicable to a particular entity, but not to the industry) raise such doubt?

Yes, such sales 'taint' the entity's intention to hold other financial assets as held to maturity unless it can be demonstrated that the sales fulfil the condition in paragraph 8.3 of AS 30in that they result from an increase in capital requirements, which is an isolated event that is beyond the entity's control, is non-recurring and could not have been reasonably anticipated by the entity.

B.18 Definition of held-to-maturity financial assets: pledged collateral, repurchase agreements (REPOs) and securities lending agreements

An entity cannot have a demonstrated ability to hold to maturity an investment if it is subject to a constraint that could frustrate its intention to hold the financial asset to maturity. Does this mean that a debt instrument that has been pledged as collateral, or transferred to another party under a REPO or securities lending transaction, and continues to be recognised cannot be classified as a held-to-maturity investment?

No. An entity's intention and ability to hold debt instruments to maturity is not necessarily constrained if those instruments have been pledged as collateral or are subject to a repurchase agreement or securities lending agreement. However, an entity does not have the positive intention and ability to hold the debt instruments until maturity if it does not expect to be able to maintain or recover access to the instruments.

B.19 Definition of held-to-maturity financial assets: 'tainting'

In response to unsolicited tender offers, Entity A sells a significant amount of financial assets classified as held to maturity on economically favourable terms. Entity A does not classify any financial assets acquired after the date of the sale as held to maturity. However, it does not

reclassify the remaining held-to-maturity investments since it maintains that it still intends to hold them to maturity. Is Entity A in compliance with AS 30?

No. Whenever a sale or transfer of more than an insignificant amount of financial assets classified as held to maturity (HTM) results in the conditions in paragraph 8.3 and Appendix A paragraph A42 of AS 30 not being satisfied, no instruments should be classified in that category. Accordingly, any remaining HTM assets are reclassified as available-for-sale financial assets. The reclassification is recorded in the reporting period in which the sales or transfers occurred and is accounted for as a change in classification under paragraph 57 of AS 30. Paragraph 8.3 of AS 30makes it clear that at least two full financial years must pass before an entity can again classify financial assets as HTM.

B.20 Definition of held-to-maturity investments: sub-categorisation for the purpose of applying the 'tainting' rule

Can an entity apply the conditions for held-to-maturity classification in paragraph 8.3 of AS 30 separately to different categories of held-to-maturity financial assets, such as debt instruments denominated in Indian Rupees and debt instruments denominated in a Foreign Currency?

No. The 'tainting rule' in paragraph 8.3 of AS 30 is clear. If an entity has sold or reclassified more than an insignificant amount of held-to-maturity investments, it cannot classify any financial assets as held-to-maturity financial assets.

B.21Definition of held-to-maturity investments: application of the 'tainting' rule on consolidation

Can an entity apply the conditions in paragraph 8.3 of AS 30 separately to held-to-maturity financial assets held by different entities in a consolidated group, for example, if those group entities are in different countries with different legal or economic environments?

No. If an entity has sold or reclassified more than an insignificant amount of investments classified as held-to-maturity in the consolidated financial statements, it cannot classify any financial assets as held-to-maturity financial assets in the consolidated financial statements unless the conditions in paragraph 8.3 of AS 30 are met.

B.22 Definition of loans and receivables: equity instrument

Can an equity instrument, such as a preference share, with fixed or determinable payments be classified within loans and receivables by the holder?

Yes. If a non-derivative equity instrument, such as a preference share, is required to be recorded as a liability by the issuer as per the relevant Accounting Standard, and it has fixed or determinable payments and is not quoted in an active market, it can be classified within loans and receivables by the holder, provided the definition is otherwise met. Paragraphs 31-46 of AS 31 provide guidance about the classification of a financial instrument as a liability or as equity from the perspective of the issuer of a financial instrument. If an instrument meets the definition of an equity instrument under AS 31, it cannot be classified within loans and receivables by the holder.

B.23 Definition of loans and receivables: banks' deposits in other banks

Banks make term deposits with the Reserve Bank of India or other banks. Sometimes, the proof of deposit (such as certificate of deposit/ receipt) is negotiable, sometimes not. Even if negotiable, the depositor bank may or may not intend to sell it. Would such a deposit fall within loans and receivables under paragraph 8.4 of AS 30?

Such a deposit meets the definition of loans and receivables, whether or not the proof of deposit is negotiable, unless the depositor bank intends to sell the instrument immediately or in the near term, in which case the deposit is classified as a financial asset held for trading.

B.24 Definition of amortised cost: perpetual debt instruments with fixed or market-based variable rate

Sometimes entities purchase or issue debt instruments that are required to be measured at amortised cost and in respect of which the issuer has no obligation to repay the principal amount. Interest may be paid either at a fixed rate or at a variable rate. Would the difference between the initial amount paid or received and zero ('the maturity amount') be amortised immediately on initial recognition for the purpose of determining amortised cost if the rate of interest is fixed or specified as a market-based variable rate?

No. Since there are no repayments of principal, there is no amortisation of the difference between the initial amount and the maturity amount if the rate of interest is fixed or specified as a market-based variable rate. Because interest payments are fixed or market-based and will be paid in perpetuity, the amortised cost (the present value of the stream of future cash payments discounted at the effective interest rate) equals the principal amount in each period (paragraph 8.7 of AS 30).

B.25 Definition of amortised cost: perpetual debt instruments with decreasing interest rate

If the stated rate of interest on a perpetual debt instrument decreases over time, would amortised cost equal the principal amount in each period?

No. From an economic perspective, some or all of the interest payments are repayments of the principal amount. For example, the interest rate may be stated as 16 per cent for the first ten years and as zero per cent in subsequent periods. In that case, the initial amount is amortised to zero over the first ten years using the effective interest method, since a portion of the interest payments represents repayments of the principal amount. The amortised cost is zero after year 10 because the present value of the stream of future cash payments in subsequent periods is zero (there are no further cash payments of either principal or interest in subsequent periods).

B.26 Example of calculating amortised cost: financial asset

Financial assets that are excluded from fair valuation and have a fixed maturity should be measured at amortised cost. How is amortised cost calculated?

Under AS 30, amortised cost is calculated using the effective interest method. The effective interest rate inherent in a financial instrument is the rate that exactly discounts the estimated cash flows associated with the financial instrument through the expected life of the instrument or, where appropriate, a shorter period to the net carrying amount at initial recognition. The computation includes all fees and points paid or received that are an integral part of the effective interest rate, directly attributable transaction costs and all other premiums or discounts.

The following example illustrates how amortised cost is calculated using the effective interest method. Entity A purchases a debt instrument with five years remaining to maturity for its fair value of ₹ 1,000 (including transaction costs). The instrument has a principal amount of ₹ 1,250 and carries fixed interest of 4.7 per cent that is paid annually (₹ 1,250 x 4.7 per cent = ₹ 59 per year). The contract also specifies that the borrower has an option to prepay the instrument and that no penalty will be charged for prepayment. At inception, the entity expects the borrower not to prepay.

It can be shown that in order to allocate interest receipts and the initial discount over the term of the debt instrument at a constant rate on the carrying amount, they must be accrued at the rate of 10 per cent annually. The table below provides information about the amortised cost, interest income and cash flows of the debt instrument in each reporting period.

Year	(a) Amortised cost at the beginning of the year	(b = a 10%) Interest income	(c) Cash flows	(d = a + b - c) Amortised cost at the end of the year
20x6	1,000	100	59	1,041
20x7	1,041	104	59	1,086
20x8	1,086	109	59	1,136
20x9	1,136	113	59	1,190
20y0	1,190	119	1,250+59	-

On the first day of 20x8, the entity revises its estimate of cash flows. It now expects that 50 per cent of the principal will be prepaid at the end of 20x8 and the remaining 50 per cent at the end of 20y0. In accordance with Appendix A paragraph A27 of AS 30, the opening balance of the debt instrument in 20x8 is adjusted. The adjusted amount is calculated by discounting the amount the entity expects to receive in 20x8 and subsequent years using the original effective interest rate (10 per cent). This results in the new opening balance in 20x8 of ₹ 1,138. The adjustment of ₹ 52 (₹ 1,138 – ₹ 1,086) is recorded in the statement of profit and loss in 20x8. The table below provides information about the amortised cost, interest income and cash flows as they would be adjusted taking into account the change in estimate.

Year	(a) Amortised cost at the beginning of the year	(b = a x 10%) Interest income	(c) Cash flows	(d = a + b - c) Amortised cost at the end of the year
20x6	1,000	100	59	1,041
20x7	1,041	104	59	1,086
20x8	1,086+52	114	625+59	568
20x9	568	57	30	595
20y0	595	60	625+30	-

If the debt instrument becomes impaired, say, at the end of 20x9, the impairment loss is calculated as the difference between the carrying amount (₹ 595) and the present value of estimated future cash flows discounted at the original effective interest rate (10 per cent).

B.27 Example of calculating amortised cost: debt instruments with stepped interest payments

Sometimes entities purchase or issue debt instruments with a predetermined rate of interest that increases or decreases progressively ('stepped interest') over the term of the debt instrument. If a debt instrument with stepped interest and no embedded derivative is issued at ₹ 1,250 and has a maturity amount of ₹ 1,250, would the amortised cost equal ₹ 1,250 in each reporting period over the term of the debt instrument?

No. Although there is no difference between the initial amount and maturity amount, an entity uses the effective interest method to allocate interest payments over the term of the debt instrument to achieve a constant rate on the carrying amount (paragraph 8.9 of AS 30 and Appendix A paragraphs A23-A27).

The following example illustrates how amortised cost is calculated using the effective interest method for an instrument with a predetermined rate of interest that increases or decreases over the term of the debt instrument ('stepped interest').

On 1 January 20x6, Entity A issues a debt instrument for a price of ₹ 1,250. The principal amount is ₹ 1,250 and the debt instrument is repayable on 31 December 20y0. The rate of interest is specified in the debt agreement as a percentage of the principal amount as follows: 6.0 per cent in 20x6 (₹ 75), 8.0 per cent in 20x7 (₹ 100), 10.0 per cent in 20x8 (₹ 125), 12.0 per cent in 20x9 (₹ 150), and 16.4 per cent in 20y0 (₹ 205). In this case, the interest rate that exactly discounts the stream of future cash payments through maturity is 10 per cent. Therefore, cash interest payments are reallocated over the term of the debt instrument for the purposes of determining amortised cost in each period. In each period, the amortised cost at the beginning of the period is multiplied by the effective interest rate of 10 per cent and added to the amortised cost. Any cash payments in the period are deducted from the resulting number. Accordingly, the amortised cost in each period is as follows:

Year	(a) Amortised cost at the beginning of the year	*(b= a x 10%)* Interest income	(c) Cash flows	*(d = a+b-c)* Amortised cost at the end of the year
20x6	1,250	125	75	1,300
20x7	1,300	130	100	1,330
20x8	1,330	133	125	1,338
20x9	1,338	134	150	1,322
20y0	1,322	133	1,250+205	-

B.28Regular way contracts: no established market

Can a contract to purchase a financial asset be a regular way contract if there is no established market for trading such a contract?

Yes. Paragraph 8.12 of AS 30 refers to terms that require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned. Marketplace, as that term is used in paragraph 8.12 of AS 30, is not limited to a formal stock exchange or organised over-the-counter market. Rather, it means the environment in which the financial asset is customarily exchanged. An acceptable timeframe would be the period reasonably and customarily required for the parties to complete the transaction and prepare and execute closing documents.

For example, a market for private issue financial instruments can be a marketplace.

B.29 Regular way contracts: forward contract

Entity ABC enters into a forward contract to purchase one million of M's equity shares in two months for ₹ 10 per share. The contract is with an individual and is not an exchange-traded contract. The contract requires ABC to take physical delivery of the shares and pay the counterparty ₹ 10 million in cash. M's shares trade in an active public market at an average of 100,000 shares a day. Regular way delivery is three days. Is the forward contract regarded as a regular way contract?

No. The contract must be accounted for as a derivative because it is not settled in the way established by regulation or convention in the marketplace concerned.

B.30 Regular way contracts: which customary settlement provisions apply?

If an entity's financial instruments trade in more than one active market, and the settlement provisions differ in the various active markets, which provisions apply in assessing whether a contract to purchase those financial instruments is a regular way contract?

The provisions that apply are those in the market in which the purchase actually takes place. To illustrate: Entity XYZ purchases one million shares of Entity ABC on a Stock Exchange, for example,

through a broker. The settlement date of the contract is six business days later. Trades for equity shares on the Stock Exchange customarily settle in three business days. Because the trade settles in six business days, it does not meet the exemption as a regular way trade.

However, if XYZ did the same transaction on a foreign exchange that has a customary settlement period of six business days, the contract would meet the exemption for a regular way trade.

B.31 Regular way contracts: share purchase by call option

Entity A purchases a call option in a public market permitting it to purchase 100 shares of Entity XYZ at any time over the next three months at a price of ₹ 100 per share. If Entity A exercises its option, it has 14 days to settle the transaction according to regulation or convention in the options market. XYZ shares are traded in an active public market that requires three-day settlement. Is the purchase of shares by exercising the option a regular way purchase of shares?

Yes. The settlement of an option is governed by regulation or convention in the marketplace for options and, therefore, upon exercise of the option it is no longer accounted for as a derivative because settlement by delivery of the shares within 14 days is a regular way transaction.

B.32 Recognition and derecognition of financial liabilities using trade date or settlement date accounting

AS 30 has special rules about recognition and derecognition of financial assets using trade date or settlement date accounting. Do these rules apply to transactions in financial instruments that are classified as financial liabilities, such as transactions in deposit liabilities and trading liabilities?

No. AS 30 does not contain any specific requirements about trade date accounting and settlement date accounting in the case of transactions in financial instruments that are classified as financial liabilities. Therefore, the general recognition and derecognition requirements in paragraph 14 and paragraph 43 of AS 30 apply. Paragraph 14 of AS 30 states that financial liabilities are recognised on the date the entity "becomes a party to the contractual provisions of the instrument". Such contracts generally are not recognised unless one of the parties has performed or the contract is a derivative contract not exempted from the scope of AS 30. Paragraph 43 of AS 30 specifies that financial liabilities are derecognised only when they are extinguished, i.e., when the obligation specified in the contract is discharged or cancelled or expires.

Section C: Embedded Derivatives

C.1 Embedded derivatives: separation of host debt instrument

If an embedded non-option derivative is required to be separated from a host debt instrument, how are the terms of the host debt instrument and the embedded derivative identified? For example, would the host debt instrument be a fixed rate instrument, a variable rate instrument or a zero coupon instrument?

The terms of the host debt instrument reflect the stated or implied substantive terms of the hybrid instrument. In the absence of implied or stated terms, the entity makes its own judgement of the terms. However, an entity may not identify a component that is not specified or may not establish terms of the host debt instrument in a manner that would result in the separation of an embedded derivative that is not already clearly present in the hybrid instrument, that is to say, it cannot create a cash flow that does not exist. For example, if a five-year debt instrument has fixed interest payments of ₹ 40,000 annually and a principal payment at maturity of ₹ 1,000,000 multiplied by the change in an equity price index, it

would be inappropriate to identify a floating rate host contract and an embedded equity swap that has an offsetting floating rate leg in lieu of identifying a fixed rate host. In that example, the host contract is a fixed rate debt instrument that pays ₹ 40,000 annually because there are no floating interest rate cash flows in the hybrid instrument.

In addition, the terms of an embedded non-option derivative, such as a forward or swap, must be determined so as to result in the embedded derivative having a fair value of zero at the inception of the hybrid instrument. If it were permitted to separate embedded non-option derivatives on other terms, a single hybrid instrument could be decomposed into an infinite variety of combinations of host debt instruments and embedded derivatives, for example, by separating embedded derivatives with terms that create leverage, asymmetry or some other risk exposure not already present in the hybrid instrument. Therefore, it is inappropriate to separate an embedded non-option derivative on terms that result in a fair value other than zero at the inception of the hybrid instrument. The determination of the terms of the embedded derivative is based on the conditions existing when the financial instrument was issued.

C.2 Embedded derivatives: separation of embedded option

The response to Question C.1 states that the terms of an embedded non-option derivative should be determined so as to result in the embedded derivative having a fair value of zero at the initial recognition of the hybrid instrument. When an embedded option-based derivative is separated, must the terms of the embedded option be determined so as to result in the embedded derivative having either a fair value of zero or an intrinsic value of zero (that is to say, be at the money) at the inception of the hybrid instrument?

No. The economic behaviour of a hybrid instrument with an option-based embedded derivative depends critically on the strike price (or strike rate) specified for the option feature in the hybrid instrument, as discussed below. Therefore, the separation of an option-based embedded derivative (including any embedded put, call, cap, floor, caption, floortion or swaption feature in a hybrid instrument) should be based on the stated terms of the option feature documented in the hybrid instrument. As a result, the embedded derivative would not necessarily have a fair value or intrinsic value equal to zero at the initial recognition of the hybrid instrument.

If an entity were required to identify the terms of an embedded option-based derivative so as to achieve a fair value of the embedded derivative of zero, the strike price (or strike rate) generally would have to be determined so as to result in the option being infinitely out of the money. This would imply a zero probability of the option feature being exercised. However, since the probability of the option feature in a hybrid instrument being exercised generally is not zero, it would be inconsistent with the likely economic behaviour of the hybrid instrument to assume an initial fair value of zero. Similarly, if an entity was required to identify the terms of an embedded option-based derivative so as to achieve an intrinsic value of zero for the embedded derivative, the strike price (or strike rate) would have to be assumed to equal the price (or rate) of the underlying variable at the initial recognition of the hybrid instrument. In this case, the fair value of the option would consist only of time value. However, such an assumption would not be consistent with the likely economic behaviour of the hybrid instrument, including the probability of the option feature being exercised, unless the agreed strike price was indeed equal to the price (or rate) of the underlying variable at the initial recognition of the hybrid instrument.

The economic nature of an option-based embedded derivative is fundamentally different from a forward-based embedded derivative (including forwards and swaps), because the terms of a forward are such that a payment based on the difference between the price of the underlying and the forward price will occur at a specified date, while the terms of an option are such that a payment based on the difference between the price of the underlying and the strike price of the option may or may not occur

depending on the relationship between the agreed strike price and the price of the underlying at a specified date or dates in the future. Adjusting the strike price of an option-based embedded derivative, therefore, alters the nature of the hybrid instrument. On the other hand, if the terms of a non-option embedded derivative in a host debt instrument were determined so as to result in a fair value of any amount other than zero at the inception of the hybrid instrument, that amount would essentially represent a borrowing or lending. Accordingly, as discussed in the answer to Question C.1, it is not appropriate to separate a non-option embedded derivative in a host debt instrument on terms that result in a fair value other than zero at the initial recognition of the hybrid instrument.

C.3 Embedded derivatives: accounting for a convertible bond

What is the accounting treatment of an investment in a bond (financial asset) that is convertible into shares of the issuing entity or another entity before maturity?

An investment in a convertible bond that is convertible before maturity generally cannot be classified as a held-to-maturity investment because that would be inconsistent with paying for the conversion feature—the right to convert into equity shares before maturity.

An investment in a convertible bond can be classified as an available-for-sale financial asset provided it is not purchased for trading purposes. The equity conversion option is an embedded derivative.

If the bond is classified as available for sale (i.e., fair value changes recognised directly in the appropriate equity account until the bond is sold), the equity conversion option (the embedded derivative) is separated. The amount paid for the bond is split between the debt instrument without the conversion option and the equity conversion option. Changes in the fair value of the equity conversion option are recognised in the statement of profit and loss unless the option is part of a cash flow hedging relationship.

If the convertible bond is measured at fair value with changes in fair value recognised in the statement of profit and loss, separating the embedded derivative from the host bond is not permitted.

C.4 Embedded derivatives: equity kicker

In some instances, venture capital entities providing subordinated loans agree that if and when the borrower lists its shares on a stock exchange, the venture capital entity is entitled to receive shares of the borrowing entity free of charge or at a very low price (an 'equity kicker') in addition to interest and repayment of principal. As a result of the equity kicker feature, the interest on the subordinated loan is lower than it would otherwise be. Assuming that the subordinated loan is not measured at fair value with changes in fair value recognised in the statement of profit and loss (paragraph 10(c) of AS 30), does the equity kicker feature meet the definition of an embedded derivative even though it is contingent upon the future listing of the borrower?

Yes. The economic characteristics and risks of an equity return are not closely related to the economic characteristics and risks of a host debt instrument (paragraph 10(a) of AS 30). The equity kicker meets the definition of a derivative because it has a value that changes in response to the change in the price of the shares of the borrower, 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 (paragraphs 10(b) and 8.1(a) of AS 30). The equity kicker feature meets the definition of a derivative even though the right to receive shares is contingent upon the future listing of the borrower. Appendix A paragraph A28 of AS 30 states that a derivative could require a payment as a result of some future event that is unrelated to a notional

amount. An equity kicker feature is similar to such a derivative except that it does not give a right to a fixed payment, but an option right, if the future event occurs.

C.5 Embedded derivatives: debt or equity host contract

Entity A purchases a five-year 'debt' instrument issued by Entity B with a principal amount of ₹ 1 million that is indexed to the share price of Entity C. At maturity, Entity A will receive from Entity B the principal amount plus or minus the change in the fair value of 10,000 shares of Entity C. The current share price is ₹ 110. No separate interest payments are made by Entity B. The purchase price is ₹ 1 million. Entity A classifies the debt instrument as available for sale. Entity A concludes that the instrument is a hybrid instrument with an embedded derivative because of the equity-indexed principal. For the purposes of separating an embedded derivative, is the host contract an equity instrument or a debt instrument?

The host contract is a debt instrument because the hybrid instrument has a stated maturity, *i.e.*, it does not meet the definition of an equity instrument (paragraphs 7 and 32 of AS 31). It is accounted for as a zero coupon debt instrument. Thus, in accounting for the host instrument, Entity A imputes interest on ₹ 1 million over five years using the applicable market interest rate at initial recognition. The embedded non-option derivative is separated so as to have an initial fair value of zero (see Question C.1).

C.6 Embedded derivatives: synthetic instruments

Entity A acquires a five-year floating rate debt instrument issued by Entity B. At the same time, it enters into a five-year pay-variable, receive-fixed interest rate swap with Entity C. Entity A regards the combination of the debt instrument and swap as a synthetic fixed rate instrument and classifies the instrument as a held-to-maturity investment, since it has the positive intention and ability to hold it to maturity. Entity A contends that separate accounting for the swap is inappropriate since Appendix A paragraph A53(a) of AS 30 requires an embedded derivative to be classified together with its host instrument if the derivative is linked to an interest rate that can change the amount of interest that would otherwise be paid or received on the host debt contract. Is the entity's analysis correct?

No. Embedded derivative instruments are terms and conditions that are included in non-derivative host contracts. It is generally inappropriate to treat two or more separate financial instruments as a single combined instrument ('synthetic instrument' accounting) for the purpose of applying AS 30. Each of the financial instruments has its own terms and conditions and each may be transferred or settled separately. Therefore, the debt instrument and the swap are classified separately. The transactions described here differ from the transactions discussed in Question B.6, which had no substance apart from the resulting interest rate swap.

C.7 Embedded derivatives: purchases and sales contracts in foreign currency instruments

A supply contract provides for payment in a currency other than (a) the functional currency of either party to the contract, (b) the currency in which the product is routinely denominated in commercial transactions around the world and (c) the currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place. Is there an embedded derivative that should be separated under AS 30?

Yes. To illustrate: an Indian entity agrees to sell oil to an entity in France. The oil contract is denominated in Swiss francs, although oil contracts are routinely denominated in US dollars in commercial transactions around the world, and Indian Rupees are commonly used in contracts to

purchase or sell non-financial items in India. Neither entity carries out any significant activities in Swiss francs. In this case, the Indian entity regards the supply contract as a host contract with an embedded foreign currency forward to purchase Swiss francs. The French entity regards the supply contact as a host contract with an embedded foreign currency forward to sell Swiss francs. Each entity includes fair value changes on the currency forward in the statement of profit and loss unless the reporting entity designates it as a cash flow hedging instrument, if appropriate.

C.8 Embedded foreign currency derivatives: unrelated foreign currency provision

Entity A, which measures items in its financial statements on the basis of the Rupees (its functional currency), enters into a contract with Entity B, which has the Norwegian krone as its functional currency, to purchase oil in six months for 1,000 US dollars. The host oil contract is not within the scope of AS 30 because it was entered into and continues to be for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (paragraph 4 and Appendix A paragraph A29 of AS 30). The oil contract includes a leveraged foreign exchange provision that states that the parties, in addition to the provision of, and payment for, oil will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars. Under paragraph 10 of AS 30, is that embedded derivative (the leveraged foreign exchange provision) regarded as closely related to the host oil contract?

No, that leveraged foreign exchange provision is separated from the host oil contract because it is not closely related to the host oil contract (Appendix A paragraph A53(d) of AS 30).

The payment provision under the host oil contract of 1,000 US dollars can be viewed as a foreign currency derivative because the US dollar is neither Entity A's nor Entity B's functional currency. This foreign currency derivative would not be separated because it follows from Appendix A paragraph A53(d) of AS 30 that a crude oil contract that requires payment in US dollars is not regarded as a host contract with a foreign currency derivative.

The leveraged foreign exchange provision that states that the parties will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars is in addition to the required payment for the oil transaction. It is unrelated to the host oil contract and therefore separated from the host oil contract and accounted for as an embedded derivative under paragraph 10 of AS 30.

C.9 Embedded foreign currency derivatives: currency of international commerce

Appendix A paragraph A53(d) of AS 30 refers to the currency in which the price of the related goods or services is routinely denominated in commercial transactions around the world. Could it be a currency that is used for a certain product or service in commercial transactions within the local area of one of the substantial parties to the contract?

No. The currency in which the price of the related goods or services is routinely denominated in commercial transactions around the world is only a currency that is used for similar transactions all around the world, not just in one local area. For example, if cross-border transactions in natural gas in North America are routinely denominated in US dollars and such transactions are routinely denominated in Euro in Europe, neither the US dollar nor the Euro is a currency in which the goods or services is routinely denominated in commercial transactions around the world.

C.10 Embedded derivatives: holder permitted, but not required, to settle without recovering substantially all of its recognised investment

If the terms of a combined instrument permit, but do not require, the holder to settle the combined instrument in a manner that causes it not to recover substantially all of its recognised investment and the issuer does not have such a right (for example, a puttable debt instrument), does the contract satisfy the condition in Appendix A paragraph A53(a) of AS 30 that the holder would not recover substantially all of its recognised investment?

No. The condition that "the holder would not recover substantially all of its recognised investment" is not satisfied if the terms of the combined instrument permit, but do not require, the investor to settle the combined instrument in a manner that causes it not to recover substantially all of its recognised investment and the issuer has no such right. Accordingly, an interest-bearing host contract with an embedded interest rate derivative with such terms is regarded as closely related to the host contract. The condition that "the holder would not recover substantially all of its recognised investment" applies to situations in which the holder can be forced to accept settlement at an amount that causes the holder not to recover substantially all of its recognised investment.

C.11Embedded derivatives: reliable determination of fair value

If an embedded derivative that is required to be separated cannot be reliably measured because it will be settled by an unquoted equity instrument whose fair value cannot be reliably measured, is the embedded derivative measured at cost?

No. In this case, the entire combined contract is treated as a financial instrument held for trading (paragraph 12 of AS 30). If the fair value of the combined instrument can be reliably measured, the combined contract is measured at fair value. The entity might conclude, however, that the equity component of the combined instrument may be sufficiently significant to preclude it from obtaining a reliable estimate of the entire instrument. In that case, the combined instrument is measured at cost less impairment.

Section D: Recognition and Derecognition

D.1 Initial Recognition

D.1.1 Recognition: cash collateral

Entity B transfers cash to Entity A as collateral for another transaction with Entity A (for example, a securities borrowing transaction). The cash is not legally segregated from Entity A's assets. Should Entity A recognise the cash collateral it has received as an asset?

Yes. The ultimate realisation of a financial asset is its conversion into cash and, therefore, no further transformation is required before the economic benefits of the cash transferred by Entity B can be realised by Entity A. Therefore, Entity A recognises the cash as an asset and a payable to Entity B while Entity B derecognises the cash and recognises a receivable from Entity A.

D.2 Regular Way Purchase or Sale of a Financial Asset

D.2.1 Trade date vs. settlement date: Amounts to be recorded for a purchase

How are the trade date and settlement date accounting principles in the Standard applied to a purchase of a financial asset?

The following example illustrates the application of the trade date and settlement date accounting principles in the Standard for a purchase of a financial asset. On 29 December 20x7, an entity commits itself to purchase a financial asset for ₹ 1,000, which is its fair value on commitment (trade) date.

Transaction costs are immaterial. On 31 December 20x7 (financial year-end) and on 4 January 20x8 (settlement date) the fair value of the asset is ₹ 1,002 and ₹ 1,003, respectively. The amounts to be recorded for the asset will depend on how it is classified and whether trade date or settlement date accounting is used, as shown in the two tables below.

SETTLEMENT DATE ACCOUNTING			
Balances	Held-to- Maturity Investments Carried at Amortised Cost	Available-for- Sale Assets Remeasured to Fair Value with Changes in the Appropriate Equity Account	Assets at Fair Value through Profit or Loss Remeasured to Fair Value with Changes in the Statement of Profit and Loss
29 December 20x7			
Financial asset	-	-	-
Financial liability	-	-	-
31 December 20x7			
Receivable	-	2	2
Financial asset	-	-	-
Financial liability	-	-	-
Appropriate Equity Account (fair value adjustment)	-	(2)	-
Retained earnings (through statement of profit and loss)	-	-	(2)
4 January 20x8			
Receivable	-	-	-
Financial asset	1,000	1,003	1,003
Financial liability	-	-	-
Appropriate Equity Account (fair value adjustment)	-	(3)	-
Retained earnings (through statement of profit and loss)	-	-	(3)

TRADE DATE ACCOUNTING			
Balances	Held-to- Maturity Investments Carried at Amortised Cost	Available-for- Sale Assets Remeasured to Fair Value with Changes in the Appropriate Equity Account	Assets at Fair Value through Profit or Loss Remeasured to Fair Value with Changes in the Statement of Profit or and Loss
29 December 20x7			
Financial asset	1,000	1,000	1,000
Financial liability	(1,000)	(1,000)	(1,000)
31 December 20x7			
Receivable	-	-	-
Financial asset	1,000	1,002	1,002
Financial liability	(1,000)	(1,000)	(1,000)
Appropriate Equity Account (fair			

value adjustment)	-	(2)	-
Retained earnings (through statement of profit and loss)	-	-	(2)
4 January 20x8			
Receivable	-	-	-
Financial asset	1,000	1,003	1,003
Financial liability	-	-	-
Appropriate Equity Account (fair value adjustment)	-	(3)	-
Retained earnings (through statement of profit and loss)	-	-	(3)

Note: When an entity applies the trade date accounting, it is not required to mark the investment to market on the settlement date. However, only with a view to present the comparative results of two methods, viz., the trade date accounting and the settlement date accounting, on the settlement date, the concerned investment has been marked to market on the settlement date in examples D.2.1 to D.2.3.

D.2.2 Trade date vs. settlement date: Amounts to be recorded for a sale

How are the trade date and settlement date accounting principles in the Standard applied to a sale of a financial asset?

The following example illustrates the application of the trade date and settlement date accounting principles in the Standard for a sale of a financial asset. On 29 December 20x8 (trade date) an entity enters into a contract to sell a financial asset for its current fair value of ₹ 1,010. The asset was acquired one year earlier for ₹ 1,000 and its amortised cost is ₹ 1,000. On 31 December 20x8 (financial year-end), the fair value of the asset is ₹ 1,012. On 4 January 20x9 (settlement date), the fair value is ₹ 1,013. The amounts to be recorded will depend on how the asset is classified and whether trade date or settlement date accounting is used as shown in the two tables below (any interest that might have accrued on the asset is disregarded).

A change in the fair value of a financial asset that is sold on a regular way basis is not recorded in the financial statements between trade date and settlement date even if the entity applies settlement date accounting because the seller's right to changes in the fair value ceases on the trade date.

SETTLEMENT DATE ACCOUNTING			
Balances	Held-to-Maturity Investments Carried at Amortised Cost	Available-for-Sale Assets Remeasured to Fair Value with Changes in the Appropriate Equity Account	Assets at Fair Value through Profit or Loss Remeasured to Fair Value with Changes in the Statement of Profit or and Loss
29 December 20x8			
Receivable	-	-	-
Financial asset	1,000	1,010	1,010
Appropriate Equity Account (fair value adjustment)	-	10	-
Retained earnings (through statement of profit and loss)	-	-	10
31 December 20x8			

Receivable	-	-	-
Financial asset	1,000	1,010	1,010
Appropriate Equity Account (fair value adjustment)	-	10	-
Retained earnings (through statement of profit and loss)	-	-	10
4 January 20x9			
Appropriate Equity Account (fair value adjustment)	-	-	-
Retained earnings (through statement of profit and loss)	10	10	10

TRADE DATE ACCOUNTING			
Balances	Held-to-Maturity Investments Carried at Amortised Cost	Available-for- Sale Assets Remeasured to Fair Value with Changes in the Appropriate Equity Account	Assets at Fair Value through Profit or Loss Remeasured to Fair Value with Changes in the Statement of Profit and Loss
29 December 20x8			
Receivable	1,010	1,010	1,010
Financial asset	-	-	-
Appropriate Equity Account (fair value adjustment)	-	-	-
Retained earnings (through statement of profit and loss)	10	10	10
31 December 20x8			
Receivable	1,010	1,010	1,010
Financial asset	-	-	-
Appropriate Equity Account (fair value adjustment)	-	-	-
Retained earnings (through statement of profit and loss)	10	10	10
4 January 20x9			
Appropriate equity account (fair value adjustment)	-	-	-
Retained earnings (through statement of profit and loss)	10	10	10

D.2.3 Settlement date accounting: exchange of non-cash financial assets

If an entity recognises sales of financial assets using settlement date accounting, would a change in the fair value of a financial asset to be received in exchange for the non-cash financial asset that is sold be recognised in accordance with paragraph 63 of AS30?

It depends. Any change in the fair value of the financial asset to be received would be accounted for under paragraph 63 of AS30 if the entity applies settlement date accounting for that category of

financial assets. However, if the entity classifies the financial asset to be received in a category for which it applies trade date accounting, the asset to be received is recognised on the trade date as described in paragraph 41 of AS30. In that case, the entity recognises a liability of an amount equal to the carrying amount of the financial asset to be delivered on settlement date.

To illustrate: on 29 December 20x8 (trade date) Entity A enters into a contract to sell Note Receivable A, which is classified under the category 'Held-to-Maturity (HTM) Investments' and, therefore, carried at amortised cost, in exchange for Bond B, which will be classified as held for trading and measured at fair value. Both assets have a fair value of ₹ 1,010 on 29 December, while the amortised cost of Note Receivable A is ₹ 1,000. Entity A uses settlement date accounting for loans and receivables and trade date accounting for assets held for trading. On 31 December 20x8 (financial year-end), the fair value of Note Receivable A is ₹ 1,012 and the fair value of Bond B is ₹ 1,009. On 4 January 20x9, the fair value of Note Receivable A is ₹ 1,013 and the fair value of Bond B is ₹ 1,007. The following entries are made:

29 December 20x8

Dr	Bond B	₹ 1,010	
	Cr Payable		₹ 1,010

31 December 20x8

Dr	Trading loss	Re. 1	
	Cr Bond B		Re. 1

4 January 20x9

Dr	Payable	₹ 1,010	
Dr	Trading loss	₹ 2	
	Cr Note Receivable A		₹ 1,000
	Cr Bond B		₹ 2
	Cr Realisation gain		₹ 10

Section E: Measurement

E.1 Initial Measurement of Financial Assets and Financial Liabilities

E.1.1 Initial measurement: transaction costs

Paragraph 47 of AS 30, *inter alia*, prescribes accounting for transaction costs upon initial measurement of financial assets and financial liabilities. How should the requirements of this paragraph regarding transaction costs be applied in practice?

For financial assets, incremental costs that are directly attributable to the acquisition of the asset, for example fees and commissions, are added to the amount originally recognised. For financial liabilities, directly related costs of issuing debt are deducted from the amount of debt originally recognised. For financial instruments that are measured at fair value through profit or loss and short-term receivables and payables (see paragraph 47(b) of AS 30), transaction costs are not added to the fair value measurement at initial recognition.

For financial instruments that are carried at amortised cost, such as held-to-maturity investments, loans and receivables (except short-term receivables), and financial liabilities that are not at fair value through profit or loss (except short-term payables), transaction costs are included in the calculation of amortised cost using the effective interest method and, in effect, amortised through profit or loss over the life of the instrument.

For available-for-sale financial assets, transaction costs are recognised in the appropriate equity account as part of a change in fair value at the next remeasurement. If an available-for-sale financial

asset has fixed or determinable payments and does not have an indefinite life, the transaction costs are amortised to the statement of profit and loss using the effective interest method. If an available-for-sale financial asset does not have fixed or determinable payments and has an indefinite life, the transaction costs are recognised in the statement of profit and loss when the asset is derecognised or becomes impaired.

Transaction costs expected to be incurred on transfer or disposal of a financial instrument are not included in the measurement of the financial instrument.

E.2 Fair Value Measurement Considerations

E.2.1 Fair value measurement considerations for investment funds

Appendix A paragraph A91 of AS 30 states that the current bid price is usually the appropriate price to be used in measuring the fair value of an asset held. The rules applicable to some investment funds require net asset values to be reported to investors on the basis of mid-market prices. In these circumstances, would it be appropriate for an investment fund to measure its assets on the basis of mid-market prices?

No. The existence of regulations that require a different measurement for specific purposes does not justify a departure from the general requirement in Appendix A paragraph A91 of AS 30 to use the current bid price in the absence of a matching liability position. In its financial statements, an investment fund measures its assets at current bid prices. In reporting its net asset value to investors, an investment fund may wish to provide a reconciliation between the fair values recognised on its balance sheet and the prices used for the net asset value calculation.

E.2.2 Fair value measurement: large holding

Entity A holds 15 per cent of the share capital in Entity B. The shares are publicly traded in an active market. The currently quoted price is ₹ 100. Daily trading volume is 0.1 per cent of outstanding shares. Because Entity A believes that the fair value of the Entity B shares it owns, if sold as a block, is greater than the quoted market price, Entity A obtains several independent estimates of the price it would obtain if it sells its holding. These estimates indicate that Entity A would be able to obtain a price of ₹ 105, *i.e.*, a 5 per cent premium above the quoted price. Which figure should Entity A use for measuring its holding at fair value?

Under Appendix A paragraph A90 of AS 30, a published price quotation in an active market is the best estimate of fair value. Therefore, Entity A uses the published price quotation (₹ 100). Entity A cannot depart from the quoted market price solely because independent estimates indicate that Entity A would obtain a higher (or lower) price by selling the holding as a block.

E.3 Gains and Losses

E.3.1 Available-for-sale financial assets: exchange of shares

Entity A holds a small number of shares in Entity B. The shares are classified as available for sale. On 20 December 20x6, the fair value of the shares is ₹ 120 and the cumulative gain recognised in the Investment Revaluation Reserve Account is ₹ 20. On the same day, Entity B is acquired by Entity C, a large public entity. As a result, Entity A receives shares in Entity C in exchange for those it had in Entity B of equal fair value. Under paragraph 61(b) of AS 30, should Entity A recognise the cumulative gain of ₹ 20 recognised in the Investment Revaluation Reserve Account in the statement of profit and loss?

Yes. The transaction qualifies for derecognition under AS 30. Paragraph 61(b) of AS 30 requires that the cumulative gain or loss that has been recognised in the Investment Revaluation Reserve Account

on an available-for-sale financial asset be recognised in the statement of profit and loss when the asset is derecognised. In the exchange of shares, Entity A disposes of the shares it had in Entity B and receives shares in Entity C.

E.3.2 AS 30 and AS 11 – Available-for-sale financial assets: separation of currency component

For an available-for-sale monetary financial asset, the entity reports changes in the carrying amount relating to changes in foreign exchange rates in the statement of profit and loss in accordance with AS 11 and other changes in the carrying amount in the Investment Revaluation Reserve Account in accordance with AS 30. How is the cumulative gain or loss that is recognised in the Investment Revaluation Reserve Account determined?

It is the difference between the amortised cost (adjusted for impairment, if any) and fair value of the available-for-sale monetary financial asset in the functional currency of the reporting entity. For the purpose of applying AS 11, the asset is treated as an asset measured at amortised cost in the foreign currency.

To illustrate: on 31 December 20x7, Entity A acquires a bond denominated in a foreign currency (FC) for its fair value of FC 1,000. The bond has five years remaining to maturity and a principal amount of FC 1,250, carries fixed interest of 4.7 per cent that is paid annually (FC 1,250 X 4.7 per cent = FC 59 per year), and has an effective interest rate of 10 per cent. Entity A classifies the bond as available for sale, and thus recognises gains and losses in the Investment Revaluation Reserve Account. The entity's functional currency is its Indian currency (₹). The exchange rate is FC1 to ₹ 1.5 and the carrying amount of the bond is ₹ 1,500 (= FC 1,000 X 1.5).

Dr	Bond	₹ 1,500	
	Cr Cash		₹ 1,500

On 31 December 20x8, the foreign currency has appreciated and the exchange rate is FC1 to ₹ 2. The fair value of the bond is FC 1,060 and thus the carrying amount is ₹ 2,120 (= FC 1,060 X 2). The amortised cost is FC 1,041 (= ₹ 2,082). In this case, the cumulative gain or loss to be recognised directly in the Investment Revaluation Reserve Account is the difference between the fair value and the amortised cost on 31 December 20x8, i.e., ₹ 38 (= ₹ 2,120 – ₹ 2,082).

Interest received on the bond on 31 December 20x8 is FC 59 (= ₹ 118). Interest income determined in accordance with the effective interest method is FC 100 (=1,000 X 10 per cent). The average exchange rate during the year is FC1 to ₹ 1.75. For the purpose of this question, it is assumed that the use of the average exchange rate provides a reliable approximation of the spot rates applicable to the accrual of interest income during the year (AS 11.). Thus, reported interest income is ₹ 175 (= FC100 X 1.75) including accretion of the initial discount of ₹ 72 (= [FC100 – FC59] X 1.75). Accordingly, the exchange difference on the bond that is recognised in the statement of profit and loss is ₹ 510 (= ₹ 2,082 – ₹ 1,500 – ₹ 72). Also, there is an exchange gain on the interest receivable for the year of ₹ 15 (= FC 59 X [2.00 – 1.75]).

Dr	Bond	₹ 620	
Dr	Cash	₹ 118	
	Cr Interest income		₹ 175
	Cr Exchange gain		₹ 525
	Cr Investment Revaluation Reserve Account		₹ 38

On 31 December 20x9, the foreign currency has appreciated further and the exchange rate is FC1 to ₹ 2.50. The fair value of the bond is FC 1,070 and thus the carrying amount is ₹ 2,675 (= FC 1,070 X 2.50). The amortised cost is FC1,086 (= ₹ 2,715). The cumulative gain or loss to be recognised directly in the Investment Revaluation Reserve Account is the difference between the fair value and the

amortised cost on 31 December 20x9, i.e. negative ₹ 40 (= ₹ 2,675 – ₹ 2,715). Thus, there is a debit to the Investment Revaluation Reserve Account equal to the change in the difference during 20x9 of ₹ 78 (= ₹ 40 + ₹ 38).

Interest received on the bond on 31 December 20x9 is FC 59 (= ₹ 148). Interest income determined in accordance with the effective interest method is FC104 (= FC 1,041 X 10 per cent). The average exchange rate during the year is FC1 to ₹ 2.25. For the purpose of this question, it is assumed that the use of the average exchange rate provides a reliable approximation of the spot rates applicable to the accrual of interest income during the year (AS 11.). Thus, recognised interest income is ₹ 234 (= FC104 X 2.25) including accretion of the initial discount of ₹ 101 (= [FC104 – FC59] X 2.25). Accordingly, the exchange difference on the bond that is recognised in the statement of profit and loss is ₹ 532 (= ₹ 2,715 – ₹ 2,082 – ₹ 101). Also, there is an exchange gain on the interest receivable for the year of ₹ 15 (= FC59 X [2.50 – 2.25]).

Dr	Bond	₹ 555	
Dr	Cash	₹ 148	
Dr	Investment Revaluation Reserve Account	₹ 78	
	Cr Interest income		₹ 234
	Cr Exchange gain		₹ 547

E.3.3 AS 30 and AS 11 – Exchange differences arising on translation of non-integral foreign operations: foreign currency translation reserve or income?

AS 11 states that all exchange differences resulting from translating the financial statements of a non-integral foreign operation should be accumulated in the foreign currency translation reserve until disposal of the net investment. This would include exchange differences arising from financial instruments carried at fair value, which would include both financial assets classified as at fair value through profit or loss and financial assets that are available for sale.

Paragraph 61 of AS 30 requires that changes in fair value of financial assets classified as at fair value through profit or loss should be recognised in the statement of profit and loss and changes in fair value of available-for-sale investments should be reported in the appropriate equity account.

If the non-integral foreign operation is a subsidiary whose financial statements are consolidated with those of its parent, in the consolidated financial statements how are paragraph 61 of AS 30 and AS 11 applied?

AS 30 applies in the accounting for financial instruments in the financial statements of a non-integral foreign operation and AS 11 applies in translating the financial statements of a non-integral foreign operation for incorporation in the financial statements of the reporting entity.

To illustrate: Entity A is domiciled in India and its functional currency and reporting currency are the Indian Rupees (₹)). A has a foreign subsidiary (Entity B) in Country Y whose functional currency is the local currency of Country Y (LCY). B is the owner of a debt instrument, which is held for trading and therefore carried at fair value under AS 30.

In B's financial statements for year 20x6, the fair value and carrying amount of the debt instrument is LCY 100 in the local currency of Country Y. In A's consolidated financial statements, the asset is translated into the Indian Rupees at the spot exchange rate applicable at the balance sheet date (2.00). Thus, the carrying amount is ₹ 200 (= LCY 100 X 2.00) in the consolidated financial statements.

At the end of year 20x7, the fair value of the debt instrument has increased to LCY 110 in the local currency of Country Y. B recognises the trading asset at LCY 110 in its balance sheet and recognises a fair value gain of LCY 10 in its statement of profit and loss. During the year, the spot exchange rate has

increased from 2.00 to 3.00 resulting in an increase in the fair value of the instrument from ₹ 200 to ₹ 330 (= LCY 110 X 3.00) in the Indian Rupees. Therefore, Entity A recognises the trading asset at ₹ 330 in its consolidated financial statements.

Entity A translates the statement of profit and loss of B "at the exchange rates at the dates of the transactions" (AS 11). Since the fair value gain has accrued through the year, A uses the average rate as a practical approximation ([3.00 + 2.00] / 2 = 2.50, in accordance with AS 11). Therefore, while the fair value of the trading asset has increased by ₹ 130 (= ₹ 330 - ₹ 200), Entity A recognises only ₹ 25 (= LCY10 X 2.5) of this increase in the consolidated statement of profit and loss to comply with AS 11. The resulting exchange difference, *i.e.*, the remaining increase in the fair value of the debt instrument (₹ 130 – ₹ 25 = ₹ 105), is accumulated in the foreign currency translation reserve until the disposal of the net investment in the non-integral foreign operation in accordance with AS 11.

E.3.4 AS 30 and AS 11 – Interaction between AS 30 and AS 11

AS 30 includes requirements about the measurement of financial assets and financial liabilities and the recognition of gains and losses on remeasurement in the statement of profit and loss. AS 11 includes rules about the reporting of foreign currency items and the recognition of exchange differences in the statement of profit and loss. In what order are AS 11 and AS 30 applied?

Balance sheet

Generally, the measurement of a financial asset or financial liability at fair value, cost or amortised cost is first determined in the foreign currency in which the item is denominated in accordance with AS 30. Then, the foreign currency amount is translated into the functional currency using the closing rate or a historical rate in accordance with AS 11 (Appendix A paragraph A103 of AS 30). For example, if a monetary financial asset (such as a debt instrument) is carried at amortised cost under AS 30, amortised cost is calculated in the currency of denomination of that financial asset. Then, the foreign currency amount is recognised using the closing rate in the entity's financial statements (AS 11). That applies regardless of whether a monetary item is measured at cost, amortised cost or fair value in the foreign currency (AS 11). A non-monetary financial asset (such as an investment in an equity instrument) is translated using the closing rate if it is carried at fair value in the foreign currency (AS 11) and at a historical rate if it is not carried at fair value under AS 30 because its fair value cannot be reliably measured (AS 11and paragraph 51(c) of AS 30).

As an exception, if the financial asset or financial liability is designated as a hedged item in a fair value hedge of the exposure to changes in foreign currency rates under AS 30, the hedged item is remeasured for changes in foreign currency rates even if it would otherwise have been recognised using a historical rate under AS 11 (paragraph 99 of AS 30), i.e., the foreign currency amount is recognised using the closing rate. This exception applies to non-monetary items that are carried in terms of historical cost in the foreign currency and are hedged against exposure to foreign currency rates (AS 11).

Statement of profit and loss

The recognition of a change in the carrying amount of a financial asset or financial liability in the statement of profit and loss depends on a number of factors, including whether it is an exchange difference or other change in carrying amount, whether it arises on a monetary item (for example, most debt instruments) or non-monetary item (such as most equity investments), whether the associated asset or liability is designated as a cash flow hedge of an exposure to changes in foreign currency rates, and whether it results from translating the financial statements of a foreign operation. The issue

of recognising changes in the carrying amount of a financial asset or financial liability held by a non-integral foreign operation is addressed in a separate question (see Question E.3.3).

Any exchange difference arising on recognising a *monetary item* at a rate different from that at which it was initially recognised during the period, or recognised in previous financial statements, is recognised in the statement of profit and loss or in the foreign currency translation reserve in accordance with AS 11 (Appendix A paragraph A103 of AS 30 and AS 11), unless the monetary item is designated as a cash flow hedge of a highly probable forecast transaction in foreign currency, in which case the requirements for recognition of gains and losses on cash flow hedges in AS 30 apply (paragraph 106 of AS 30). Differences arising from recognising a monetary item at a foreign currency amount different from that at which it was previously recognised are accounted for in a similar manner, since all changes in the carrying amount relating to foreign currency movements should be treated consistently. All other changes in the balance sheet measurement of a monetary item are recognised in the statement of profit and loss or in the appropriate equity account, say, Investment Revaluation Reserve Account, in accordance with AS 30. For example, although an entity recognises gains and losses on available-for-sale monetary financial assets in the equity account (paragraph 61(b) of AS 30), the entity nevertheless recognises the changes in the carrying amount relating to changes in foreign exchange rates in the statement of profit and loss (AS 11).

Any changes in the carrying amount of a *non-monetary item* are recognised in the statement of profit and loss or in the equity account in accordance with AS 30 (Appendix A paragraph A103 of AS 30). For example, for available-for-sale financial assets the entire change in the carrying amount, including the effect of changes in foreign currency rates, is reported in the equity account. If the non-monetary item is designated as a cash flow hedge of an unrecognised firm commitment or a highly probable forecast transaction in foreign currency, the requirements for recognition of gains and losses on cash flow hedges in AS 30 apply (paragraph 106 of AS 30).

When some portion of the change in carrying amount is recognised in an appropriate equity account and some portion is recognised in the statement of profit and loss, for example, if the amortised cost of a foreign currency bond classified as available for sale has increased in foreign currency (resulting in a gain in the statement of profit and loss) but its fair value has decreased in the functional currency (resulting in a loss in the foreign currency translation reserve), an entity cannot offset those two components for the purposes of determining gains or losses that should be recognised in the statement of profit and loss or in the equity account.

E.4 Impairment and Uncollectibility of Financial Assets

E.4.1 Objective evidence of impairment

Does AS 30 require that an entity be able to identify a single, distinct past causative event to conclude that it is probable that an impairment loss on a financial asset has been incurred?

No. Paragraph 65 of AS 30 states "It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment." Also, paragraph 66 of AS 30 states that "a downgrade of an entity's credit rating is not, by itself, evidence of impairment, although it may be evidence of impairment when considered with other available information". Other factors that an entity considers in determining whether it has objective evidence that an impairment loss has been incurred include information about the debtors' or issuers' liquidity, solvency and business and financial risk exposures, levels of and trends in delinquencies for similar financial assets, national and local economic trends and conditions, and the fair value of collateral and guarantees. These and other factors may, either individually or taken together, provide

sufficient objective evidence that an impairment loss has been incurred in a financial asset or group of financial assets.

E.4.2 Impairment: future losses

Does AS 30 permit the recognition of an impairment loss through the establishment of an allowance for future losses when a loan is given? For example, if Entity A lends ₹ 1,000 to Customer B, can it recognise an immediate impairment loss of ₹ 10 if Entity A, based on historical experience, expects that 1 per cent of the principal amount of loans given will not be collected?

No. Paragraph 47 of AS 30 requires a financial asset to be initially measured at fair value. For a loan asset, the fair value is the amount of cash lent adjusted for any fees and costs (unless a portion of the amount lent is compensation for other stated or implied rights or privileges). In addition, paragraph 64 of AS 30 requires that an impairment loss is recognised only if there is objective evidence of impairment as a result of a past event that occurred after initial recognition. Accordingly, it is inconsistent with paragraphs 47 and 64 of AS 30 to reduce the carrying amount of a loan asset on initial recognition through the recognition of an immediate impairment loss.

E.4.3 Assessment of impairment: principal and interest

Because of Customer B's financial difficulties, Entity A is concerned that Customer B will not be able to make all principal and interest payments due on a loan in a timely manner. It negotiates a restructuring of the loan. Entity A expects that Customer B will be able to meet its obligations under the restructured terms. Would Entity A recognise an impairment loss if the restructured terms are as reflected in any of the following cases?

(a) Customer B will pay the full principal amount of the original loan five years after the original due date, but none of the interest due under the original terms.

(b) Customer B will pay the full principal amount of the original loan on the original due date, but none of the interest due under the original terms.

(c) Customer B will pay the full principal amount of the original loan on the original due date with interest only at a lower interest rate than the interest rate inherent in the original loan.

(d) Customer B will pay the full principal amount of the original loan five years after the original due date and all interest accrued during the original loan term, but no interest for the extended term.

(e) Customer B will pay the full principal amount of the original loan five years after the original due date and all interest, including interest for both the original term of the loan and the extended term.

Paragraph 64 of AS 30 indicates that an impairment loss has been incurred if there is objective evidence of impairment. The amount of the impairment loss for a loan measured at amortised cost is the difference between the carrying amount of the loan and the present value of future principal and interest payments discounted at the loan's original effective interest rate. In cases (a)-(d) above, the present value of the future principal and interest payments discounted at the loan's original effective interest rate will be lower than the carrying amount of the loan. Therefore, an impairment loss is recognised in those cases.

In case (e), even though the timing of payments has changed, the lender will receive interest on interest, and the present value of the future principal and interest payments discounted at the loan's original effective interest rate will equal the carrying amount of the loan. Therefore, there is no impairment loss. However, this fact pattern is unlikely given Customer B's financial difficulties.

E.4.4 Assessment of impairment: fair value hedge

A loan with fixed interest rate payments is hedged against the exposure to interest rate risk by a receive-variable, pay-fixed interest rate swap. The hedge relationship qualifies for fair value hedge accounting and is reported as a fair value hedge. Thus, the carrying amount of the loan includes an adjustment for fair value changes attributable to movements in interest rates. Should an assessment of impairment in the loan take into account the fair value adjustment for interest rate risk?

Yes. The loan's original effective interest rate before the hedge becomes irrelevant once the carrying amount of the loan is adjusted for any changes in its fair value attributable to interest rate movements. Therefore, the original effective interest rate and amortised cost of the loan are adjusted to take into account recognised fair value changes. The adjusted effective interest rate is calculated using the adjusted carrying amount of the loan.

An impairment loss on the hedged loan is calculated as the difference between its carrying amount after adjustment for fair value changes attributable to the risk being hedged and the estimated future cash flows of the loan discounted at the adjusted effective interest rate. When a loan is included in a portfolio hedge of interest rate risk, the entity should allocate the change in the fair value of the hedged portfolio to the loans (or groups of similar loans) being assessed for impairment on a systematic and rational basis.

E.4.5 Impairment: provision matrix

A financial institution calculates impairment in the unsecured portion of loans and receivables on the basis of a provision matrix that specifies fixed provision rates for the number of days a loan has been classified as non-performing (zero per cent if less than 90 days, 20 per cent if 90-180 days, 50 per cent if 181-365 days and 100 per cent if more than 365 days). Can the results be considered to be appropriate for the purpose of calculating the impairment loss on loans and receivables under paragraph 69 of AS 30?

Not necessarily. Paragraph 69 of AS 30 requires impairment or bad debt losses to be calculated as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial instrument's original effective interest rate.

E.4.6 Impairment: excess losses

Does AS 30 permit an entity to recognise impairment or bad debt losses in excess of impairment losses that are determined on the basis of objective evidence about impairment in identified individual financial assets or identified groups of similar financial assets?

No. AS 30 does not permit an entity to recognise impairment or bad debt losses in addition to those that can be attributed to individually identified financial assets or identified groups of financial assets with similar credit risk characteristics (paragraph 70 of AS 30) on the basis of objective evidence about the existence of impairment in those assets (paragraph 64 of AS 30). Amounts that an entity might want to set aside for additional possible impairment in financial assets, such as reserves that cannot be supported by objective evidence about impairment, are not recognised as impairment or bad debt losses under AS 30. If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics (paragraph 70 of AS 30).

E.4.7 Recognition of impairment on a portfolio basis

Paragraph 69 of AS 30 requires that impairment be recognised for financial assets carried at amortised cost. Paragraph 70 of AS 30 states that impairment may be measured and recognised

individually or on a portfolio basis for a group of similar financial assets. If one asset in the group is impaired but the fair value of another asset in the group is above its amortised cost, does AS 30 allow non-recognition of the impairment of the first asset?

No. If an entity knows that an individual financial asset carried at amortised cost is impaired, paragraph 69 of AS 30 requires that the impairment of that asset should be recognised. It states: "the amount of the loss is measured as the difference between *the asset's* carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate" (*emphasis added*). Measurement of impairment on a portfolio basis under paragraph 70 AS 30 may be applied to groups of small balance items and to financial assets that are individually assessed and found not to be impaired when there is indication of impairment in a group of similar assets and impairment cannot be identified with an individual asset in that group.

E.4.8 Impairment: recognition of collateral

If an impaired financial asset is secured by collateral and foreclosure is probable, is the collateral recognised as an asset separate from the impaired financial asset?

No. The measurement of the impaired financial asset reflects the fair value of the collateral. The collateral would generally not meet the recognition criteria until it is transferred to the lender. Accordingly, the collateral is not recognised as an asset separate from the impaired financial asset before foreclosure.

E.4.9 Impairment of non-monetary available-for-sale financial asset

If a non-monetary financial asset, such as an equity instrument, measured at fair value with gains and losses recognised in the appropriate equity account becomes impaired, should the cumulative net loss recognised in the equity account, including any portion attributable to foreign currency changes, be recognised in the statement of profit and loss?

Yes. Paragraph 76 of AS 30 states that when a decline in the fair value of an available-for-sale financial asset has been recognised directly in the equity account and there is objective evidence that the asset is impaired, the cumulative net loss that had been recognised directly in the equity account should be removed from the equity account and recognised in the statement of profit and loss even though the asset has not been derecognised. Any portion of the cumulative net loss that is attributable to foreign currency changes on that asset that had been recognised in the equity account is also recognised in the statement of profit and loss. Any subsequent losses, including any portion attributable to foreign currency changes, are also recognised in the statement of profit and loss until the asset is derecognised.

E.4.10 Impairment: whether the appropriate equity account created to recognise gains or losses on the available-for-sale financial assets can be negative

Paragraph 76 of AS 30 requires that gains and losses arising from changes in fair value on available-for-sale financial assets are recognised directly in the appropriate equity account. If the aggregate fair value of such assets is less than their carrying amount, should the aggregate net loss that has been recognised directly in the equity account be removed from the equity account and recognised in the statement of profit and loss?

Not necessarily. The relevant criterion is not whether the aggregate fair value is less than the carrying amount, but whether there is objective evidence that a financial asset or group of assets is impaired. An entity assesses at each balance sheet date whether there is any objective evidence that a financial asset or group of assets may be impaired, in accordance with paragraphs 65-67 of AS 30.. Paragraph

66 of AS 30 states that a downgrade of an entity's credit rating is not, by itself, evidence of impairment, although it may be evidence of impairment when considered with other available information. Additionally, a decline in the fair value of a financial asset below its cost or amortised cost is not necessarily evidence of impairment (for example, a decline in the fair value of an investment in a debt instrument that results from an increase in the basic, risk-free interest rate).

Section F Hedging

F.1 Hedging Instruments

F.1.1 Hedging the fair value exposure of a bond denominated in a foreign currency

Entity J, whose functional currency is the Indian Rupees, has issued 5 million five-year US dollar fixed rate debt. Also, it owns a 5 million five-year fixed rate US dollar bond which it has classified as available for sale. Can Entity J designate its US dollar liability as a hedging instrument in a fair value hedge of the entire fair value exposure of its US dollar bond?

No. Paragraph 81 of AS 30 permits a non-derivative to be used as a hedging instrument only for a hedge of a foreign currency risk. Entity J's bond has a fair value exposure to foreign currency and interest rate changes and credit risk.

Alternatively, can the US dollar liability be designated as a fair value hedge or cash flow hedge of the foreign currency component of the bond?

Yes. However, hedge accounting is unnecessary because the amortised cost of the hedging instrument and the hedged item are both remeasured using closing rates. Regardless of whether Entity J designates the relationship as a cash flow hedge or a fair value hedge, the effect on profit or loss is the same. Any gain or loss on the non-derivative hedging instrument designated as a cash flow hedge is immediately recognised in the statement of profit and loss to correspond with the recognition of the change in spot rate on the hedged item in the statement of profit and loss as required by AS 11.

F.1.2 Hedging with a non-derivative financial asset or liability

Entity J's functional currency is the Indian Rupees. It has issued a fixed rate debt instrument with semi-annual interest payments that matures in two years with principal due at maturity of 5 million US dollars. It has also entered into a fixed price sales commitment for 5 million US dollars that matures in two years and is not accounted for as a derivative because it meets the exemption for normal sales in paragraph 4. Can Entity J designate its US dollar liability as a fair value hedge of the entire fair value exposure of its fixed price sales commitment and qualify for hedge accounting?

No. Paragraph 81 of AS 30 permits a non-derivative asset or liability to be used as a hedging instrument only for a hedge of a foreign currency risk.

Alternatively, can Entity J designate its US dollar liability as a cash flow hedge of the foreign currency exposure associated with the future receipt of US dollars on the fixed price sales commitment?

Yes. AS 30 permits the designation of a non-derivative asset or liability as a hedging instrument in either a cash flow hedge or a fair value hedge of the exposure to changes in foreign exchange rates of a firm commitment (paragraph 97 of AS 30). Any gain or loss on the non-derivative hedging instrument that is recognised in the appropriate equity account during the period preceding the future sale is recognised in the statement of profit and loss when the sale takes place (paragraph 106 of AS 30).

Alternatively, can Entity J designate the sales commitment as the hedging instrument instead of the hedged item?

No. Only a derivative instrument or a non-derivative financial asset or liability can be designated as a hedging instrument in a hedge of a foreign currency risk. A firm commitment cannot be designated as a hedging instrument. However, if the foreign currency component of the sales commitment is required to be separated as an embedded derivative under paragraph 10 and Appendix A paragraph A53(d) of AS 30, it could be designated as a hedging instrument in a hedge of the exposure to changes in the fair value of the maturity amount of the debt attributable to foreign currency risk.

F.1.3 Hedge accounting: use of written options in combined hedging instruments

Issue (a) - Does Appendix A paragraph A114 of AS 30 preclude the use of an interest rate collar or other derivative instrument that combines a written option component and a purchased option component as a hedging instrument?

It depends. An interest rate collar or other derivative instrument that includes a written option cannot be designated as a hedging instrument if it is a net written option, because Appendix A paragraph A114 of AS 30 precludes the use of a written option as a hedging instrument unless it is designated as an offset to a purchased option. An interest rate collar or other derivative instrument that includes a written option may be designated as a hedging instrument, however, if the combination is a net purchased option or zero cost collar.

Issue (b) - What factors indicate that an interest rate collar or other derivative instrument that combines a written option component and a purchased option component is not a net written option?

The following factors taken together suggest that an interest rate collar or other derivative instrument that includes a written option is not a net written option.

(a) No net premium is received either at inception or over the life of the combination of options. The distinguishing feature of a written option is the receipt of a premium to compensate the writer for the risk incurred.

(b) Except for the strike prices, the critical terms and conditions of the written option component and the purchased option component are the same (including underlying variable or variables, currency denomination and maturity date). Also, the notional amount of the written option component is not greater than the notional amount of the purchased option component.

F.1.4 Internal hedges

Some entities use internal derivative contracts (internal hedges) to transfer risk exposures between different companies within a group or divisions within a single legal entity. Does paragraph 82 of AS 30 prohibit hedge accounting in such cases?

Yes, if the derivative contracts are internal to the entity being reported on. AS 30 does not specify how an entity should manage its risk. However, it states that internal hedging transactions do not qualify for hedge accounting. This applies both (a) in consolidated financial statements for intragroup hedging transactions, and (b) in the individual or separate financial statements of a legal entity for hedging transactions between divisions in the entity. The principles of preparing consolidated financial statements in AS 21 require that "intragroup balances, transactions, income and expenses should be eliminated in full".

On the other hand, an intragroup hedging transaction may be designated as a hedge in the individual or separate financial statements of a group entity, if the intragroup transaction is an external transaction from the perspective of the group entity. In addition, if the internal contract is offset with an external party the external contract may be regarded as the hedging instrument and the hedging relationship may qualify for hedge accounting.

The following summarises the application of AS 30 to internal hedging transactions.

- AS 30 does not preclude an entity from using internal derivative contracts for risk management purposes and it does not preclude internal derivatives from being accumulated at the treasury level or some other central location so that risk can be managed on an entity-wide basis or at some higher level than the separate legal entity or division.
- Internal derivative contracts between two separate entities within a consolidated group can qualify for hedge accounting by those entities in their individual or separate financial statements, even though the internal contracts are not offset by derivative contracts with a party external to the consolidated group.
- Internal derivative contracts between two separate divisions within the same legal entity can qualify for hedge accounting in the individual or separate financial statements of that legal entity only if those contracts are offset by derivative contracts with a party external to the legal entity.
- Internal derivative contracts between separate divisions within the same legal entity and between separate entities within the consolidated group can qualify for hedge accounting in the consolidated financial statements only if the internal contracts are offset by derivative contracts with a party external to the consolidated group.
- If the internal derivative contracts are not offset by derivative contracts with external parties, the use of hedge accounting by group entities and divisions using internal contracts must be reversed on consolidation.

To illustrate: the banking division of Entity A enters into an internal interest rate swap with the trading division of the same entity. The purpose is to hedge the interest rate risk exposure of a loan (or group of similar loans) in the loan portfolio. Under the swap, the banking division pays fixed interest payments to the trading division and receives variable interest rate payments in return.

If a hedging instrument is not acquired from an external party, AS 30 does not allow hedge accounting treatment for the hedging transaction undertaken by the banking and trading divisions. Paragraph 82 of AS 30 indicates that only derivatives that involve a party external to the entity can be designated as hedging instruments and, further, that any gains or losses on intragroup or intra-entity transactions should be eliminated on consolidation. Therefore, transactions between different divisions within Entity A do not qualify for hedge accounting treatment in the financial statements of Entity A. Similarly, transactions between different entities within a group do not qualify for hedge accounting treatment in consolidated financial statements.

However, if in addition to the internal swap in the above example the trading division enters into an interest rate swap or other contract with an external party that offsets the exposure hedged in the internal swap, hedge accounting is permitted under AS 30. For the purposes of AS 30, the hedged item is the loan (or group of similar loans) in the banking division and the hedging instrument is the external interest rate swap or other contract.

The trading division may aggregate several internal swaps or portions of them that are not offsetting each other and enter into a single third party derivative contract that offsets the aggregate exposure. Under AS 30, such external hedging transactions may qualify for hedge accounting treatment provided that the hedged items in the banking division are identified and the other conditions for hedge accounting are met. It should, however, be noted that paragraph 88 of AS 30 does not permit hedge accounting treatment for held-to-maturity investments if the hedged risk is the exposure to interest rate changes.

F.1.5 Offsetting internal derivative contracts used to manage interest rate risk

If a central treasury function enters into internal derivative contracts with subsidiaries and various divisions within the consolidated group to manage interest rate risk on a centralised basis, can those contracts qualify for hedge accounting in the consolidated financial statements if, before laying off the risk, the internal contracts are first netted against each other and only the net exposure is offset in the marketplace with external derivative contracts?

No. An internal contract designated at the subsidiary level or by a division as a hedge results in the recognition of changes in the fair value of the item being hedged in the statement of profit and loss (a fair value hedge) or in the recognition of the changes in the fair value of the internal derivative in the appropriate equity account (a cash flow hedge). There is no basis for changing the measurement attribute of the item being hedged in a fair value hedge unless the exposure is offset with an external derivative. There is also no basis for including the gain or loss on the internal derivative in the equity account for one entity and recognising it in the statement of profit and loss by the other entity unless it is offset with an external derivative. In cases where two or more internal derivatives are used to manage interest rate risk on assets or liabilities at the subsidiary or division level and those internal derivatives are offset at the treasury level, the effect of designating the internal derivatives as hedging instruments is that the hedged non-derivative exposures at the subsidiary or division levels would be used to offset each other on consolidation. Accordingly, since paragraph 81 of AS 30 does not permit designating non-derivatives as hedging instruments, except for foreign currency exposures, the results of hedge accounting from the use of internal derivatives at the subsidiary or division level that are not laid off with external parties must be reversed on consolidation.

It should be noted, however, that there will be no effect on profit or loss and equity of reversing the effect of hedge accounting in consolidation for internal derivatives that offset each other at the consolidation level if they are used in the same type of hedging relationship at the subsidiary or division level and, in the case of cash flow hedges, where the hedged items affect profit or loss in the same period. Just as the internal derivatives offset at the treasury level, their use as fair value hedges by two separate entities or divisions within the consolidated group will also result in the offset of the fair value amounts recognised in the statement of profit and loss, and their use as cash flow hedges by two separate entities or divisions within the consolidated group will also result in the fair value amounts being offset against each other in the appropriate equity account. However, there may be an effect on individual line items in both the consolidated statement of profit and loss and the consolidated balance sheet, for example when internal derivatives that hedge assets (or liabilities) in a fair value hedge are offset by internal derivatives that are used as a fair value hedge of other assets (or liabilities) that are recognised in a different balance sheet or statement of profit and loss line item. In addition, to the extent that one of the internal contracts is used as a cash flow hedge and the other is used in a fair value hedge, the effect on profit or loss and equity would not offset since the gain (or loss) on the internal derivative used as a fair value hedge would be recognised in the statement of profit and loss and the corresponding loss (or gain) on the internal derivative used as a cash flow hedge would be recognised in the appropriate equity account. Question F.1.4 describes the application of AS 30 to internal hedging transactions.

F.1.6 Offsetting internal derivative contracts used to manage foreign currency risk

If a central treasury function enters into internal derivative contracts with subsidiaries and various divisions within the consolidated group to manage foreign currency risk on a centralised basis, can those contracts be used as a basis for identifying external transactions that qualify for hedge accounting in the consolidated financial statements if, before laying off

the risk, the internal contracts are first netted against each other and only the net exposure is offset by entering into a derivative contract with an external party?

It depends. AS 21, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements,* requires all internal transactions to be eliminated in consolidated financial statements. As stated in paragraph 82 of AS 30, internal hedging transactions do not qualify for hedge accounting in the consolidated financial statements of the group. Therefore, if an entity wishes to achieve hedge accounting in the consolidated financial statements, it must designate a hedging relationship between a qualifying external hedging instrument and a qualifying hedged item.

As discussed in Question F.1.5, the accounting effect of two or more internal derivatives that are used to manage interest rate risk at the subsidiary or division level and are offset at the treasury level is that the hedged non-derivative exposures at those levels would be used to offset each other on consolidation. There is no effect on profit or loss or equity if (a) the internal derivatives are used in the same type of hedge relationship (i.e. fair value or cash flow hedges) and (b), in the case of cash flow hedges, any derivative gains and losses that are initially recognised in the equity account are recognised in the statement of profit and loss in the same period(s). When these two conditions are met, the gains and losses on the internal derivatives that are recognised in the statement of profit and loss or in the equity account will offset on consolidation resulting in the same profit or loss and equity as if the derivatives had been eliminated. However, there may be an effect on individual line items, in both the consolidated statement of profit and loss and the consolidated balance sheet, that would need to be eliminated. In addition, there is an effect on profit or loss and equity if some of the offsetting internal derivatives are used in cash flow hedges, while others are used in fair value hedges. There is also an effect on profit or loss and equity for offsetting internal derivatives that are used in cash flow hedges if the derivative gains and losses that are initially recognised in the equity account are recognised in the statement of profit and loss in different periods (because the hedged items affect profit or loss in different periods).

As regards foreign currency risk, provided that the internal derivatives represent the transfer of foreign currency risk on underlying non-derivative financial assets or liabilities, hedge accounting can be applied because paragraph 81 of AS 30 permits a non-derivative financial asset or liability to be designated as a hedging instrument for hedge accounting purposes for a hedge of a foreign currency risk. Accordingly, in this case the internal derivative contracts can be used as a basis for identifying external transactions that qualify for hedge accounting in the consolidated financial statements even if they are offset against each other. However, for consolidated financial statements, it is necessary to designate the hedging relationship so that it involves only external transactions.

Furthermore, the entity cannot apply hedge accounting to the extent that two or more offsetting internal derivatives represent the transfer of foreign currency risk on underlying forecast transactions or unrecognised firm commitments. This is because an unrecognised firm commitment or forecast transaction does not qualify as a hedging instrument under AS 30. Accordingly, in this case the internal derivatives cannot be used as a basis for identifying external transactions that qualify for hedge accounting in the consolidated financial statements. As a result, any cumulative net gain or loss on an internal derivative that has been included in the initial carrying amount of an asset or liability (basis adjustment) or deferred in the equity account would have to be reversed on consolidation if it cannot be demonstrated that the offsetting internal derivative represented the transfer of a foreign currency risk on a financial asset or liability to an external hedging instrument.

F.1.7 Internal derivatives: examples of applying Question F.1.6

In each case, FC = foreign currency, Indian Rupees (₹) = local currency (which is the entity's functional currency), and TC = treasury centre.

Case 1: Offset of fair value hedges

Subsidiary A has trade receivables of FC100, due in 60 days, which it hedges using a forward contract with TC. Subsidiary B has payables of FC50, also due in 60 days, which it hedges using a forward contact with TC.

TC nets the two internal derivatives and enters into a net external forward contract to pay FC50 and receive Indian Rupees in 60 days.

At the end of month 1, FC weakens against Rupees. A incurs a foreign exchange loss of ₹ 10 on its receivables, offset by a gain of ₹ 10 on its forward contract with TC. B makes a foreign exchange gain of ₹ 5 on its payables offset by a loss of ₹ 5 on its forward contract with TC. TC makes a loss of ₹ 10 on its internal forward contract with A, a gain of ₹ 5 on its internal forward contract with B, and a gain of ₹ 5 on its external forward contract.

At the end of month 1, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting intragroup transactions or events are shown in italics.

A's entries

Dr	Foreign exchange loss	₹ 10	
	Cr Receivables		₹ 10
Dr	*Internal contract TC*	*₹ 10*	
	Cr *Internal gain TC*		*₹ 10*

B's entries

Dr	Payables	₹ 5	
	Cr Foreign exchange gain		₹ 5
Dr	*Internal loss TC*	*₹ 5*	
	Cr *Internal contract TC*		*₹ 5*

TC's entries

Dr	*Internal loss A*	*₹ 10*	
	Cr *Internal contract A*		*₹ 10*
Dr	*Internal contract B*	*₹ 5*	
	Cr *Internal gain B*		*₹ 5*
Dr	External forward contract	₹ 5	
	Cr Foreign exchange gain		₹ 5

Both A and B could apply hedge accounting in their individual financial statements provided all conditions in AS 30 are met. However, in this case, no hedge accounting is required because gains and losses on the internal derivatives and the offsetting losses and gains on the hedged receivables and payables are recognised immediately in the statements of profit and loss of A and B without hedge accounting.

In the consolidated financial statements, the internal derivative transactions are eliminated. In economic terms, the payable in B hedges FC50 of the receivables in A. The external forward contract in TC hedges the remaining FC50 of the receivable in A. Hedge accounting is not necessary in the consolidated financial statements because monetary items are measured at spot foreign exchange rates under AS 11 irrespective of whether hedge accounting is applied.

The net balances before and after elimination of the accounting entries relating to the internal derivatives are the same, as set out below. Accordingly, there is no need to make any further accounting entries to meet the requirements of AS 30.

	Debit	Credit
Receivables	-	₹ 10
Payables	₹ 5	-
External forward contract	₹ 5	-
Gains and losses	-	-
Internal contracts	-	-

Case 2: Offset of cash flow hedges

To extend the example, A also has highly probable future revenues of FC200 on which it expects to receive cash in 90 days. B has highly probable future expenses of FC500 (advertising cost), also to be paid for in 90 days. A and B enter into separate forward contracts with TC to hedge these exposures and TC enters into an external forward contract to receive FC300 in 90 days.

As before, FC weakens at the end of month 1. A incurs a 'loss' of ₹ 20 on its anticipated revenues because the Rupees value of these revenues decreases. This is offset by a 'gain' of ₹ 20 on its forward contract with TC.

B incurs a 'gain' of ₹ 50 on its anticipated advertising cost because the Rupees value of the expense decreases. This is offset by a 'loss' of ₹ 50 on its transaction with TC.

TC incurs a 'gain' of ₹ 50 on its internal transaction with B, a 'loss' of ₹ 20 on its internal transaction with A and a loss of ₹ 30 on its external forward contract.

A and B complete the necessary documentation, the hedges are effective, and both A and B qualify for hedge accounting in their individual financial statements. A defers the gain of ₹ 20 on its internal derivative transaction in the 'Hedging Reserve' Account and B defers the loss of ₹ 50 in its 'Hedging Reserve' Account. TC does not claim hedge accounting, but measures both its internal and external derivative positions at fair value, which net to zero.

At the end of month 1, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting intragroup transactions or events are shown in italics.

A's entries

Dr	*Internal contract TC*	*₹ 20*	
	Cr Hedging Reserve Account		*₹ 20*

B's entries

Dr	*Hedging Reserve Account*	*₹ 50*	
	Cr Internal contract TC		*₹ 50*

TC's entries

Dr	*Internal loss A*	*₹ 20*	
	Cr Internal contract A		*₹ 20*
Dr	*Internal contract B*	*₹ 50*	
	Cr Internal gain B		*₹ 50*
Dr	Foreign exchange loss	₹ 30	
	Cr External forward contract		₹ 30

For the consolidated financial statements, TC's external forward contract on FC300 is designated, at the beginning of month 1, as a hedging instrument of the first FC300 of B's highly probable future expenses. AS 30 requires that in the consolidated financial statements at the end of month 1, the accounting effects of the internal derivative transactions must be eliminated.

However, the net balances before and after elimination of the accounting entries relating to the internal derivatives are the same, as set out below. Accordingly, there is no need to make any further accounting entries in order for the requirements of AS 30 to be met.

	Debit	Credit
External forward contract	-	₹ 30
Hedging Reserve Account	₹ 30	-
Gains and losses	-	-
Internal contracts	-	-

Case 3: Offset of fair value and cash flow hedges

Assume that the exposures and the internal derivative transactions are the same as in cases 1 and 2. However, instead of entering into two external derivatives to hedge separately the fair value and cash flow exposures, TC enters into a single net external derivative to receive FC250 in exchange for Rupees in 90 days.

TC has four internal derivatives, two maturing in 60 days and two maturing in 90 days. These are offset by a net external derivative maturing in 90 days. The interest rate differential between FC and Rupees is minimal, and therefore the ineffectiveness resulting from the mismatch in maturities is expected to have a minimal effect on profit or loss in TC.

As in cases 1 and 2, A and B apply hedge accounting for their cash flow hedges and TC measures its derivatives at fair value. A defers a gain of ₹ 20 on its internal derivative transaction in Hedging Reserve Account and B defers a loss of ₹ 50 on its internal derivative transaction in its Hedging Reserve Account.

At the end of month 1, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting intragroup transactions or events are shown in italics.

A's entries

Dr	Foreign exchange loss	₹ 10	
	Cr Receivables		₹ 10
Dr	*Internal contract TC*	*₹ 10*	
	Cr Internal gain TC		*₹ 10*
Dr	*Internal contract TC*	*₹ 20*	
	Cr Hedging Reserve Account		*₹ 20*

B's entries

Dr	Payables	₹ 5	
	Cr Foreign exchange gain		₹ 5
Dr	*Internal loss TC*	*₹ 5*	
	Cr Internal contract TC		*₹ 5*
Dr	*Hedging Reserve Account*	*₹ 50*	
	Cr Internal contract TC		*₹ 50*

TC's entries

Dr	*Internal loss A*	*₹ 10*	
	Cr Internal contract A		*₹ 10*
Dr	*Internal loss A*	*₹ 20*	
	Cr Internal contract A		*₹ 20*
Dr	*Internal contract B*	*₹ 5*	
	Cr Internal gain B		*₹ 5*

Dr	*Internal contract B*	*₹ 50*	
	Cr Internal gain B		*₹ 50*
Dr	Foreign exchange loss	₹ 25	
	Cr External forward contract		₹ 25

TOTAL (for the internal derivatives)	A ₹	B ₹	Total TC
Income (fair value hedges)	10	(5)	5
Hedging Reserve Account (cash flow hedges)	20	(50)	(30)
Total	30	(55)	(25)

Combining these amounts with the external transactions (i.e., those not marked in italics above) produces the total net balances before elimination of the internal derivatives as follows:

	Debit	Credit
Receivables	-	₹ 10
Payables	₹ 5	-
Forward contract	-	₹ 25
Hedging Reserve Account	₹ 30	-
Gains and losses	-	-
Internal contracts	-	-

For the consolidated financial statements, the following designations are made at the beginning of month 1:

- the payable of FC50 in B is designated as a hedge of the first FC50 of the highly probable future revenues in A. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Payable ₹ 5; Cr Hedging Reserve Account ₹ 5;
- the receivable of FC100 in A is designated as a hedge of the first FC100 of the highly probable future expenses in B. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Hedging Reserve Account ₹ 10, Cr Receivable ₹ 10; and
- the external forward contract on FC250 in TC is designated as a hedge of the next FC250 of highly probable future expenses in B. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Hedging Reserve Account ₹ 25; Cr External forward contract ₹ 25.

In the consolidated financial statements at the end of month 1, AS 30 requires the accounting effects of the internal derivative transactions to be eliminated.

However, the total net balances before and after elimination of the accounting entries relating to the internal derivatives are the same, as set out below. Accordingly, there is no need to make any further accounting entries to meet the requirements of AS 30.

	Debit	Credit
Receivables	-	₹ 10
Payables	₹ 5	-
Forward contract	-	₹ 25
Hedging Reserve Account	₹ 30	-
Gains and losses	-	-
Internal contracts	-	-

Case 4: Offset of fair value and cash flow hedges with adjustment to carrying amount of inventory

Assume similar transactions as in case 3, except that the anticipated cash outflow of FC500 in B relates to the purchase of inventory that is delivered after 60 days. Assume also that the entity has a policy of basis-adjusting hedged forecast non-financial items. At the end of month 2, there are no further changes in exchange rates or fair values. At that date, the inventory is delivered and the loss of ₹ 50 on B's internal derivative, deferred in Hedging Reserve Account in month 1, is adjusted against the carrying amount of inventory in B. The gain of ₹ 20 on A's internal derivative is deferred in Hedging Reserve Account as before.

In the consolidated financial statements, there is now a mismatch compared with the result that would have been achieved by unwinding and redesignating the hedges. The external derivative (FC250) and a proportion of the receivable (FC50) offset FC300 of the anticipated inventory purchase. There is a natural hedge between the remaining FC200 of anticipated cash outflow in B and the anticipated cash inflow of FC200 in A. This relationship does not qualify for hedge accounting under AS 30 and this time there is only a partial offset between gains and losses on the internal derivatives that hedge these amounts.

At the end of months 1 and 2, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting intragroup transactions or events are shown in italics.

A's entries (all at the end of month 1)

Dr	Foreign exchange loss	₹ 10	
	Cr Receivables		₹ 10
Dr	*Internal contract TC*	*₹ 10*	
	Cr Internal gain TC		*₹ 10*
Dr	*Internal contract TC*	*₹ 20*	
	Cr Hedging Reserve Account		*₹ 20*

B's entries

At the end of month 1:

Dr	Payables	₹ 5	
	Cr Foreign exchange gain		₹ 5
Dr	*Internal loss TC*	*₹ 5*	
	Cr Internal contract TC		*₹ 5*
Dr	*Hedging Reserve Account*	*₹ 50*	
	Cr Internal contract TC		*₹ 50*

At the end of month 2:

Dr	Inventory	₹ 50	
	Cr Hedging Reserve Account		₹ 50

TC's entries (all at the end of month 1)

Dr	*Internal loss A*	*₹ 10*	
	Cr Internal contract A		*₹ 10*
Dr	*Internal loss A*	*₹ 20*	
	Cr Internal contract A		*₹ 20*
Dr	*Internal contract B*	*₹ 5*	
	Cr Internal gain B		*₹ 5*
Dr	*Internal contract B*	*₹ 50*	
	Cr Internal gain B		*₹ 50*
Dr	Foreign exchange loss	₹ 25	
	Cr Forward contract		₹ 25

TOTAL (for the internal derivatives)	A ₹	B ₹	Total ₹
Income (fair value hedges)	10	(5)	5
Hedging Reserve Account (cash flow hedges)	20	-	20
Basis adjustment (inventory)	-	(50)	(50)
Total	30	(55)	(25)

Combining these amounts with the external transactions (*i.e.*, those not marked in italics above) produces the total net balances before elimination of the internal derivatives as follows:

	Debit	Credit
Receivables	-	₹ 10
Payables	₹ 5	-
Forward contract	-	₹ 25
Hedging Reserve Account	-	₹ 20
Basis adjustment (inventory)	₹ 50	-
Gains and losses	-	-
Internal contracts	-	-

For the consolidated financial statements, the following designations are made at the beginning of month 1:

- the payable of FC50 in B is designated as a hedge of the first FC50 of the highly probable future revenues in A. Therefore, at the end of month 1, the following entry is made in the consolidated financial statements: Dr Payables ₹ 5; Cr Hedging Reserve Account ₹ 5.
- the receivable of FC100 in A is designated as a hedge of the first FC100 of the highly probable future expenses in B. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Hedging Reserve Account ₹ 10; Cr Receivable ₹ 10; and at the end of month 2, Dr Inventory ₹ 10; Cr Hedging Reserve Account ₹ 10.
- the external forward contract on FC250 in TC is designated as a hedge of the next FC250 of highly probable future expenses in B. Therefore, at the end of month 1, the following entry is made in the consolidated financial statements: Dr Hedging Reserve Account ₹ 25; Cr External forward contract ₹ 25; and at the end of month 2, Dr Inventory ₹ 25; Cr Hedging Reserve Account ₹ 25.

The total net balances after elimination of the accounting entries relating to the internal derivatives are as follows:

	Debit	Credit
Receivables	-	₹ 10
Payables	₹ 5	-
Forward contract	-	₹ 25
Hedging Reserve Account	-	₹ 5
Basis adjustment (inventory)	₹ 35	-
Gains and losses	-	-
Internal contracts	-	-

These total net balances are different from those that would be recognised if the internal derivatives were not eliminated, and it is these net balances that AS 30 requires to be included in the consolidated financial statements. The accounting entries required to adjust the total net balances before elimination of the internal derivatives are as follows:

(a) to reclassify ₹ 15 of the loss on B's internal derivative that is included in inventory to reflect that FC150 of the forecast purchase of inventory is not hedged by an external instrument (neither the external forward contract of FC250 in TC nor the external payable of FC100 in A); and

(b) to reclassify the gain of ₹ 15 on A's internal derivative to reflect that the forecast revenues of FC150 to which it relates is not hedged by an external instrument.

The net effect of these two adjustments is as follows:

Dr	Hedging Reserve Account Cr Inventory	₹ 15	 ₹ 15

F.1.8 Combination of written and purchased options

In most cases, Appendix A paragraph A114 of AS 30 prohibits the use of written options as hedging instruments. If a combination of a written option and purchased option (such as an interest rate collar) is transacted as a single instrument with one counterparty, can an entity split the derivative instrument into its written option component and purchased option component and designate the purchased option component as a hedging instrument?

No. Paragraph 83 of AS 30 specifies that a hedging relationship is designated by an entity for a hedging instrument in its entirety. The only exceptions permitted are splitting the time value and intrinsic value of an option and splitting the interest element and spot price on a forward. Question F.1.3 addresses the issue of whether and when a combination of options is considered as a written option.

F.1.9 Delta-neutral hedging strategy

Does AS 30 permit an entity to apply hedge accounting for a 'delta-neutral' hedging strategy and other dynamic hedging strategies under which the quantity of the hedging instrument is constantly adjusted in order to maintain a desired hedge ratio, for example, to achieve a delta-neutral position insensitive to changes in the fair value of the hedged item?

Yes. Paragraph 83 of AS 30 states that "a dynamic hedging strategy that assesses both the intrinsic value and time value of an option contract can qualify for hedge accounting". For example, a portfolio insurance strategy that seeks to ensure that the fair value of the hedged item does not drop below a certain level, while allowing the fair value to increase, may qualify for hedge accounting.

To qualify for hedge accounting, the entity must document how it will monitor and update the hedge and measure hedge effectiveness, be able to track properly all terminations and redesignations of the hedging instrument, and demonstrate that all other criteria for hedge accounting in paragraph 98 of AS 30 are met. Also, it must be able to demonstrate an expectation that the hedge will be highly effective for a specified short period of time during which the hedge is not expected to be adjusted.

F.1.10 Hedging instrument: out of the money put option

Entity A has an investment in one share of Entity B, which it has classified as available for sale. To give itself partial protection against decreases in the share price of Entity B, Entity A acquires a put option on one share of Entity B and designates the change in the intrinsic value of the put as a hedging instrument in a fair value hedge of changes in the fair value of its share in Entity B. The put gives Entity A the right to sell one share of Entity B at a strike price of ₹ 90. At the inception of the hedging relationship, the share has a quoted price of ₹ 100. Since the put option gives Entity A the right to dispose of the share at a price of ₹ 90, the put should normally be fully effective in offsetting price declines below ₹ 90 on an intrinsic value basis. Price changes above ₹ 90 are not hedged. In this case, are changes in the fair value of the share of Entity B for prices above ₹ 90 regarded as hedge ineffectiveness under paragraph 98 of AS 30 and recognised in the statement of profit and loss under paragraph 99 of AS 30?

No. Paragraph 83 of AS 30 permits Entity A to designate changes in the intrinsic value of the option as the hedging instrument. The changes in the intrinsic value of the option provide protection against the risk of variability in the fair value of one share of Entity B below or equal to the strike price of the put of ₹ 90. For

prices above ₹ 90, the option is out of the money and has no intrinsic value. Accordingly, gains and losses on one share of Entity B for prices above ₹ 90 are not attributable to the hedged risk for the purposes of assessing hedge effectiveness and recognising gains and losses on the hedged item.

Therefore, Entity A reports changes in the fair value of the share in the Investment Revaluation Reserve Account if it is associated with variation in its price above ₹ 90 (paragraphs 61 and 101 of AS 30). Changes in the fair value of the share associated with price declines below ₹ 90 form part of the designated fair value hedge and are recognised in the statement of profit and loss under paragraph 99(b) of AS 30. Assuming the hedge is effective, those changes are offset by changes in the intrinsic value of the put, which are also recognised in the statement of profit and loss (paragraph 99(a) of AS 30). Changes in the time value of the put are excluded from the designated hedging relationship and recognised in the statement of profit and loss under paragraph 61(a) of AS 30.

F.1.11 Hedging instrument: proportion of the cash flows of a cash instrument

In the case of foreign exchange risk, a non-derivative financial asset or non-derivative financial liability can potentially qualify as a hedging instrument. Can an entity treat the cash flows for specified periods during which a financial asset or financial liability that is designated as a hedging instrument remains outstanding as a proportion of the hedging instrument under paragraph 84 of AS 30, and exclude the other cash flows from the designated hedging relationship?

No. Paragraph 84 of AS 30 indicates that a hedging relationship may not be designated for only a portion of the time period in which the hedging instrument is outstanding. For example, the cash flows during the first three years of a ten-year borrowing denominated in a foreign currency cannot qualify as a hedging instrument in a cash flow hedge of the first three years of revenue in the same foreign currency. On the other hand, a non-derivative financial asset or financial liability denominated in a foreign currency may potentially qualify as a hedging instrument in a hedge of the foreign currency risk associated with a hedged item that has a remaining time period until maturity that is equal to or longer than the remaining maturity of the hedging instrument (see Question F.2.17).

F.1.12 Hedges of more than one type of risk

Issue (a) - Normally a hedging relationship is designated between an entire hedging instrument and a hedged item so that there is a single measure of fair value for the hedging instrument. Does this preclude designating a single financial instrument simultaneously as a hedging instrument in both a cash flow hedge and a fair value hedge?

No. For example, entities commonly use a combined interest rate and currency swap to convert a variable rate position in a foreign currency to a fixed rate position in the functional currency. Paragraph 85 of AS 30 allows the swap to be designated separately as a fair value hedge of the currency risk and a cash flow hedge of the interest rate risk provided the conditions in paragraph 85 of AS 30 are met.

Issue (b) - If a single financial instrument is a hedging instrument in two different hedges, is special disclosure required?

AS 32 on '*Financial Instruments: Disclosures*'[53] requires disclosures separately for designated fair value hedges, cash flow hedges and hedges of a net investment in a non-integral foreign operation. The instrument in question would be reported in the AS 32 disclosures separately for each type of hedge.

F.1.13 Hedging instrument: dual foreign currency forward exchange contract

Entity A's functional currency is the Indian rupees. Entity A has a five-year floating rate US dollar liability and a ten-year fixed rate pound sterling-denominated note receivable. The

[53] A separate Accounting Standard (AS) 32 on *Financial Instruments: Disclosures* is being formulated.

principal amounts of the asset and liability when converted into the Indian rupees are the same. Entity A enters into a single foreign currency forward contract to hedge its foreign currency exposure on both instruments under which it receives US dollars and pays pounds sterling at the end of five years. If Entity A designates the forward exchange contract as a hedging instrument in a cash flow hedge against the foreign currency exposure on the principal repayments of both instruments, can it qualify for hedge accounting?

Yes. Paragraph 85 of AS 30 permits designating a single hedging instrument as a hedge of multiple types of risk if three conditions are met. In this example, the derivative hedging instrument satisfies all of these conditions, as follows:

(a) The risks hedged can be identified clearly. The risks are the exposures to changes in the exchange rates between US dollars and Indian Rupees, and Indian Rupees and pounds, respectively.

(b) The effectiveness of the hedge can be demonstrated. For the pound sterling loan, the effectiveness is measured as the degree of offset between the fair value of the principal repayment in pounds sterling and the fair value of the pound sterling payment on the forward exchange contract. For the US dollar liability, the effectiveness is measured as the degree of offset between the fair value of the principal repayment in US dollars and the US dollar receipt on the forward exchange contract. Even though the receivable has a ten-year life and the forward protects it for only the first five years, hedge accounting is permitted for only a portion of the exposure as described in Question F.2.17.

(c) It is possible to ensure that there is specific designation of the hedging instrument and different risk positions. The hedged exposures are identified as the principal amounts of the liability and the note receivable in their respective currency of denomination.

F.1.14 Concurrent offsetting swaps and use of one as a hedging instrument

Entity A enters into an interest rate swap and designates it as a hedge of the fair value exposure associated with fixed rate debt. The fair value hedge meets the hedge accounting criteria of AS 30. Entity A simultaneously enters into a second interest rate swap with the same swap counterparty that has terms that fully offset the first interest rate swap. Is Entity A required to view the two swaps as one unit and therefore precluded from applying fair value hedge accounting to the first swap?

It depends. AS 30 is transaction-based. If the second swap was not entered into in contemplation of the first swap or there is a substantive business purpose for structuring the transactions separately, then the swaps are not viewed as one unit.

For example, some entities have a policy that requires a centralised dealer or treasury subsidiary to enter into third-party derivative contracts on behalf of other subsidiaries within the organisation to hedge the subsidiaries' interest rate risk exposures. The dealer or treasury subsidiary also enters into internal derivative transactions with those subsidiaries in order to track those hedges operationally within the organisation. Because the dealer or treasury subsidiary also enters into derivative contracts as part of its trading operations, or because it may wish to rebalance the risk of its overall portfolio, it may enter into a derivative contract with the same third party during the same business day that has substantially the same terms as a contract entered into as a hedging instrument on behalf of another subsidiary. In this case, there is a valid business purpose for entering into each contract.

Judgement is applied to determine whether there is a substantive business purpose for structuring the transactions separately. For example, if the sole purpose is to obtain fair value accounting treatment for the debt, there is no substantive business purpose.

F.2 Hedged Items

F.2.1 Whether a derivative can be designated as a hedged item

Does AS 30 permit designating a derivative instrument (whether a stand-alone or separately recognised embedded derivative) as a hedged item either individually or as part of a hedged group in a fair value or cash flow hedge, for example, by designating a pay-variable, receive-fixed Forward Rate Agreement (FRA) as a cash flow hedge of a pay-fixed, receive-variable FRA?

No. Derivative instruments are always deemed held for trading and measured at fair value with gains and losses recognised in the statement of profit and loss unless they are designated and effective hedging instruments (paragraph 8.17 of AS 30). As an exception, Appendix A paragraph A114 of AS 30 permits the designation of a purchased option as the hedged item in a fair value hedge.

F.2.2 Cash flow hedge: anticipated issue of fixed rate debt

Is hedge accounting allowed for a hedge of an anticipated issue of fixed rate debt?

Yes. This would be a cash flow hedge of a highly probable forecast transaction that will affect profit or loss (paragraph 96 of AS 30) provided that the conditions in paragraph 98 of AS 30 are met.

To illustrate: Entity R periodically issues new bonds to refinance maturing bonds, provide working capital and for various other purposes. When Entity R decides it will be issuing bonds, it may hedge the risk of changes in the long-term interest rate from the date it decides to issue the bonds to the date the bonds are issued. If long-term interest rates go up, the bond will be issued either at a higher rate or with a higher discount or smaller premium than was originally expected. The higher rate being paid or decrease in proceeds is normally offset by the gain on the hedge. If long-term interest rates go down, the bond will be issued either at a lower rate or with a higher premium or a smaller discount than was originally expected. The lower rate being paid or increase in proceeds is normally offset by the loss on the hedge.

For example, in August 20x6 Entity R decided it would issue ₹ 200 million seven-year bonds in January 20x7. Entity R performed historical correlation studies and determined that a seven-year treasury bond adequately correlates to the bonds Entity R expected to issue, assuming a hedge ratio of 0.93 futures contracts to one debt unit. Therefore, Entity R hedged the anticipated issue of the bonds by selling (shorting) ₹ 186 million worth of futures on seven-year treasury bonds. From August 20x6 to January 20x7 interest rates increased. The short futures positions were closed in January 20x7, the date the bonds were issued, and resulted in a ₹ 1.2 million gain that will offset the increased interest payments on the bonds and, therefore, will affect profit or loss over the life of the bonds. The hedge qualifies as a cash flow hedge of the interest rate risk on the forecast issue of debt.

F.2.3 Hedge accounting: core deposit intangibles

Is hedge accounting treatment permitted for a hedge of the fair value exposure of core deposit intangibles (i.e., value of long-term relationships with depositors)?

It depends on whether the core deposit intangible is generated internally or acquired (*e.g.*, as part of a business combination).

Internally generated core deposit intangibles are not recognised as intangible assets under AS 26. Because they are not recognised, they cannot be designated as a hedged item.

If a core deposit intangible is acquired together with a related portfolio of deposits, the core deposit intangible is required to be recognised separately as an intangible asset (or as part of the related acquired portfolio of deposits) if it meets the recognition criteria in paragraph 20 of AS 26, *Intangible Assets*. A recognised core deposit intangible asset could be designated as a hedged item, but only if it

meets the conditions in paragraph 98 of AS 30, including the requirement in paragraph 98(d) of AS 30 that the effectiveness of the hedge can be measured reliably. Because it is often difficult to measure reliably the fair value of a core deposit intangible asset on initial recognition, it is unlikely that the requirement in paragraph 98(d) of AS 30 will be met.

F.2.4 Hedge accounting: hedging of future foreign currency revenue streams

Is hedge accounting permitted for a currency borrowing that hedges an expected but not contractual revenue stream in foreign currency?

Yes, if the revenues are highly probable. Under paragraph 96(b) of AS 30 a hedge of an anticipated sale may qualify as a cash flow hedge. For example, an airline entity may use sophisticated models based on experience and economic data to project its revenues in various currencies. If it can demonstrate that forecast revenues for a period of time into the future in a particular currency are "highly probable", as required by paragraph 98 of AS 30, it may designate a currency borrowing as a cash flow hedge of the future revenue stream. The portion of the gain or loss on the borrowing that is determined to be an effective hedge is recognised directly in the appropriate equity account until the revenues occur.

It is unlikely that an entity can reliably predict 100 per cent of revenues for a future year. On the other hand, it is possible that a portion of predicted revenues, normally those expected in the short term, will meet the "highly probable" criterion.

F.2.5 Cash flow hedges: 'all in one' hedge

If a derivative instrument is expected to be settled gross by delivery of the underlying asset in exchange for the payment of a fixed price, can the derivative instrument be designated as the hedging instrument in a cash flow hedge of that gross settlement assuming the other cash flow hedge accounting criteria are met?

Yes. A derivative instrument that will be settled gross can be designated as the hedging instrument in a cash flow hedge of the variability of the consideration to be paid or received in the future transaction that will occur on gross settlement of the derivative contract itself because there would be an exposure to variability in the purchase or sale price without the derivative. This applies to all fixed price contracts that are accounted for as derivatives under AS 30.

For example, if an entity enters into a fixed price contract to sell a commodity and that contract is accounted for as a derivative under AS 30 (for example, because the entity has a practice of settling such contracts net in cash or of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin), the entity may designate the fixed price contract as a cash flow hedge of the variability of the consideration to be received on the sale of the asset (a future transaction) even though the fixed price contract is the contract under which the asset will be sold. Also, if an entity enters into a forward contract to purchase a debt instrument that will be settled by delivery, but the forward contract is a derivative because its term exceeds the regular way delivery period in the marketplace, the entity may designate the forward as a cash flow hedge of the variability of the consideration to be paid to acquire the debt instrument (a future transaction), even though the derivative is the contract under which the debt instrument will be acquired.

F.2.6 Hedge relationships: entity-wide risk

An entity has a fixed rate asset and a fixed rate liability, each having the same principal amount. Under the terms of the instruments, interest payments on the asset and liability occur in the same period and the net cash flow is always positive because the interest rate on the asset

exceeds the interest rate on the liability. The entity enters into an interest rate swap to receive a floating interest rate and pay a fixed interest rate on a notional amount equal to the principal of the asset and designates the interest rate swap as a fair value hedge of the fixed rate asset. Does the hedging relationship qualify for hedge accounting even though the effect of the interest rate swap on an entity-wide basis is to create an exposure to interest rate changes that did not previously exist?

Yes. AS 30 does not require risk reduction on an entity-wide basis as a condition for hedge accounting. Exposure is assessed on a transaction basis and, in this instance, the asset being hedged has a fair value exposure to interest rate increases that is offset by the interest rate swap.

F.2.7 Cash flow hedge: forecast transaction related to an entity's equity

Can a forecast dividend payments to shareholders be designated as a hedged item in a cash flow hedge?

No. To qualify as a hedged item, the forecast transaction must expose the entity to a particular risk that can affect profit or loss (paragraph 96 of AS 30). The classification of financial instruments as liabilities or equity generally provides the basis for determining whether transactions or other payments relating to such instruments are recognised as expense or income in the statement of profit and loss or are recognised directly in the revenue reserves and surplus (AS 31). For example, distributions to holders of an equity instrument are recognised by the issuer directly in the revenue reserves and surplus (paragraph 64 of AS 31). Therefore, such distributions cannot be designated as a hedged item. However, a declared dividend that has not yet been paid and is recognised as a financial liability may qualify as a hedged item, for example, for foreign currency risk if it is denominated in a foreign currency.

F.2.8 Hedge accounting: risk of a transaction not occurring

Does AS 30 permit an entity to apply hedge accounting to a hedge of the risk that a transaction will not occur, for example, if that would result in less revenue to the entity than expected?

No. The risk that a transaction will not occur is an overall business risk that is not eligible as a hedged item. Hedge accounting is permitted only for risks associated with recognised assets and liabilities, firm commitments, highly probable forecast transactions and net investments in foreign operations (paragraph 96 of AS 30).

F.2.9 Held-to-maturity investments: hedging variable interest rate payments

Can an entity designate a pay-variable, receive-fixed interest rate swap as a cash flow hedge of a variable rate, held-to-maturity investment?

No. It is inconsistent with the designation of a debt investment as being held-to-maturity to designate a swap as a cash flow hedge of the debt investment's variable interest rate payments. Paragraph 88 of AS 30 states that a held-to-maturity investment cannot be a hedged item with respect to interest rate risk or prepayment risk "because designation of an investment as held-to-maturity requires an intention to hold the investment until maturity without regard to changes in the fair value or cash flows of such an investment attributable to changes in interest rates".

F.2.10 Hedged items: purchase of held-to-maturity investment

An entity forecasts the purchase of a financial asset that it intends to classify as held-to-maturity when the forecast transaction occurs. It enters into a derivative contract with the intent to lock in the current interest rate and designates the derivative as a hedge of the forecast purchase of the financial asset. Can the hedging relationship qualify for cash flow hedge accounting even though the asset will be classified as a held-to-maturity investment?

Yes. With respect to interest rate risk, AS 30 prohibits hedge accounting for financial assets that are classified as held-to-maturity (paragraph 88 of AS 30). However, even though the entity intends to classify the asset as held-to-maturity, the instrument is not classified as such until the transaction occurs.

F.2.11 Cash flow hedges: reinvestment of funds obtained from held-to-maturity investments

An entity owns a variable rate asset that it has classified as held-to-maturity. It enters into a derivative contract with the intention to lock in the current interest rate on the reinvestment of variable rate cash flows, and designates the derivative as a cash flow hedge of the forecast future interest receipts on debt instruments resulting from the reinvestment of interest receipts on the held-to-maturity asset. Assuming that the other hedge accounting criteria are met, can the hedging relationship qualify for cash flow hedge accounting even though the interest payments that are being reinvested come from an asset that is classified as held-to-maturity?

Yes. Paragraph 88 of AS 30 states that a held-to-maturity investment cannot be a hedged item with respect to interest rate risk. Question F.2.9 specifies that this applies not only to fair value hedges (*i.e.*, hedges of the exposure to fair value interest rate risk associated with held-to-maturity investments that pay fixed interest), but also to cash flow hedges (*i.e.*, hedges of the exposure to cash flow interest rate risk associated with held-to-maturity investments that pay variable interest at current market rates). However, in this instance, the derivative is designated as an offset of the exposure to cash flow risk associated with forecast future interest receipts on debt instruments resulting from the forecast reinvestment of variable rate cash flows on the held-to-maturity investment. The source of the funds forecast to be reinvested is not relevant in determining whether the reinvestment risk can be hedged. Accordingly, designation of the derivative as a cash flow hedge is permitted. This answer applies also to a hedge of the exposure to cash flow risk associated with the forecast future interest receipts on debt instruments resulting from the reinvestment of interest receipts on a fixed rate asset classified as held to maturity.

F.2.12 Hedge accounting: prepayable financial asset

If the issuer has the right to prepay a financial asset, can the investor designate the cash flows after the prepayment date as part of the hedged item?

Cash flows after the prepayment date may be designated as the hedged item to the extent it can be demonstrated that they are "highly probable" (paragraph 98 of AS 30). For example, cash flows after the prepayment date may qualify as highly probable if they result from a group or pool of similar assets (for example, mortgage loans) for which prepayments can be estimated with a high degree of accuracy or if the prepayment option is significantly out of the money. In addition, the cash flows after the prepayment date may be designated as the hedged item if a comparable option exists in the hedging instrument.

F.2.13 Fair value hedge: risk that could affect profit or loss

Is fair value hedge accounting permitted for exposure to interest rate risk in fixed rate loans that are classified as loans and receivables?

Yes. Under AS 30, loans and receivables are carried at amortised cost. Banking institutions generally hold the bulk of their loans and receivables until maturity. Thus, changes in the fair value of such loans and receivables that are due to changes in market interest rates will not affect profit or loss. Paragraph 96 of AS 30 specifies that a fair value hedge is a hedge of the exposure to changes in fair value that is attributable to a particular risk and that can affect profit or loss. Therefore, paragraph 96 of AS 30 may appear to preclude fair value hedge accounting for loans and receivables. However, it follows from paragraph 88 of AS 30 that loans and receivables can be hedged items with respect to interest rate risk

since they are not designated as held-to-maturity investments. The entity could sell them and the change in fair values would affect profit or loss. Thus, fair value hedge accounting is permitted for loans and receivables.

F.2.14 Intragroup and intra-entity hedging transactions

An Australian entity, whose functional currency is the Australian dollar, has forecast purchases in Japanese yen that are highly probable. The Australian entity is wholly owned by an Indian entity, which prepares consolidated financial statements (which include the Australian subsidiary) in Indian Rupees. The Indian parent entity enters into a forward contract to hedge the change in yen relative to the Australian dollar. Can that hedge qualify for hedge accounting in the consolidated financial statements, or must the Australian subsidiary that has the foreign currency exposure be a party to the hedging transaction?

Yes. The hedge can qualify for hedge accounting provided the other hedge accounting criteria in AS 30 are met. Since the Australian entity did not hedge the foreign currency exchange risk associated with the forecast purchases in yen, the effects of exchange rate changes between the Australian dollar and the yen will affect the Australian entity's statement of profit and loss and, therefore, would also affect consolidated statement of profit and loss. AS 30 does not require that the operating unit that is exposed to the risk being hedged be a party to the hedging instrument.

F.2.15 Internal contracts: single offsetting external derivative

An entity uses what it describes as internal derivative contracts to document the transfer of responsibility for interest rate risk exposures from individual divisions to a central treasury function. The central treasury function aggregates the internal derivative contracts and enters into a single external derivative contract that offsets the internal derivative contracts on a net basis. For example, if the central treasury function has entered into three internal receive-fixed, pay-variable interest rate swaps that lay off the exposure to variable interest cash flows on variable rate liabilities in other divisions and one internal receive-variable, pay-fixed interest rate swap that lays off the exposure to variable interest cash flows on variable rate assets in another division, it would enter into an interest rate swap with an external counterparty that exactly offsets the four internal swaps. Assuming that the hedge accounting criteria are met, in the entity's financial statements would the single offsetting external derivative qualify as a hedging instrument in a hedge of a part of the underlying items on a gross basis?

Yes, but only to the extent the external derivative is designated as an offset of cash inflows or cash outflows on a gross basis. Paragraph 94 of AS 30 indicates that a hedge of an overall net position does not qualify for hedge accounting. However, it does permit designating a part of the underlying items as the hedged position on a gross basis. Therefore, even though the purpose of entering into the external derivative was to offset internal derivative contracts on a net basis, hedge accounting is permitted if the hedging relationship is defined and documented as a hedge of a part of the underlying cash inflows or cash outflows on a gross basis. An entity follows the approach outlined in paragraph 94 and Appendix A paragraph A125 of AS 30 to designate part of the underlying cash flows as the hedged position.

F.2.16 Internal contracts: external derivative contracts that are settled net

Issue (a) - An entity uses internal derivative contracts to transfer interest rate risk exposures from individual divisions to a central treasury function. For each internal derivative contract, the central treasury function enters into a derivative contract with a single external counterparty that offsets the internal derivative contract. For example, if the central treasury function has entered into a receive-5 per cent-fixed, pay-LIBOR interest rate swap with another division that

has entered into the internal contract with central treasury to hedge the exposure to variability in interest cash flows on a pay-LIBOR borrowing, central treasury would enter into a pay-5 per cent-fixed, receive-LIBOR interest rate swap on the same principal terms with the external counterparty. Although each of the external derivative contracts is formally documented as a separate contract, only the net of the payments on all of the external derivative contracts is settled since there is a netting agreement with the external counterparty. Assuming that the other hedge accounting criteria are met, can the individual external derivative contracts, such as the pay-5 per cent-fixed, receive- LIBOR interest rate swap above, be designated as hedging instruments of underlying gross exposures, such as the exposure to changes in variable interest payments on the pay-LIBOR borrowing above, even though the external derivatives are settled on a net basis?

Generally, yes. External derivative contracts that are legally separate contracts and serve a valid business purpose, such as laying off risk exposures on a gross basis, qualify as hedging instruments even if those external contracts are settled on a net basis with the same external counterparty, provided the hedge accounting criteria in AS 30 are met. See also Question F.1.14.

Issue (b) - Treasury observes that by entering into the external offsetting contracts and including them in the centralised portfolio, it is no longer able to evaluate the exposures on a net basis. Treasury wishes to manage the portfolio of offsetting external derivatives separately from other exposures of the entity. Therefore, it enters into an additional, single derivative to offset the risk of the portfolio. Can the individual external derivative contracts in the portfolio still be designated as hedging instruments of underlying gross exposures even though a single external derivative is used to offset fully the market exposure created by entering into the external contracts?

Generally, yes. The purpose of structuring the external derivative contracts in this manner is consistent with the entity's risk management objectives and strategies. As indicated above, external derivative contracts that are legally separate contracts and serve a valid business purpose qualify as hedging instruments. Moreover, the answer to Question F.1.14 specifies that hedge accounting is not precluded simply because the entity has entered into a swap that mirrors exactly the terms of another swap with the same counterparty if there is a substantive business purpose for structuring the transactions separately.

F.2.17 Partial term hedging

Paragraph 84 of AS 30 indicates that a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding. Is it permitted to designate a derivative as hedging only a portion of the time period to maturity of a hedged item?

Yes. A financial instrument may be a hedged item for only a portion of its cash flows or fair value, if effectiveness can be measured and the other hedge accounting criteria are met.

To illustrate: Entity A acquires a 10 per cent fixed rate government bond with a remaining term to maturity of ten years. Entity A classifies the bond as available for sale. To hedge itself against fair value exposure on the bond associated with the present value of the interest rate payments until year 5, Entity A acquires a five-year pay-fixed, receive-floating swap. The swap may be designated as hedging the fair value exposure of the interest rate payments on the government bond until year 5 and the change in value of the principal payment due at maturity to the extent affected by changes in the yield curve relating to the five years of the swap.

F.2.18 Hedging instrument: cross-currency interest rate swap

Entity A's functional currency is the Indian Rupee. Entity A has a five-year floating rate US dollar liability and a 10-year fixed rate pound sterling-denominated note receivable. Entity A wishes to hedge the foreign currency exposure on its asset and liability and the fair value interest rate exposure on the receivable and enters into a matching cross-currency interest rate swap to receive floating rate US dollars and pay fixed rate pounds sterling and to exchange the dollars for the pounds at the end of five years. Can Entity A designate the swap as a hedging instrument in a fair value hedge against both foreign currency risk and interest rate risk, although both the pound sterling and US dollar are foreign currencies to Entity A?

Yes. Paragraph 90 of AS 30 permits hedge accounting for components of risk, if effectiveness can be measured. Also, paragraph 85 of AS 30 permits designating a single hedging instrument as a hedge of more than one type of risk if the risks can be identified clearly, effectiveness can be demonstrated, and specific designation of the hedging instrument and different risk positions can be ensured. Therefore, the swap may be designated as a hedging instrument in a fair value hedge of the pound sterling receivable against exposure to changes in its fair value associated with changes in UK interest rates for the initial partial term of five years and the exchange rate between pounds and US dollars. The swap is measured at fair value with changes in fair value recognised in the statement of profit and loss. The carrying amount of the receivable is adjusted for changes in its fair value caused by changes in UK interest rates for the first five-year portion of the yield curve. The receivable and payable are remeasured using spot exchange rates under AS 11 and the changes to their carrying amounts recognised in the statement of profit and loss.

F.2.19 Hedged items: hedge of foreign currency risk of publicly traded shares

Entity A acquires shares in Entity B on a US stock exchange for their fair value of US Dollar (USD) 1,000. It classifies the shares as available for sale. To protect itself from the exposure to changes in the foreign exchange rate associated with the shares, it enters into a forward contract to sell USD 750. Entity A intends to roll over the forward exchange contract for as long as it retains the shares. Assuming that the other hedge accounting criteria are met, could the forward exchange contract qualify as a hedge of the foreign exchange risk associated with the shares?

Yes, but only if there is a clear and identifiable exposure to changes in foreign exchange rates. Therefore, hedge accounting is permitted if (a) the equity instrument is not traded on an exchange (or in another established marketplace) where trades are denominated in the same currency as the functional currency of Entity A and (b) dividends to Entity A are not denominated in that currency. Thus, if a share is traded in multiple currencies and one of those currencies is the functional currency of the reporting entity, hedge accounting for the foreign currency component of the share price is not permitted.

If so, could the forward exchange contract be designated as a hedging instrument in a hedge of the foreign exchange risk associated with the portion of the fair value of the shares up to USD 750 in foreign currency?

Yes. AS 30 permits designating a portion of the cash flow or fair value of a financial asset as the hedged item if effectiveness can be measured (paragraph 90 of AS 30). Therefore, Entity A may designate the forward exchange contract as a hedge of the foreign exchange risk associated with only a portion of the fair value of the shares in foreign currency. It could either be designated as a fair value hedge of the foreign exchange exposure of USD 750 associated with the shares or as a cash flow hedge of a forecast sale of the shares, provided the timing of the sale is identified. Any variability in the

fair value of the shares in foreign currency would not affect the assessment of hedge effectiveness unless the fair value of the shares in foreign currency was to fall below USD 750.

F.2.20 Hedge accounting: stock index

An entity may acquire a portfolio of shares to replicate a stock index and a put option on the index to protect itself from fair value losses. Does AS 30 permit designating the put on the stock index as a hedging instrument in a hedge of the portfolio of shares?

No. If similar financial instruments are aggregated and hedged as a group, paragraph 93 of AS 30 states that the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group. In the scenario above, the change in the fair value attributable to the hedged risk for each individual item in the group (individual share prices) is not expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group.

F.2.21 Hedge accounting: netting of assets and liabilities

Can an entity group financial assets together with financial liabilities for the purpose of determining the net cash flow exposure to be hedged for hedge accounting purposes?

An entity's hedging strategy and risk management practices may assess cash flow risk on a net basis but paragraph 94 of AS 30 does not permit designating a net cash flow exposure as a hedged item for hedge accounting purposes. Appendix A paragraph A125 of AS 30 provides an example of how a bank might assess its risk on a net basis (with similar assets and liabilities grouped together) and then qualify for hedge accounting by hedging on a gross basis.

F.3 Hedge Accounting

F.3.1 Cash flow hedge: fixed interest rate cash flows

An entity issues a fixed rate debt instrument and enters into a receive-fixed, pay-variable interest rate swap to offset the exposure to interest rate risk associated with the debt instrument. Can the entity designate the swap as a cash flow hedge of the future interest cash outflows associated with the debt instrument?

No. Paragraph 96(b) of AS 30 states that a cash flow hedge is "a hedge of the exposure to variability in cash flows". In this case, the issued debt instrument does not give rise to any exposure to variability in cash flows since the interest payments are fixed. The entity may designate the swap as a fair value hedge of the debt instrument, but it cannot designate the swap as a cash flow hedge of the future cash outflows of the debt instrument.

F.3.2 Cash flow hedge: reinvestment of fixed interest rate cash flows

An entity manages interest rate risk on a net basis. On 1 January 20x7, it forecasts aggregate cash inflows of ₹ 100 on fixed rate assets and aggregate cash outflows of ₹ 90 on fixed rate liabilities in the first quarter of 20x8. For risk management purposes it uses a receive-variable, pay-fixed Forward Rate Agreement (FRA) to hedge the forecast net cash inflow of ₹ 10. The entity designates as the hedged item the first ₹ 10 of cash inflows on fixed rate assets in the first quarter of 20x8. Can it designate the receive-variable, pay-fixed FRA as a cash flow hedge of the exposure to variability to cash flows in the first quarter of 20x8 associated with the fixed rate assets?

No. The FRA does not qualify as a cash flow hedge of the cash flow relating to the fixed rate assets because they do not have a cash flow exposure. The entity could, however, designate the FRA as a hedge of the fair value exposure that exists before the cash flows are remitted.

In some cases, the entity could also hedge the interest rate exposure associated with the forecast reinvestment of the interest and principal it receives on fixed rate assets (see Question F.6.2). However, in this example, the FRA does not qualify for cash flow hedge accounting because it increases rather than reduces the variability of interest cash flows resulting from the reinvestment of interest cash flows (for example, if market rates increase, there will be a cash inflow on the FRA and an increase in the expected interest cash inflows resulting from the reinvestment of interest cash inflows on fixed rate assets). However, potentially it could qualify as a cash flow hedge of a portion of the refinancing of cash outflows on a gross basis.

F.3.3 Foreign currency hedge

Entity A has a foreign currency liability payable in six months' time and it wishes to hedge the amount payable on settlement against foreign currency fluctuations. To that end, it takes out a forward contract to buy the foreign currency in six months' time. Should the hedge be treated as:

(a) a fair value hedge of the foreign currency liability with gains and losses on revaluing the liability and the forward contract at the year-end both recognized in the statement of profit and loss; or

(b) a cash flow hedge of the amount to be settled in the future with gains and losses on revaluing the forward contract recognised in the Hedging Reserve Account?

AS 30 does not preclude either of these two methods. If the hedge is treated as a fair value hedge, the gain or loss on the fair value remeasurement of the hedging instrument and the gain or loss on the fair value remeasurement of the hedged item for the hedged risk are recognised immediately in the statement of profit and loss. If the hedge is treated as a cash flow hedge with the gain or loss on remeasuring the forward contract recognised in the Hedging Reserve Account, that amount is recognised in the statement of profit and loss in the same period or periods during which the hedged item (the liability) affects profit or loss, *i.e.*, when the liability is remeasured for changes in foreign exchange rates. Therefore, if the hedge is effective, the gain or loss on the derivative is released to the statement of profit and loss in the same periods during which the liability is remeasured, not when the payment occurs. See Question F.3.4.

F.3.4 Foreign currency cash flow hedge

An entity exports a product at a price denominated in a foreign currency. At the date of the sale, the entity obtains a receivable for the sale price payable in 90 days and takes out a 90-day forward exchange contract in the same currency as the receivable to hedge its foreign currency exposure.

Under AS 11, the sale is recorded at the spot rate at the date of sale, and the receivable is restated during the 90-day period for changes in exchange rates with the difference being taken to the statement of profit and loss.

If the foreign exchange contract is designated as a hedging instrument, does the entity have a choice whether to designate the foreign exchange contract as a fair value hedge of the foreign currency exposure of the receivable or as a cash flow hedge of the collection of the receivable?

Yes. If the entity designates the foreign exchange contract as a fair value hedge, the gain or loss from remeasuring the forward exchange contract at fair value is recognised immediately in the statement of profit and loss and the gain or loss on remeasuring the receivable is also recognised in the statement of profit and loss.

If the entity designates the foreign exchange contract as a cash flow hedge of the foreign currency risk associated with the collection of the receivable, the portion of the gain or loss that is determined to be an effective hedge is recognised directly in the Hedging Reserve Account, and the ineffective portion in the statement of profit and loss (paragraph 106 of AS 30). The amount recognised directly in the Hedging Reserve Account is transferred to the statement of profit and loss in the same period or periods during which changes in the measurement of the receivable affect profit or loss (paragraph 111 of AS 30).

F.3.5 Fair value hedge: variable rate debt instrument

Does AS 30 permit an entity to designate a portion of the risk exposure of a variable rate debt instrument as a hedged item in a fair value hedge?

Yes. A variable rate debt instrument may have an exposure to changes in its fair value due to credit risk. It may also have an exposure to changes in its fair value relating to movements in the market interest rate in the periods between which the variable interest rate on the debt instrument is reset. For example, if the debt instrument provides for annual interest payments reset to the market rate each year, a portion of the debt instrument has an exposure to changes in fair value during the year.

F.3.6 Fair value hedge: inventory

Paragraph 96(a) of AS 30 states that a fair value hedge is "a hedge of the exposure to changes in fair value of a recognised asset or liability ... that is attributable to a particular risk and could affect profit or loss". Can an entity designate inventories, such as copper inventory, as the hedged item in a fair value hedge of the exposure to changes in the price of the inventories, such as the copper price, although inventories are measured at the lower of cost and net realisable value under AS 2, *Valuation of Inventories*?

Yes. The inventories may be hedged for changes in fair value due to changes in the copper price because the change in fair value of inventories will affect profit or loss when the inventories are sold or their carrying amount is written down. The adjusted carrying amount becomes the cost basis for the purpose of applying the lower of cost and net realisable value test under AS 2. The hedging instrument used in a fair value hedge of inventories may alternatively qualify as a cash flow hedge of the future sale of the inventory.

F.3.7 Hedge accounting: forecast transaction

For cash flow hedges, a forecast transaction that is subject to a hedge must be "highly probable". How should the term "highly probable" be interpreted?

The term "highly probable" indicates a much greater likelihood of happening than the term "more likely than not". An assessment of the likelihood that a forecast transaction will take place is not based solely on management's intentions because intentions are not verifiable. A transaction's probability should be supported by observable facts and the attendant circumstances.

In assessing the likelihood that a transaction will occur, an entity should consider the following circumstances:

(a) the frequency of similar past transactions;

(b) the financial and operational ability of the entity to carry out the transaction;

(c) substantial commitments of resources to a particular activity (for example, a manufacturing facility that can be used in the short run only to process a particular type of commodity);

(d) the extent of loss or disruption of operations that could result if the transaction does not occur;

(e) the likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose (for example, an entity that intends to raise cash may have several ways of doing so, ranging from a short-term bank loan to an offering of equity shares); and

(f) the entity's business plan.

The length of time until a forecast transaction is projected to occur is also a factor in determining probability. Other factors being equal, the more distant a forecast transaction is, the less likely it is that the transaction would be regarded as highly probable and the stronger the evidence that would be needed to support an assertion that it is highly probable.

For example, a transaction forecast to occur in five years may be less likely to occur than a transaction forecast to occur in one year. However, forecast interest payments for the next 20 years on variable rate debt would typically be highly probable if supported by an existing contractual obligation.

In addition, other factors being equal, the greater the physical quantity or future value of a forecast transaction in proportion to the entity's transactions of the same nature, the less likely it is that the transaction would be regarded as highly probable and the stronger the evidence that would be required to support an assertion that it is highly probable. For example, less evidence generally would be needed to support forecast sales of 100,000 units in the next month than 950,000 units in that month when recent sales have averaged 950,000 units per month for the past three months.

A history of having designated hedges of forecast transactions and then determining that the forecast transactions are no longer expected to occur would call into question both an entity's ability to predict forecast transactions accurately and the propriety of using hedge accounting in the future for similar forecast transactions.

F.3.8 Retrospective designation of hedges

Does AS 30 permit an entity to designate hedge relationships retrospectively?

No. Designation of hedge relationships takes effect prospectively from the date all hedge accounting criteria in paragraph 98 of AS 30 are met. In particular, hedge accounting can be applied only from the date the entity has completed the necessary documentation of the hedge relationship, including identification of the hedging instrument, the related hedged item or transaction, the nature of the risk being hedged, and how the entity will assess hedge effectiveness.

F.3.9 Hedge accounting: designation at the inception of the hedge

Does AS 30 permit an entity to designate and formally document a derivative contract as a hedging instrument after entering into the derivative contract?

Yes, prospectively. For hedge accounting purposes, AS 30 requires a hedging instrument to be designated and formally documented as such from the inception of the hedge relationship (paragraph 98 of AS 30); in other words, a hedge relationship cannot be designated retrospectively. Also, it precludes designating a hedging relationship for only a portion of the time period during which the hedging instrument remains outstanding (paragraph 84 of AS 30). However, it does not require the hedging instrument to be acquired at the inception of the hedge relationship.

F.3.10 Hedge accounting: identification of hedged forecast transaction

Can a forecast transaction be identified as the purchase or sale of the last 15,000 units of a product in a specified period or as a percentage of purchases or sales during a specified period?

No. The hedged forecast transaction must be identified and documented with sufficient specificity so that when the transaction occurs, it is clear whether the transaction is or is not the hedged transaction.

Therefore, a forecast transaction may be identified as the sale of the first 15,000 units of a specific product during a specified three-month period, but it could not be identified as the last 15,000 units of that product sold during a three-month period because the last 15,000 units cannot be identified when they are sold. For the same reason, a forecast transaction cannot be specified solely as a percentage of sales or purchases during a period.

F.3.11 Cash flow hedge: documentation of timing of forecast transaction

For a hedge of a forecast transaction, should the documentation of the hedge relationship that is established at inception of the hedge identify the date on, or time period in which, the forecast transaction is expected to occur?

Yes. To qualify for hedge accounting, the hedge must relate to a specific identified and designated risk (Appendix A paragraph A135 of AS 30) and it must be possible to measure its effectiveness reliably (paragraph 98(d) of AS 30). Also, the hedged forecast transaction must be highly probable (paragraph 98(c) of AS 30). To meet these criteria, an entity is not required to predict and document the exact date a forecast transaction is expected to occur. However, it is required to identify and document the time period during which the forecast transaction is expected to occur within a reasonably specific and generally narrow range of time from a most probable date, as a basis for assessing hedge effectiveness. To determine that the hedge will be highly effective in accordance with paragraph 98(d) AS 30, it is necessary to ensure that changes in the fair value of the expected cash flows are offset by changes in the fair value of the hedging instrument and this test may be met only if the timing of the cash flows occur within close proximity to each other. If the forecast transaction is no longer expected to occur, hedge accounting is discontinued in accordance with paragraph 112(c) of AS 30.

F.4 Hedge Effectiveness

F.4.1 Hedging on an after-tax basis

Hedging is often done on an after-tax basis. Is hedge effectiveness assessed after taxes?

AS 30 permits, but does not require, assessment of hedge effectiveness on an after-tax basis. If the hedge is undertaken on an after-tax basis, it is so designated at inception as part of the formal documentation of the hedging relationship and strategy.

F.4.2 Hedge effectiveness: assessment on cumulative basis

Paragraph 98(b) of AS 30 requires that the hedge is expected to be highly effective. Should expected hedge effectiveness be assessed separately for each period or cumulatively over the life of the hedging relationship?

Expected hedge effectiveness may be assessed on a cumulative basis if the hedge is so designated, and that condition is incorporated into the appropriate hedging documentation. Therefore, even if a hedge is not expected to be highly effective in a particular period, hedge accounting is not precluded if effectiveness is expected to remain sufficiently high over the life of the hedging relationship. However, any ineffectiveness is required to be recognised in the statement of profit and loss as it occurs.

To illustrate: an entity designates a LIBOR-based interest rate swap as a hedge of a borrowing whose interest rate is a UK base rate plus a margin. The UK base rate changes, perhaps, once each quarter or less, in increments of 25-50 basis points, while LIBOR changes daily. Over a period of 1-2 years, the hedge is expected to be almost perfect. However, there will be quarters when the UK base rate does not change at all, while LIBOR has changed significantly. This would not necessarily preclude hedge accounting.

F.4.3 Hedge effectiveness: counterparty credit risk

Must an entity consider the likelihood of default by the counterparty to the hedging instrument in assessing hedge effectiveness?

Yes. An entity cannot ignore whether it will be able to collect all amounts due under the contractual provisions of the hedging instrument. When assessing hedge effectiveness, both at the inception of the hedge and on an ongoing basis, the entity considers the risk that the counterparty to the hedging instrument will default by failing to make any contractual payments to the entity. For a cash flow hedge, if it becomes probable that a counterparty will default, an entity would be unable to conclude that the hedging relationship is expected to be highly effective in achieving offsetting cash flows. As a result, hedge accounting would be discontinued. For a fair value hedge, if there is a change in the counterparty's creditworthiness, the fair value of the hedging instrument will change, which affects the assessment of whether the hedge relationship is effective and whether it qualifies for continued hedge accounting.

F.4.4 Hedge effectiveness: effectiveness tests

How should hedge effectiveness be measured for the purposes of initially qualifying for hedge accounting and for continued qualification?

AS 30 does not provide specific guidance about how effectiveness tests are performed. Appendix A paragraph A129 of AS 30 specifies that a hedge is normally regarded as highly effective only if (a) at inception and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated, and (b) the actual results are within a range of 80-125 per cent. Appendix A paragraph A129 of AS 30 also states that the expectation in (a) can be demonstrated in various ways.

The appropriateness of a given method of assessing hedge effectiveness will depend on the nature of the risk being hedged and the type of hedging instrument used. The method of assessing effectiveness must be reasonable and consistent with other similar hedges unless different methods are explicitly justified. An entity is required to document at the inception of the hedge how effectiveness will be assessed and then to apply that effectiveness test on a consistent basis for the duration of the hedge.

Several mathematical techniques can be used to measure hedge effectiveness, including ratio analysis, *i.e.*, a comparison of hedging gains and losses with the corresponding gains and losses on the hedged item at a point in time, and statistical measurement techniques such as regression analysis. If regression analysis is used, the entity's documented policies for assessing effectiveness must specify how the results of the regression will be assessed.

F.4.5 Hedge effectiveness: less than 100 per cent offset

If a cash flow hedge is regarded as highly effective because the actual risk offset is within the allowed 80-125 per cent range of deviation from full offset, is the gain or loss on the ineffective portion of the hedge recognised in the appropriate equity account?

No. Paragraph 106(a) of AS 30 indicates that only the effective portion is recognised directly in the equity account. Paragraph 106(b) of AS 30 requires the portion of the gain or loss on the hedging instrument that is determined to be an ineffective hedge to be recognised in the statement of profit and loss.

F.4.6 Assuming perfect hedge effectiveness

If the principal terms of the hedging instrument and of the entire hedged asset or liability or hedged forecast transaction are the same, can an entity assume perfect hedge effectiveness without further effectiveness testing?

No. Paragraph 98(e) of AS 30 requires an entity to assess hedges on an ongoing basis for hedge effectiveness. It cannot assume hedge effectiveness even if the principal terms of the hedging instrument and the hedged item are the same, since hedge ineffectiveness may arise because of other attributes such as the liquidity of the instruments or their credit risk (Appendix A paragraph A134 of AS 30). It may, however, designate only certain risks in an overall exposure as being hedged and thereby improve the effectiveness of the hedging relationship. For example, for a fair value hedge of a debt instrument, if the derivative hedging instrument has a credit risk that is equivalent to the AA-rate, it may designate only the risk related to AA-rated interest rate movements as being hedged, in which case changes in credit spreads generally will not affect the effectiveness of the hedge.

F.5 Cash Flow Hedges

F.5.1 Hedge accounting: non-derivative monetary asset or non-derivative monetary liability used as a hedging instrument

If an entity designates a non-derivative monetary asset as a foreign currency cash flow hedge of the repayment of the principal of a non-derivative monetary liability, would the exchange differences on the hedged item be recognised in the statement of profit and loss (AS 11) and the exchange differences on the hedging instrument be recognised in the appropriate equity account until the repayment of the liability (paragraph 106 of AS 30)?

No. Exchange differences on the monetary asset and the monetary liability are both recognised in the statement of profit and loss in the period in which they arise (AS 11). Appendix A paragraph A103 of AS 30 specifies that if there is a hedge relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in fair values of those financial instruments are recognised in the statement of profit and loss.

F.5.2 Cash flow hedges: performance of hedging instrument (1)

Entity A has a floating rate liability of ₹ 1,000 with five years remaining to maturity. It enters into a five-year pay-fixed, receive-floating interest rate swap in the same currency and with the same principal terms as the liability to hedge the exposure to variable cash flow payments on the floating rate liability attributable to interest rate risk. At inception, the fair value of the swap is zero. Subsequently, there is an increase of ₹ 49 in the fair value of the swap. This increase consists of a change of ₹ 50 resulting from an increase in market interest rates and a change of minus ₹ 1 resulting from an increase in the credit risk of the swap counterparty. There is no change in the fair value of the floating rate liability, but the fair value (present value) of the future cash flows needed to offset the exposure to variable interest cash flows on the liability increases by ₹ 50. Assuming that Entity A determines that the hedge is still highly effective, is there ineffectiveness that should be recognised in the statement of profit and loss?

No. A hedge of interest rate risk is not fully effective if part of the change in the fair value of the derivative is attributable to the counterparty's credit risk (Appendix A paragraph A134 of AS 30). However, because Entity A determines that the hedge relationship is still highly effective, it credits the effective portion of the change in fair value of the swap, *i.e.*, the net change in fair value of ₹ 49, to the appropriate equity account. There is no debit to the statement of profit and loss for the change in fair value of the swap attributable to the deterioration in the credit quality of the swap counterparty, because the cumulative change in the present value of the future cash flows needed to offset the exposure to variable interest cash flows on the hedged item, *i.e.*, ₹ 50, exceeds the cumulative change in value of the hedging instrument, i.e., ₹ 49.

Dr	Swap Cr Appropriate equity account	₹ 49	 ₹ 49

If Entity A concludes that the hedge is no longer highly effective, it discontinues hedge accounting prospectively as from the date the hedge ceased to be highly effective in accordance with paragraph 112 of AS 30.

Would the answer change if the fair value of the swap instead increases to ₹ 51 of which ₹ 50 results from the increase in market interest rates and ₹ 1 from a decrease in the credit risk of the swap counterparty?

Yes. In this case, there is a credit to the statement of profit and loss of ₹ 1 for the change in fair value of the swap attributable to the improvement in the credit quality of the swap counterparty. This is because the cumulative change in the value of the hedging instrument, *i.e.*, ₹ 51, exceeds the cumulative change in the present value of the future cash flows needed to offset the exposure to variable interest cash flows on the hedged item, *i.e.*, ₹ 50. The difference of ₹ 1 represents the excess ineffectiveness attributable to the derivative hedging instrument, the swap, and is recognised in the statement of profit and loss.

Dr	Swap Cr Appropriate equity account Cr Statement of profit and loss	₹ 51	 ₹ 50 Re. 1

F.5.3 Cash flow hedges: performance of hedging instrument (2)

On 30 September 20x7, Entity A hedges the anticipated sale of 24 tonnes of pulp on 1 March 20x8 by entering into a short forward contract on 24 tonnes of pulp. The contract requires net settlement in cash determined as the difference between the future spot price of pulp on a specified commodity exchange and ₹ 1,000. Entity A expects to sell the pulp in a different, local market. Entity A determines that the forward contract is an effective hedge of the anticipated sale and that the other conditions for hedge accounting are met. It assesses hedge effectiveness by comparing the entire change in the fair value of the forward contract with the change in the fair value of the expected cash inflows. On 31 December, the spot price of pulp has increased both in the local market and on the exchange. The increase in the local market exceeds the increase on the exchange. As a result, the present value of the expected cash inflow from the sale on the local market is ₹ 1,100. The fair value of Entity A's forward contract is negative ₹ 80. Assuming that Entity A determines that the hedge is still highly effective, is there ineffectiveness that should be recognised in the statement of profit and loss?

No. In a cash flow hedge, ineffectiveness is not recognised in the financial statements when the cumulative change in the fair value of the hedged cash flows exceeds the cumulative change in the value of the hedging instrument. In this case, the cumulative change in the fair value of the forward contract is ₹ 80, while the fair value of the cumulative change in expected future cash flows on the hedged item is ₹ 100. Since the fair value of the cumulative change in expected future cash flows on the hedged item from the inception of the hedge exceeds the cumulative change in fair value of the hedging instrument (in absolute amounts), no portion of the gain or loss on the hedging instrument is recognised in the statement of profit and loss (paragraph 106(a) of AS 30). Because Entity A determines that the hedge relationship is still highly effective, it debits the entire change in fair value of the forward contract (₹ 80) to the appropriate equity account.

Dr	Appropriate equity account	₹ 80	
	Cr Forward		₹ 80

If Entity A concludes that the hedge is no longer highly effective, it discontinues hedge accounting prospectively as from the date the hedge ceases to be highly effective in accordance with paragraph 112 of AS 30.

F.5.4 Cash flow hedges: forecast transaction occurs before the specified period

An entity designates a derivative as a hedging instrument in a cash flow hedge of a forecast transaction, such as a forecast sale of a commodity. The hedging relationship meets all the hedge accounting conditions, including the requirement to identify and document the period in which the transaction is expected to occur within a reasonably specific and narrow range of time (see Question F.2.17). If, in a subsequent period, the forecast transaction is expected to occur in an earlier period than originally anticipated, can the entity conclude that this transaction is the same as the one that was designated as being hedged?

Yes. The change in timing of the forecast transaction does not affect the validity of the designation. However, it may affect the assessment of the effectiveness of the hedging relationship. Also, the hedging instrument would need to be designated as a hedging instrument for the whole remaining period of its existence in order for it to continue to qualify as a hedging instrument (see paragraph 84 of AS 30 and Question F.2.17).

F.5.5 Cash flow hedges: measuring effectiveness for a hedge of a forecast transaction in a debt instrument

A forecast investment in an interest-earning asset or forecast issue of an interest-bearing liability creates a cash flow exposure to interest rate changes because the related interest payments will be based on the market rate that exists when the forecast transaction occurs. The objective of a cash flow hedge of the exposure to interest rate changes is to offset the effects of future changes in interest rates so as to obtain a single fixed rate, usually the rate that existed at the inception of the hedge that corresponds with the term and timing of the forecast transaction. During the period of the hedge, it is not possible to determine what the market interest rate for the forecast transaction will be at the time the hedge is terminated or when the forecast transaction occurs. In this case, how is the effectiveness of the hedge assessed and measured?

During this period, effectiveness can be measured on the basis of changes in interest rates between the designation date and the interim effectiveness measurement date. The interest rates used to make this measurement are the interest rates that correspond with the term and occurrence of the forecast transaction that existed at the inception of the hedge and that exist at the measurement date as evidenced by the term structure of interest rates.

Generally it will not be sufficient simply to compare cash flows of the hedged item with cash flows generated by the derivative hedging instrument as they are paid or received, since such an approach ignores the entity's expectations of whether the cash flows will offset in subsequent periods and whether there will be any resulting ineffectiveness.

The discussion that follows illustrates the mechanics of establishing a cash flow hedge and measuring its effectiveness. For the purpose of the illustrations, assume that an entity expects to issue a ₹ 100,000 one-year debt instrument in three months. The instrument will pay interest quarterly with principal due at maturity. The entity is exposed to interest rate increases and establishes a hedge of the interest cash flows of the debt by entering into a forward starting interest rate swap. The swap has a term of one year and will start in three months to correspond with the terms of the forecast debt issue. The entity will pay a fixed rate and receive a variable rate, and the entity designates the risk being hedged as the LIBOR-based interest component in the forecast issue of the debt.

Yield curve

The yield curve provides the foundation for computing future cash flows and the fair value of such cash flows both at the inception of, and during, the hedging relationship. It is based on current market yields on applicable reference bonds that are traded in the marketplace. Market yields are converted to spot interest rates ('spot rates' or 'zero coupon rates') by eliminating the effect of coupon payments on the market yield. Spot rates are used to discount future cash flows, such as principal and interest rate payments, to arrive at their fair value. Spot rates also are used to compute forward interest rates that are used to compute variable and estimated future cash flows. The relationship between spot rates and one-period forward rates is shown by the following formula:

Spot–forward relationship

$$F = \frac{(1 + SR_t)^t}{(1 + SR_{t-1})^{t-1}} - 1$$

where F = forward rate (%)

SR = spot rate (%)

t = period in time (e.g., 1, 2, 3, 4, 5)

Also, for the purpose of this illustration, assume that the following quarterly-period term structure of interest rates using quarterly compounding exists at the inception of the hedge.

Yield curve at inception – (beginning of period 1)

Forward periods	1	2	3	4	5
Spot rates	3.75%	4.50%	5.50%	6.00%	6.25%
Forward rates (computed)	3.75%	5.25%	7.51%	7.50%	7.25%

The one-period forward rates are computed on the basis of spot rates for the applicable maturities. For example, the current forward rate for Period 2 calculated using the formula above is equal to [1.0450^2 / 1.0375] – 1 = 5.25 per cent. The current one-period forward rate for Period 2 is different from the current spot rate for Period 2, since the spot rate is an interest rate from the beginning of Period 1 (spot) to the end of Period 2, while the forward rate is an interest rate from the beginning of Period 2 to the end of Period 2.

Hedged item

In this example, the entity expects to issue a ₹ 100,000 one-year debt instrument in three months with quarterly interest payments. The entity is exposed to interest rate increases and would like to eliminate the effect on cash flows of interest rate changes that may happen before the forecast transaction takes place. If that risk is eliminated, the entity would obtain an interest rate on its debt issue that is equal to the one-year forward coupon rate currently available in the marketplace in three months. That forward coupon rate, which is different from the forward (spot) rate, is 6.86 per cent, computed from the term structure of interest rates shown above. It is the market rate of interest that exists at the inception of the hedge, given the terms of the forecast debt instrument. It results in the fair value of the debt being equal to par at its issue.

At the inception of the hedging relationship, the expected cash flows of the debt instrument can be calculated on the basis of the existing term structure of interest rates. For this purpose, it is assumed that interest rates do not change and that the debt would be issued at 6.86 per cent at the beginning of Period 2. In this case, the cash flows and fair value of the debt instrument would be as follows at the beginning of Period 2.

Issue of fixed rate debt

Beginning of period 2 - No rate changes (Spot based on forward rates)

	Total					
Original forward periods		1	2	3	4	5
Remaining periods			1	2	3	4
Spot rates (computed)			5.25%	6.38%	6.75%	6.88%
Forward rates			5.25%	7.51%	7.50%	7.25%
	₹		₹	₹	₹	₹
Cash flows:						
Fixed interest @ 6.86%			1,716	1,716	1,716	1,716
Principal						100,000
Fair value:						
Interest	6,592		1,694	1,663	1,632	1,603
Principal	93,408					93,408[54]
Total	100,000					

Since it is assumed that interest rates do not change, the fair value of the interest and principal amounts equals the par amount of the forecast transaction. The fair value amounts are computed on the basis of the spot rates that exist at the inception of the hedge for the applicable periods in which the cash flows would occur had the debt been issued at the date of the forecast transaction. They reflect the effect of discounting those cash flows on the basis of the periods that will remain after the debt instrument is issued. For example, the spot rate of 6.38 per cent is used to discount the interest cash flow that is expected to be paid in Period 3, but it is discounted for only two periods because it will occur two periods after the forecast transaction.

The forward interest rates are the same as shown previously, since it is assumed that interest rates do not change. The spot rates are different but they have not actually changed. They represent the spot rates one period forward and are based on the applicable forward rates.

Hedging instrument

The objective of the hedge is to obtain an overall interest rate on the forecast transaction and the hedging instrument that is equal to 6.86 per cent, which is the market rate at the inception of the hedge for the period from Period 2 to Period 5. This objective is accomplished by entering into a forward starting interest rate swap that has a fixed rate of 6.86 per cent. Based on the term structure of interest rates that exist at the inception of the hedge, the interest rate swap will have such a rate. At the inception of the hedge, the fair value of the fixed rate payments on the interest rate swap will equal the fair value of the variable rate payments, resulting in the interest rate swap having a fair value of zero. The expected cash flows of the interest rate swap and the related fair value amounts are shown as follows.

Interest rate swap

	Total					
Original forward periods		*1*	*2*	*3*	*4*	*5*
Remaining periods			*1*	*2*	*3*	*4*
	₹		*₹*	*₹*	*₹*	*₹*
Cash flows:						
Fixed interest @ 6.86%			1,716	1,716	1,716	1,716

[54] Rs. 100,000 / (1 + [0.0688 / 4])^4

Forecast variable interest			1,313	1,877	1,876	1,813
Forecast based on forward rate			*5.25%*	*7.51%*	*7.50%*	*7.25%*
Net interest			(403)	161	160	97
Fair value:						
Discount rate (spot)			*5.25%*	*6.38%*	*6.75%*	*6.88%*
Fixed interest	6,592		1,694	1,663	1,632	1,603
Forecast variable interest	6,592		1,296	1,819	1,784	1,693
Fair value of interest rate swap	0		(398)	156	152	90

At the inception of the hedge, the fixed rate on the forward swap is equal to the fixed rate the entity would receive if it could issue the debt in three months under terms that exist today.

Measuring hedge effectiveness

If interest rates change during the period the hedge is outstanding, the effectiveness of the hedge can be measured in various ways.

Assume that interest rates change as follows immediately before the debt is issued at the beginning of Period 2.

Yield curve - Rates increase 200 basis points

Forward periods	*1*	*2*	*3*	*4*	*5*
Remaining periods		*1*	*2*	*3*	*4*
Spot rates		5.75%	6.50%	7.50%	8.00%
Forward rates		5.75%	7.25%	9.51%	9.50%

Under the new interest rate environment, the fair value of the pay-fixed at 6.86 per cent, receive-variable interest rate swap that was designated as the hedging instrument would be as follows.

Fair value of interest rate swap

	Total					
Original forward periods		*1*	*2*	*3*	*4*	*5*
Remaining periods			*1*	*2*	*3*	*4*
	₹	₹	₹	₹	₹	₹
Cash flows:						
Fixed interest @ 6.86%			1,716	1,716	1,716	1,716
Forecast variable interest			1,438	1,813	2,377	2,376
Forecast based on new forward rate			*5.75%*	*7.25%*	*9.51%*	*9.50%*
Net interest			(279)	97	661	660
Fair value:						
New discount rate (spot)			*5.75%*	*6.50%*	*7.50%*	*8.00%*
Fixed interest	6,562		1,692	1,662	1,623	1,585
Forecast variable interest	7,615		1,417	1,755	2,248	2,195
Fair value of net interest	1,053		(275)	93	625	610

In order to compute the effectiveness of the hedge, it is necessary to measure the change in the present value of the cash flows or the value of the hedged forecast transaction. There are at least two methods of accomplishing this measurement.

Method A – Compute change in fair value of debt

	Total					
Original forward periods		*1*	*2*	*3*	*4*	*5*

Remaining periods			*1*	*2*	*3*	*4*
	₹		*₹*	*₹*	*₹*	*₹*
Cash flows:						
Fixed interest @ 6.86%			1,716	1,716	1,716	1,716
Principal						100,000
Fair value:						
New discount rate (spot)			*5.75%*	*6.50%*	*7.50%*	*8.00%*
Interest	6,562		1,692	1,662	1,623	1,585
Principal	92,385					92,385[55]
Total	98,947					
Fair value at inception	100,000					
Fair value difference	(1,053)					

Under Method A, a computation is made of the fair value in the new interest rate environment of debt that carries interest that is equal to the coupon interest rate that existed at the inception of the hedging relationship (6.86 per cent). This fair value is compared with the expected fair value as of the beginning of Period 2 that was calculated on the basis of the term structure of interest rates that existed at the inception of the hedging relationship, as illustrated above, to determine the change in the fair value. Note that the difference between the change in the fair value of the swap and the change in the expected fair value of the debt exactly offset in this example, since the terms of the swap and the forecast transaction match each other.

Method B – Compute change in fair value of cash flows

	Total					
Original forward periods		*1*	*2*	*3*	*4*	*5*
Remaining periods			*1*	*2*	*3*	*4*
Market rate at inception			6.86%	6.86%	6.86%	6.86%
Current forward rate			5.75%	7.25%	9.51%	9.50%
Rate difference			1.11%	(0.39%)	(2.64%)	(2.64%)
Cash flow difference (principal rate)			₹ 279	(₹ 97)	(₹ 661)	(₹ 660)
Discount rate (spot)			*5.75%*	*6.50%*	*7.50%*	*8.00%*
Fair value of difference	(₹ 1,053)		₹ 275	(₹ 93)	(₹ 625)	(₹ 610)

Under Method B, the present value of the change in cash flows is computed on the basis of the difference between the forward interest rates for the applicable periods at the effectiveness measurement date and the interest rate that would have been obtained if the debt had been issued at the market rate that existed at the inception of the hedge. The market rate that existed at the inception of the hedge is the one-year forward coupon rate in three months. The present value of the change in cash flows is computed on the basis of the current spot rates that exist at the effectiveness measurement date for the applicable periods in which the cash flows are expected to occur. This method also could be referred to as the 'theoretical swap' method (or 'hypothetical derivative' method) because the comparison is between the hedged fixed rate on the debt and the current variable rate, which is the same as comparing cash flows on the fixed and variable rate legs of an interest rate swap.

As before, the difference between the change in the fair value of the swap and the change in the present value of the cash flows exactly offset in this example, since the terms match.

[55] ₹ 100,000 / (1 + [0.08 / 4])^4

Other considerations

There is an additional computation that should be performed to compute ineffectiveness before the expected date of the forecast transaction that has not been considered for the purpose of this illustration. The fair value difference has been determined in each of the illustrations as of the expected date of the forecast transaction immediately before the forecast transaction, *i.e.*, at the beginning of Period 2. If the assessment of hedge effectiveness is done before the forecast transaction occurs, the difference should be discounted to the current date to arrive at the actual amount of ineffectiveness. For example, if the measurement date were one month after the hedging relationship was established and the forecast transaction is now expected to occur in two months, the amount would have to be discounted for the remaining two months before the forecast transaction is expected to occur to arrive at the actual fair value. This step would not be necessary in the examples provided above because there was no ineffectiveness. Therefore, additional discounting of the amounts, which net to zero, would not have changed the result.

Under Method B, ineffectiveness is computed on the basis of the difference between the forward coupon interest rates for the applicable periods at the effectiveness measurement date and the interest rate that would have been obtained if the debt had been issued at the market rate that existed at the inception of the hedge. Computing the change in cash flows based on the difference between the forward interest rates that existed at the inception of the hedge and the forward rates that exist at the effectiveness measurement date is inappropriate if the objective of the hedge is to establish a single fixed rate for a series of forecast interest payments. This objective is met by hedging the exposures with an interest rate swap as illustrated in the above example. The fixed interest rate on the swap is a blended interest rate composed of the forward rates over the life of the swap. Unless the yield curve is flat, the comparison between the forward interest rate exposures over the life of the swap and the fixed rate on the swap will produce different cash flows whose fair values are equal only at the inception of the hedging relationship. This difference is shown in the table below.

	Total					
Original forward periods		*1*	*2*	*3*	*4*	*5*
Remaining periods			*1*	*2*	*3*	*4*
Forward rate at inception			5.25%	7.51%	7.50%	7.25%
Current forward rate			5.75%	7.25%	9.51%	9.50%
Rate difference			(0.50%)	0.26%	(2.00%)	(2.25%)
Cash flow difference (principal rate)			(₹ 125)	₹ 64	(₹ 501)	(₹ 563)
Discount rate (spot)			5.75%	6.50%	7.50%	8.00%
Fair value of difference	(₹ 1,055)		(₹ 123)	₹ 62	(₹ 474)	(₹ 520)
Fair value of interest rate swap	₹ 1,053					
Ineffectiveness	(₹ 2)					

If the objective of the hedge is to obtain the forward rates that existed at the inception of the hedge, the interest rate swap is ineffective because the swap has a single blended fixed coupon rate that does not offset a series of different forward interest rates. However, if the objective of the hedge is to obtain the forward coupon rate that existed at the inception of the hedge, the swap is effective, and the comparison based on differences in forward interest rates suggests ineffectiveness when none may exist. Computing ineffectiveness based on the difference between the forward interest rates that existed at the inception of the hedge and the forward rates that exist at the effectiveness measurement date would be an appropriate measurement of ineffectiveness if the hedging objective is to lock in those forward interest rates. In that case, the appropriate hedging instrument would be a series of

forward contracts each of which matures on a repricing date that corresponds with the date of the forecast transactions.

It also should be noted that it would be inappropriate to compare only the variable cash flows on the interest rate swap with the interest cash flows in the debt that would be generated by the forward interest rates. That methodology has the effect of measuring ineffectiveness only on a portion of the derivative, and AS 30 does not permit the bifurcation of a derivative for the purposes of assessing effectiveness in this situation (paragraph 83 of AS 30). It is recognised, however, that if the fixed interest rate on the interest rate swap is equal to the fixed rate that would have been obtained on the debt at inception, there will be no ineffectiveness assuming that there are no differences in terms and no change in credit risk or it is not designated in the hedging relationship.

F.5.6 Cash flow hedges: firm commitment to purchase inventory in a foreign currency

Entity A has the Indian Rupees (₹) as its functional currency and reporting currency. On 30 June 20x7, it enters into a forward exchange contract to receive Foreign Currency (FC) 100,000 and deliver ₹ 109,600 on 30 June 20x8 at an initial cost and fair value of zero. It designates the forward exchange contract as a hedging instrument in a cash flow hedge of a firm commitment to purchase a certain quantity of paper on 31 March 20x8 and the resulting payable of FC100,000, which is to be paid on 30 June 20x8. All hedge accounting conditions in AS 30 are met. The financial year has been presumed to be the accounting year.

As indicated in the table below, on 30 June 20x7, the spot exchange rate is ₹ 1.072 to FC1, while the twelve-month forward exchange rate is ₹ 1.096 to FC1. On 31 December 20x7, the spot exchange rate is ₹ 1.080 to FC1, while the six-month forward exchange rate is ₹ 1.092 to FC1. On 31 March 20x8, the spot exchange rate is ₹ 1.074 to FC1, while the three-month forward rate is ₹ 1.076 to FC1. On 30 June 20x8, the spot exchange rate is ₹ 1.072 to FC1. The applicable yield curve in the local currency is flat at 6 per cent per year throughout the period. The fair value of the forward exchange contract is negative ₹ 388 on 31 December 20x7 {([1.092 X 100,000] – 109,600)/$1.06^{(6/12)}$}, negative ₹ 1,971 on 31 March 20x8 {([1.076 X 100,000] – 109,600)/$1.06^{(3/12)}$}, and negative ₹ 2,400 on 30 June 20x8 {1.072 X 100,000 – 109,600}.

Date	Spot rate	Forward rate to 30 June 20x8	Fair value of forward contract
30 June 20x7	1.072	1.096	-
31 December 20x7	1.080	1.092	(388)
31 March 20x8	1.074	1.076	(1,971)
30 June 20x8	1.072	-	(2,400)

Issue (a) - What is the accounting for these transactions if the hedging relationship is designated as being for changes in the fair value of the forward exchange contract and the entity's accounting policy is to apply basis adjustment to non-financial assets that result from hedged forecast transactions?

The accounting entries are as follows.

30 June 20x7

Dr	Forward	₹ 0	
	Cr Cash		₹ 0

To record the forward exchange contract at its initial amount of zero (paragraph 47 of AS 30). The hedge is expected to be fully effective because the critical terms of the forward exchange contract and

the purchase contract and the assessment of hedge effectiveness are based on the forward price (Appendix A paragraph A133 of AS 30).

31 December 20x7

Dr	Appropriate equity account	₹ 388	
	Cr Forward liability		₹ 388

To record the change in the fair value of the forward exchange contract between 30 June 20x7 and 31 December 20x7, *i.e.*, ₹ 388 – 0 = ₹ 388, directly in the appropriate equity account (paragraph 106 of AS 30). The hedge is fully effective because the loss on the forward exchange contract (₹ 388) exactly offsets the change in cash flows associated with the purchase contract based on the forward price [(₹ 388) = {([1.092 x 100,000] – 109,600)/$1.06^{(6/12)}$} – {([1.096 x 100,000] – 109,600) / 1.06}].

31 March 20x8

Dr	Appropriate equity account	₹ 1,583	
	Cr Forward liability		₹ 1,583

To record the change in the fair value of the forward exchange contract between 1 January 20x8 and 31 March 20x8 (i.e., ₹ 1,971 – ₹ 388 = ₹ 1,583), directly in the appropriate equity account (paragraph 106 of AS 30). The hedge is fully effective because the loss on the forward exchange contract (₹ 1,583) exactly offsets the change in cash flows associated with the purchase contract based on the forward price [(₹ 1,583) = {([1.076 X 100,000] – 109,600)/$1.06^{(3/12)}$} – {([1.092 X 100,000] – 109,600) /$1.06^{(6/12)}$}].

Dr	Paper (purchase price)	₹ 107,400	
Dr	Paper (hedging loss)	₹ 1,971	
	Cr Appropriate equity account		₹ 1,971
	Cr Payable		₹ 107,400

To recognise the purchase of the paper at the spot rate (1.074 X FC 100,000) and remove the cumulative loss on the forward exchange contract that has been recognised directly in the equity account (₹ 1,971) and include it in the initial measurement of the purchased paper. Accordingly, the initial measurement of the purchased paper is ₹ 109,371 consisting of a purchase consideration of ₹ 107,400 and a hedging loss of ₹ 1,971.

30 June 20x8

Dr	Payable	₹ 107,400	
	Cr Cash		₹ 107,200
	Cr Statement of profit and loss		₹ 200

To record the settlement of the payable at the spot rate (FC 100,000 X 1.072 = 107,200) and the associated exchange gain of ₹ 200 (₹ 107,400 – ₹ 107,200).

Dr	Statement of profit and loss	₹ 429	
	Cr Forward liability		₹ 429

To record the loss on the forward exchange contract between 1 April 20x8 and 30 June 20x8 (i.e., ₹ 2,400 – ₹ 1,971 = ₹ 429) in the statement of profit and loss. The hedge is regarded as fully effective because the loss on the forward exchange contract (₹ 429) exactly offsets the change in the fair value of the payable based on the forward price (₹ 429 = ([1.072 X 100,000] – 109,600 – {([1.076 X 100,000] – 109,600)/$1.06^{(3/12)}$}).

Dr	Forward liability	₹ 2,400	
	Cr Cash		₹ 2,400

To record the net settlement of the forward exchange contract.

Issue (b) – What is the accounting for these transactions if the hedging relationship instead is designated as being for changes in the spot element of the forward exchange contract and the interest element is excluded from the designated hedging relationship (paragraph 83 of AS 30)?

The accounting entries are as follows.

30 June 20x7

Dr	Forward	₹ 0	
	Cr Cash		₹ 0

To record the forward exchange contract at its initial amount of zero (paragraph 47 of AS 30). The hedge is expected to be fully effective because the critical terms of the forward exchange contract and the purchase contract are the same and the change in the premium or discount on the forward contract is excluded from the assessment of effectiveness (Appendix A paragraph A133 of AS 30).

31 December 20x7

Dr	Statement of profit and loss (interest element)	₹ 1,165	
	Cr Appropriate equity account (spot element)		₹ 777
	Cr Forward liability		₹ 388

To record the change in the fair value of the forward exchange contract between 30 June 20x7 and 31 December 20x7, *i.e.*, ₹ 388 – 0 = ₹ 388. The change in the present value of spot settlement of the forward exchange contract is a gain of ₹ 777 ({([1.080 X 100,000] – 107,200)/1.06$^{(6/12)}$} – {([1.072 X 100,000] – 107,200)/1.06}), which is recognised directly in the appropriate equity account (paragraph 106(a) of AS 30). The change in the interest element of the forward exchange contract (the residual change in fair value) is a loss of ₹ 1,165 (388 + 777), which is recognised in the statement of profit and loss (paragraphs 83 and 61(a) of AS 30). The hedge is fully effective because the gain in the spot element of the forward contract (₹ 777) exactly offsets the change in the purchase price at spot rates (₹ 777 = {([1.080 X 100,000] – 107,200)/1.06$^{(6/12)}$} – {([1.072 X 100,000] – 107,200)/1.06}).

31 March 20x8

Dr	Appropriate equity account (spot element)	₹ 580	
Dr	Statement of profit and loss (interest element)	₹ 1,003	
	Cr Forward liability		₹ 1,583

To record the change in the fair value of the forward exchange contract between 1 January 20x8 and 31 March 20x8, *i.e.*, ₹ 1,971 – ₹ 388 = ₹ 1,583. The change in the present value of the spot settlement of the forward exchange contract is a loss of ₹ 580 ({([1.074 X 100,000] – 107,200)/1.06$^{(3/12)}$} – {([1.080 X 100,000] – 107,200)/1.06$^{(6/12)}$}), which is recognised directly in the appropriate equity account (paragraph 106(a) of AS 30). The change in the interest element of the forward exchange contract (the residual change in fair value) is a loss of ₹ 1,003 (₹ 1,583 – ₹ 580), which is recognised in statement of profit and loss (paragraphs 83 and 61(a) of AS 30). The hedge is fully effective because the loss in the spot element of the forward contract (₹ 580) exactly offsets the change in the purchase price at spot rates [(580) = {([1.074 X 100,000] – 107,200)/1.06$^{(3/12)}$} – {([1.080 X 100,000] – 107,200)/1.06$^{(6/12)}$}].

Dr	Paper (purchase price)	₹ 107,400	
Dr	Appropriate equity account	₹ 197	
	Cr Paper (hedging gain)		₹ 197
	Cr Payable		₹ 107,400

To recognise the purchase of the paper at the spot rate (= 1.074 X FC 100,000) and remove the cumulative gain on the spot element of the forward exchange contract that has been recognised directly in the equity account (₹ 777 – ₹ 580 = ₹ 197) and include it in the initial measurement of the purchased paper. Accordingly, the initial measurement of the purchased paper is ₹ 107,203, consisting of a purchase consideration of ₹ 107,400 and a hedging gain of ₹ 197.

30 June 20x8

Dr	Payable	₹ 107,400	
	Cr Cash		₹ 107,200
	Cr Statement of profit and loss		₹ 200

To record the settlement of the payable at the spot rate (FC 100,000 x 1.072 = ₹ 107,200) and the associated exchange gain of ₹ 200 (– [1.072 – 1.074] x FC 100,000).

Dr	Statement of profit and loss (spot element)	₹ 197	
Dr	Statement of profit and loss (interest element)	₹ 232	
	Cr Forward liability		₹ 429

To record the change in the fair value of the forward exchange contract between 1 April 20x8 and 30 June 20x8 (i.e., ₹ 2,400 – ₹ 1,971 = ₹ 429). The change in the present value of the spot settlement of the forward exchange contract is a loss of ₹ 197 ([1.072 x 100,000] – 107,200 – {([1.074 x 100,000] – 107,200)/$1.06^{(3/12)}$}), which is recognised in the statement of profit and loss. The change in the interest element of the forward exchange contract (the residual change in fair value) is a loss of ₹ 232 (₹ 429 – ₹ 197), which is recognised in the statement of profit and loss. The hedge is fully effective because the loss in the spot element of the forward contract (₹ 197) exactly offsets the change in the present value of the spot settlement of the payable [(₹ 197) = {[1.072 x 100,000] – 107,200 – {([1.074 x 100,000] – 107,200)/$1.06^{(3/12)}$}].

Dr	Forward liability	₹ 2,400	
	Cr Cash		₹ 2,400

To record the net settlement of the forward exchange contract.

The following table provides an overview of the components of the change in fair value of the hedging instrument over the term of the hedging relationship. It illustrates that the way in which a hedging relationship is designated affects the subsequent accounting for that hedging relationship, including the assessment of hedge effectiveness and the recognition of gains and losses.

Period ending	Change in spot settlement	Fair value of change in spot settlement	Change in forward settlement	Fair value of change in forward settlement	Fair value of change in interest element
	₹	₹	₹	₹	₹
June 20x7	-	-	-	-	-
December	800	777	(400)	(388)	(1,165)

20x7					
March 20x8	(600)	(580)	(1,600)	(1,583)	(1,003)
June 20x8	(200)	(197)	(400)	(429)	(232)
Total	-	-	(2,400)	(2,400)	(2,400)

F.6 Hedges: Other issues

F.6.1 Hedge accounting: management of interest rate risk in financial institutions

Some banks and other financial institutions manage their exposure to interest rate risk on a net basis for all or parts of their activities. They have systems to accumulate critical information throughout the entity about their financial assets, financial liabilities and forward commitments, including loan commitments. This information is used to estimate and aggregate cash flows and to schedule such estimated cash flows into the applicable future periods in which they are expected to be paid or received. The systems generate estimates of cash flows based on the contractual terms of the instruments and other factors, including estimates of prepayments and defaults. For risk management purposes, many financial institutions use derivative contracts to offset some or all exposure to interest rate risk on a net basis.

If a financial institution manages interest rate risk on a net basis, can its activities potentially qualify for hedge accounting under AS 30?

Yes. However, to qualify for hedge accounting the derivative hedging instrument that hedges the net position for risk management purposes must be designated for accounting purposes as a hedge of a gross position related to assets, liabilities, forecast cash inflows or forecast cash outflows giving rise to the net exposure (paragraph 94 and Appendix A paragraphs A125 and A136 of AS 30). It is not possible to designate a net position as a hedged item under AS 30 because of the inability to associate hedging gains and losses with a specific item being hedged and, correspondingly, to determine objectively the period in which such gains and losses should be recognised in the statement of profit and loss.

Hedging a net exposure to interest rate risk can often be defined and documented to meet the qualifying criteria for hedge accounting in paragraph 98 of AS 30 if the objective of the activity is to offset a specific, identified and designated risk exposure that ultimately affects the entity's profit or loss (Appendix A paragraph A135 of AS 30) and the entity designates and documents its interest rate risk exposure on a gross basis. Also, to qualify for hedge accounting the information systems must capture sufficient information about the amount and timing of cash flows and the effectiveness of the risk management activities in accomplishing their objective.

The factors an entity must consider for hedge accounting purposes if it manages interest rate risk on a net basis are discussed in Question F.6.2.

F.6.2 Hedge accounting considerations when interest rate risk is managed on a net basis

If an entity manages its exposure to interest rate risk on a net basis, what are the issues the entity should consider in defining and documenting its interest rate risk management activities to qualify for hedge accounting and in establishing and accounting for the hedge relationship?

Issues (a)-(l) below deal with the main issues. First, Issues (a) and (b) discuss the designation of derivatives used in interest rate risk management activities as fair value hedges or cash flow hedges. As noted there, hedge accounting criteria and accounting consequences differ between fair value hedges and cash flow hedges. Since it may be easier to achieve hedge accounting treatment if derivatives used in interest rate risk management activities are designated as cash flow hedging instruments, Issues (c)-(l) expand on various aspects of the accounting for cash flow hedges. Issues

(c)-(f) consider the application of the hedge accounting criteria for cash flow hedges in AS 30, and Issues (g) and (h) discuss the required accounting treatment. Finally, Issues (i)-(l) elaborate on other specific issues relating to the accounting for cash flow hedges.

Issue (a) – Can a derivative that is used to manage interest rate risk on a net basis be designated under AS 30 as a hedging instrument in a fair value hedge or a cash flow hedge of a gross exposure?

Both types of designation are possible under AS 30. An entity may designate the derivative used in interest rate risk management activities either as a fair value hedge of assets, liabilities and firm commitments or as a cash flow hedge of forecast transactions, such as the anticipated reinvestment of cash inflows, the anticipated refinancing or rollover of a financial liability, and the cash flow consequences of the resetting of interest rates for an asset or a liability.

In economic terms, it does not matter whether the derivative instrument is regarded as a fair value hedge or as a cash flow hedge. Under either perspective of the exposure, the derivative has the same economic effect of reducing the net exposure. For example, a receive-fixed, pay-variable interest rate swap can be considered to be a cash flow hedge of a variable rate asset or a fair value hedge of a fixed rate liability. Under either perspective, the fair value or cash flows of the interest rate swap offset the exposure to interest rate changes. However, accounting consequences differ depending on whether the derivative is designated as a fair value hedge or a cash flow hedge, as discussed in Issue (b).

To illustrate: a bank has the following assets and liabilities with a maturity of two years.

	Variable interest ₹	Fixed interest ₹
Assets	60	100
Liabilities	(100)	(60)
Net	(40)	40

The bank takes out a two-year swap with a notional principal of ₹ 40 to receive a variable interest rate and pay a fixed interest rate to hedge the net exposure. As discussed above, this may be regarded and designated either as a fair value hedge of ₹ 40 of the fixed rate assets or as a cash flow hedge of ₹ 40 of the variable rate liabilities.

Issue (b) – What are the critical considerations in deciding whether a derivative that is used to manage interest rate risk on a net basis should be designated as a hedging instrument in a fair value hedge or a cash flow hedge of a gross exposure?

Critical considerations include the assessment of hedge effectiveness in the presence of prepayment risk and the ability of the information systems to attribute fair value or cash flow changes of hedging instruments to fair value or cash flow changes, respectively, of hedged items, as discussed below.

For accounting purposes, the designation of a derivative as hedging a fair value exposure or a cash flow exposure is important because both the qualification requirements for hedge accounting and the recognition of hedging gains and losses for these categories are different. It is often easier to demonstrate high effectiveness for a cash flow hedge than for a fair value hedge.

Effects of prepayments

Prepayment risk inherent in many financial instruments affects the fair value of an instrument and the timing of its cash flows and impacts on the effectiveness test for fair value hedges and the highly probable test for cash flow hedges, respectively.

Effectiveness is often more difficult to achieve for fair value hedges than for cash flow hedges when the instrument being hedged is subject to prepayment risk. For a fair value hedge to qualify for hedge

accounting, the changes in the fair value of the derivative hedging instrument must be expected to be highly effective in offsetting the changes in the fair value of the hedged item (paragraph 98(b) of AS 30). This test may be difficult to meet if, for example, the derivative hedging instrument is a forward contract having a fixed term and the financial assets being hedged are subject to prepayment by the borrower. Also, it may be difficult to conclude that, for a portfolio of fixed rate assets that are subject to prepayment, the changes in the fair value for each individual item in the group will be expected to be approximately proportional to the overall changes in fair value attributable to the hedged risk of the group. Even if the risk being hedged is a benchmark interest rate, to be able to conclude that fair value changes will be proportional for each item in the portfolio, it may be necessary to disaggregate the asset portfolio into categories based on term, coupon, credit, type of loan and other characteristics.

In economic terms, a forward derivative instrument could be used to hedge assets that are subject to prepayment but it would be effective only for small movements in interest rates. A reasonable estimate of prepayments can be made for a given interest rate environment and the derivative position can be adjusted as the interest rate environment changes. If an entity's risk management strategy is to adjust the amount of the hedging instrument periodically to reflect changes in the hedged position, the entity needs to demonstrate that the hedge is expected to be highly effective only for the period until the amount of the hedging instrument is next adjusted. However, for that period, the expectation of effectiveness has to be based on existing fair value exposures and the potential for interest rate movements without consideration of future adjustments to those positions. Furthermore, the fair value exposure attributable to prepayment risk can generally be hedged with options.

For a cash flow hedge to qualify for hedge accounting, the forecast cash flows, including the reinvestment of cash inflows or the refinancing of cash outflows, must be highly probable (paragraph 98(c) of AS 30) and the hedge expected to be highly effective in achieving offsetting changes in the cash flows of the hedged item and hedging instrument (paragraph 98(b) of AS 30). Prepayments affect the timing of cash flows and, therefore, the probability of occurrence of the forecast transaction. If the hedge is established for risk management purposes on a net basis, an entity may have sufficient levels of highly probable cash flows on a gross basis to support the designation for accounting purposes of forecast transactions associated with a portion of the gross cash flows as the hedged item. In this case, the portion of the gross cash flows designated as being hedged may be chosen to be equal to the amount of net cash flows being hedged for risk management purposes.

Systems considerations

The accounting for fair value hedges differs from that for cash flow hedges. It is usually easier to use existing information systems to manage and track cash flow hedges than it is for fair value hedges.

Under fair value hedge accounting, the assets or liabilities that are designated as being hedged are remeasured for those changes in fair values during the hedge period that are attributable to the risk being hedged. Such changes adjust the carrying amount of the hedged items and, for interest sensitive assets and liabilities, may result in an adjustment of the effective interest rate of the hedged item (paragraph 99 of AS 30). As a consequence of fair value hedging activities, the changes in fair value have to be allocated to the assets or liabilities being hedged in order for the entity to be able to recompute their effective interest rate, determine the subsequent amortisation of the fair value adjustment to the statement of profit and loss, and determine the amount that should be recognised in the statement of profit and loss when assets are sold or liabilities extinguished (paragraphs 99 and 103 of AS 30). To comply with the requirements for fair value hedge accounting, it will generally be necessary to establish a system to track the changes in the fair value attributable to the hedged risk, associate those changes with individual hedged items, recompute the effective interest rate of the

hedged items, and amortise the changes to the statement of profit and loss over the life of the respective hedged item.

Under cash flow hedge accounting, the cash flows relating to the forecast transactions that are designated as being hedged reflect changes in interest rates. The adjustment for changes in the fair value of a hedging derivative instrument is initially recognised in the appropriate equity account (paragraph 106 of AS 30). To comply with the requirements for cash flow hedge accounting, it is necessary to determine when the adjustments to the equity account from changes in the fair value of a hedging instrument should be recognised in the statement of profit and loss (paragraphs 111 and 112 of AS 30). For cash flow hedges, it is not necessary to create a separate system to make this determination. The system used to determine the extent of the net exposure provides the basis for scheduling the changes in the cash flows of the derivative and the recognition of such changes in the statement of profit and loss.

The timing of the recognition in the statement of profit and loss can be predetermined when the hedge is associated with the exposure to changes in cash flows. The forecast transactions that are being hedged can be associated with a specific principal amount in specific future periods composed of variable rate assets and cash inflows being reinvested or variable rate liabilities and cash outflows being refinanced, each of which creates a cash flow exposure to changes in interest rates. The specific principal amounts in specific future periods are equal to the notional amount of the derivative hedging instruments and are hedged only for the period that corresponds to the repricing or maturity of the derivative hedging instruments so that the cash flow changes resulting from changes in interest rates are matched with the derivative hedging instrument. Paragraph 111 of AS 30 specifies that the amounts recognised in the equity account should be reclassified into, *i.e.*, recognised in the statement of profit and loss in the same period or periods during which the hedged item affects profit or loss.

Issue (c) – If a hedging relationship is designated as a cash flow hedge relating to changes in cash flows resulting from interest rate changes, what would be included in the documentation required by paragraph 98(a) of AS 30?

The following would be included in the documentation.

The hedging relationship – The maturity schedule of cash flows used for risk management purposes to determine exposures to cash flow mismatches on a net basis would provide part of the documentation of the hedging relationship.

The entity's risk management objective and strategy for undertaking the hedge - The entity's overall risk management objective and strategy for hedging exposures to interest rate risk would provide part of the documentation of the hedging objective and strategy.

The type of hedge - The hedge is documented as a cash flow hedge.

The hedged item - The hedged item is documented as a group of forecast transactions (interest cash flows) that are expected to occur with a high degree of probability in specified future periods, for example, scheduled on a monthly basis. The hedged item may include interest cash flows resulting from the reinvestment of cash inflows, including the resetting of interest rates on assets, or from the refinancing of cash outflows, including the resetting of interest rates on liabilities and rollovers of financial liabilities. As discussed in Issue (e), the forecast transactions meet the probability test if there are sufficient levels of highly probable cash flows in the specified future periods to encompass the amounts designated as being hedged on a gross basis.

The hedged risk - The risk designated as being hedged is documented as a portion of the overall exposure to changes in a specified market interest rate, often the risk-free interest rate or an interbank offered rate, common to all items in the group. To help ensure that the hedge effectiveness test is met

at inception of the hedge and subsequently, the designated hedged portion of the interest rate risk could be documented as being based on the same yield curve as the derivative hedging instrument.

The hedging instrument - Each derivative hedging instrument is documented as a hedge of specified amounts in specified future time periods corresponding with the forecast transactions occurring in the specified future time periods designated as being hedged.

The method of assessing effectiveness - The effectiveness test is documented as being measured by comparing the changes in the cash flows of the derivatives allocated to the applicable periods in which they are designated as a hedge to the changes in the cash flows of the forecast transactions being hedged. Measurement of the cash flow changes is based on the applicable yield curves of the derivatives and hedged items.

Issue (d) – If the hedging relationship is designated as a cash flow hedge, how does an entity satisfy the requirement for an expectation of high effectiveness in achieving offsetting changes in paragraph 98(b) of AS 30?

An entity may demonstrate an expectation of high effectiveness by preparing an analysis demonstrating high historical and expected future correlation between the interest rate risk designated as being hedged and the interest rate risk of the hedging instrument. Existing documentation of the hedge ratio used in establishing the derivative contracts may also serve to demonstrate an expectation of effectiveness.

Issue (e) – If the hedging relationship is designated as a cash flow hedge, how does an entity demonstrate a high probability of the forecast transactions occurring as required by paragraph 98(c) of AS 30?

An entity may do this by preparing a cash flow maturity schedule showing that there exist sufficient aggregate gross levels of expected cash flows, including the effects of the resetting of interest rates for assets or liabilities, to establish that the forecast transactions that are designated as being hedged are highly probable to occur. Such a schedule should be supported by management's stated intentions and past practice of reinvesting cash inflows and refinancing cash outflows.

For example, an entity may forecast aggregate gross cash inflows of ₹ 100 and aggregate gross cash outflows of ₹ 90 in a particular time period in the near future. In this case, it may wish to designate the forecast reinvestment of gross cash inflows of ₹ 10 as the hedged item in the future time period. If more than ₹ 10 of the forecast cash inflows are contractually specified and have low credit risk, the entity has strong evidence to support an assertion that gross cash inflows of ₹ 10 are highly probable to occur and to support the designation of the forecast reinvestment of those cash flows as being hedged for a particular portion of the reinvestment period. A high probability of the forecast transactions occurring may also be demonstrated under other circumstances.

Issue (f) – If the hedging relationship is designated as a cash flow hedge, how does an entity assess and measure effectiveness under paragraphs 98(d) and 98(e) of AS 30?

Effectiveness is required to be measured at a minimum at the time an entity prepares its annual or interim financial reports. However, an entity may wish to measure it more frequently on a specified periodic basis, at the end of each month or other applicable reporting period. It is also measured whenever derivative positions designated as hedging instruments are changed or hedges are terminated to ensure that the recognition in the statement of profit and loss of the changes in the fair value amounts on assets and liabilities and the recognition of changes in the fair value of derivative instruments designated as cash flow hedges are appropriate.

Changes in the cash flows of the derivative are computed and allocated to the applicable periods in which the derivative is designated as a hedge and are compared with computations of changes in the cash flows of the forecast transactions. Computations are based on yield curves applicable to the hedged items and the derivative hedging instruments and applicable interest rates for the specified periods being hedged.

The schedule used to determine effectiveness could be maintained and used as the basis for determining the period in which the hedging gains and losses recognised initially in the appropriate equity account are reclassified out of the equity account and recognised in the statement of profit and loss.

Issue (g) – If the hedging relationship is designated as a cash flow hedge, how does an entity account for the hedge?

The hedge is accounted for as a cash flow hedge in accordance with the provisions in paragraphs 106-111 of AS 30, as follows:

(i) the portion of gains and losses on hedging derivatives determined to result from effective hedges is recognised in the appropriate equity account whenever effectiveness is measured; and

(ii) the portion of gains and losses resulting from hedging derivatives that is determined to be an ineffective hedge is recognised in the statement of profit and loss.

Paragraph 111 of AS 30 specifies that the amounts recognised in the equity account should be reclassified into, i.e., recognised in the statement of profit and loss in the same period or periods during which the hedged item affects profit or loss. Accordingly, when the forecast transactions occur, the amounts previously recognised in the equity account are recognised in the statement of profit and loss. For example, if an interest rate swap is designated as a hedging instrument of a series of forecast cash flows, the changes in the cash flows of the swap are recognised in the statement of profit and loss in the periods when the forecast cash flows and the cash flows of the swap offset each other.

Issue (h) – If the hedging relationship is designated as a cash flow hedge, what is the treatment of any net cumulative gains and losses recognised in the appropriate equity account if the hedging instrument is terminated prematurely, the hedge accounting criteria are no longer met, or the hedged forecast transactions are no longer expected to take place?

If the hedging instrument is terminated prematurely or the hedge no longer meets the criteria for qualification for hedge accounting, for example, the forecast transactions are no longer highly probable, the net cumulative gain or loss recognised in the equity account remains in the equity account until the forecast transaction occurs (paragraphs 112(a) and 112(b) of AS 30). If the hedged forecast transactions are no longer expected to occur, the net cumulative gain or loss is recognised in the statement of profit and loss (paragraph 112(c) of AS 30).

Issue (i) – Paragraph 84 of AS 30 states that a hedging relationship may not be designated for only a portion of the time period in which a hedging instrument is outstanding. If the hedging relationship is designated as a cash flow hedge, and the hedge subsequently fails the test for being highly effective, does paragraph 84 of AS 30 preclude redesignating the hedging instrument?

No. Paragraph 84 of AS 30 indicates that a derivative instrument may not be designated as a hedging instrument for only a portion of its remaining period to maturity. Paragraph 84 does not refer to the derivative instrument's original period to maturity. If there is a hedge effectiveness failure, the portion of the gain or loss on the derivative instrument that is determined to be an ineffective hedge is recognised immediately in the statement of profit and loss (paragraph 106(b) of AS 30) and hedge accounting

based on the previous designation of the hedge relationship cannot be continued (paragraph 112 of AS 30). In this case, the derivative instrument may be redesignated prospectively as a hedging instrument in a new hedging relationship provided this hedging relationship satisfies the necessary conditions. The derivative instrument must be redesignated as a hedge for the entire time period it remains outstanding.

Issue (j) – For cash flow hedges, if a derivative is used to manage a net exposure to interest rate risk and the derivative is designated as a cash flow hedge of forecast interest cash flows or portions of them on a gross basis, does the occurrence of the hedged forecast transaction give rise to an asset or liability that will result in a portion of the hedging gains and losses that were recognised in the appropriate equity account remaining in the equity account?

No. In the hedging relationship described in Issue (c) above, the hedged item is a group of forecast transactions consisting of interest cash flows in specified future periods. The hedged forecast transactions do not result in the recognition of assets or liabilities and the effect of interest rate changes that are designated as being hedged is recognised in the statement of profit and loss in the period in which the forecast transactions occur. Although this is not relevant for the types of hedges described here, if instead the derivative is designated as a hedge of a forecast purchase of a financial asset or issue of a financial liability, the associated gains or losses that were recognised directly in the equity account are 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 incurred affects the statement of profit and loss (such as in the periods that interest expenses are recognised). However, if an entity expects at any time that all or a portion of a net loss recognised directly in the equity account will not be recovered in one or more future periods, it should immediately reclassify into, i.e., recognise in, the statement of profit and loss the amount that is not expected to be recovered.

Issue (k) – In the answer to Issue (c) above it was indicated that the designated hedged item is a portion of a cash flow exposure. Does AS 30 permit a portion of a cash flow exposure to be designated as a hedged item?

Yes. AS 30 does not specifically address a hedge of a portion of a cash flow exposure for a forecast transaction. However, AS 30 paragraph 90 specifies that a financial asset or liability may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value, if effectiveness can be measured. The ability to hedge a portion of a cash flow exposure resulting from the resetting of interest rates for assets and liabilities suggests that a portion of a cash flow exposure resulting from the forecast reinvestment of cash inflows or the refinancing or rollover of financial liabilities can also be hedged. The basis for qualification as a hedged item of a portion of an exposure is the ability to measure effectiveness. This is further supported by AS 30 paragraph 92, which specifies that a non-financial asset or liability can be hedged only in its entirety or for foreign currency risk but not for a portion of other risks because of the difficulty of isolating and measuring the appropriate portion of the cash flows or fair value changes attributable to a specific risk. Accordingly, assuming effectiveness can be measured, a portion of a cash flow exposure of forecast transactions associated with, for example, the resetting of interest rates for a variable rate asset or liability can be designated as a hedged item.

Issue (l) – In the answer to Issue (c) above it was indicated that the hedged item is documented as a group of forecast transactions. Since these transactions will have different terms when they occur, including credit exposures, maturities and option features, how can an entity satisfy the tests in paragraphs 87 and 93 of AS 30 requiring the hedged group to have similar risk characteristics?

Paragraph 87 of AS 30 provides for hedging a group of assets, liabilities, firm commitments or forecast transactions with similar risk characteristics. Paragraph 93 of AS 30 provides additional guidance and specifies that portfolio hedging is permitted if two conditions are met, namely: the individual items in the portfolio share the same risk for which they are designated, and the change in the fair value attributable to the hedged risk for each individual item in the group will be expected to be approximately proportional to the overall change in fair value.

When an entity associates a derivative hedging instrument with a gross exposure, the hedged item typically is a group of forecast transactions. For hedges of cash flow exposures relating to a group of forecast transactions, the overall exposure of the forecast transactions and the assets or liabilities that are repriced may have very different risks. The exposure from forecast transactions may differ depending on the terms that are expected as they relate to credit exposures, maturities, options and other features. Although the overall risk exposures may be different for the individual items in the group, a specific risk inherent in each of the items in the group can be designated as being hedged.

The items in the portfolio do not necessarily have to have the same overall exposure to risk, provided they share the same risk for which they are designated as being hedged. A common risk typically shared by a portfolio of financial instruments is exposure to changes in the risk-free or benchmark interest rate or to changes in a specified rate that has a credit exposure equal to the highest credit-rated instrument in the portfolio (*i.e.*, the instrument with the lowest credit risk). If the instruments that are grouped into a portfolio have different credit exposures, they may be hedged as a group for a portion of the exposure. The risk they have in common that is designated as being hedged is the exposure to interest rate changes from the highest credit rated instrument in the portfolio. This ensures that the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group. It is likely there will be some ineffectiveness if the hedging instrument has a credit quality that is inferior to the credit quality of the highest credit-rated instrument being hedged, since a hedging relationship is designated for a hedging instrument in its entirety (paragraph 83 of AS 30). For example, if a portfolio of assets consists of assets rated A, BB and B, and the current market interest rates for these assets are LIBOR+20 basis points, LIBOR+40 basis points and LIBOR+60 basis points, respectively, an entity may use a swap that pays fixed interest rate and for which variable interest payments based on LIBOR are made to hedge the exposure to variable interest rates. If LIBOR is designated as the risk being hedged, credit spreads above LIBOR on the hedged items are excluded from the designated hedge relationship and the assessment of hedge effectiveness.

F.6.3 Illustrative example of applying the approach in Question F.6.2

The purpose of this example is to illustrate the process of establishing, monitoring and adjusting hedge positions and of qualifying for cash flow hedge accounting in applying the approach to hedge accounting described in Question F.6.2 when a financial institution manages its interest rate risk on an entity-wide basis. To this end, this example identifies a methodology that allows for the use of hedge accounting and takes advantage of existing risk management systems so as to avoid unnecessary changes to it and to avoid unnecessary bookkeeping and tracking.

The approach illustrated here reflects only one of a number of risk management processes that could be employed and could qualify for hedge accounting. Its use is not intended to suggest that other alternatives could not or should not be used. The approach being illustrated could also be applied in other circumstances (such as for cash flow hedges of commercial entities), for example, hedging the rollover of commercial paper financing.

Identifying, assessing and reducing cash flow exposures

The discussion and illustrations that follow focus on the risk management activities of a financial institution that manages its interest rate risk by analysing expected cash flows in Indian Rupees on an entity-wide basis. The cash flow analysis forms the basis for identifying the interest rate risk of the entity, entering into hedging transactions to manage the risk, assessing the effectiveness of risk management activities, and qualifying for and applying cash flow hedge accounting.

The illustrations that follow assume that an entity, a financial institution, had the following expected future net cash flows and hedging positions outstanding in Indian Rupees, consisting of interest rate swaps, at the beginning of Period X0. The cash flows shown are expected to occur at the end of the period and, therefore, create a cash flow interest exposure in the following period as a result of the reinvestment or repricing of the cash inflows or the refinancing or repricing of the cash outflows.

The illustrations assume that the entity has an ongoing interest rate risk management programme. Schedule I shows the expected cash flows and hedging positions that existed at the beginning of Period X0. It is included here to provide a starting point in the analysis. It provides a basis for considering existing hedges in connection with the evaluation that occurs at the beginning of Period X1.

Schedule I – End of period – Expected cash flows and hedging positions

Quarterly period (units)	*X0* ₹	*X1* ₹	*X2* ₹	*X3* ₹	*X4* ₹	*X5* ₹	*…n* ₹
Expected net cash flows		1,100	1,500	1,200	1,400	1,500	x,xxx
Outstanding interest rate swaps:							
Receive-fixed, pay-variable (notional amounts)	2,000	2,000	2,000	1,200	1,200	1,200	x,xxx
Pay-fixed, receive-variable (notional amounts)	(1,000)	(1,000)	(1,000)	(500)	(500)	(500)	x,xxx
Net exposure after outstanding swaps		100	500	500	700	800	x,xxx

The schedule depicts five quarterly periods. The actual analysis would extend over a period of many years, represented by the notation '…n'. A financial institution that manages its interest rate risk on an entity-wide basis re-evaluates its cash flow exposures periodically. The frequency of the evaluation depends on the entity's risk management policy.

For the purposes of this illustration, the entity is re-evaluating its cash flow exposures at the end of Period X0. The first step in the process is the generation of forecast net cash flow exposures from existing interest-earning assets and interest-bearing liabilities, including the rollover of short-term assets and short-term liabilities. Schedule II below illustrates the forecast of net cash flow exposures. A common technique for assessing exposure to interest rates for risk management purposes is an interest rate sensitivity gap analysis showing the gap between interest rate-sensitive assets and interest rate-sensitive liabilities over different time intervals. Such an analysis could be used as a starting point for identifying cash flow exposures to interest rate risk for hedge accounting purposes.

Schedule II – Forecast net cash flow and repricing exposures

Quarterly period Units	*Notes*	*X1* ₹	*X2* ₹	*X3* ₹	*X4* ₹	*X5* ₹	*…n* ₹
CASH INFLOW AND REPRICING EXPOSURES - from assets							
Principal and interest payments:							
Long-term fixed rate	(1)	2,400	3,000	3,000	1,000	1,200	x,xxx
Short-term (roll over)	(1)(2)	1,575	1,579	1,582	1,586	1,591	x,xxx

Variable rate – principal payments	(1)	2,000	1,000	-	500	500	x,xxx
Variable rate - estimated interest	(2)	125	110	105	114	118	x,xxx
Total expected cash inflows		*6,100*	*5,689*	*4,687*	*3,200*	*3,409*	*x,xxx*
Variable rate asset balances	(3)	8,000	7,000	7,000	6,500	6,000	x,xxx
Cash inflows and repricings	(4)	14,100	12,689	11,687	9,700	9,409	x,xxx
CASH OUTFLOW AND REPRICING EXPOSURES - from liabilities							
Principal and interest payments:							
Long-term fixed rate	(1)	2,100	400	500	500	301	x,xxx
Short-term (roll over)	(1)(2)	735	737	738	740	742	x,xxx
Variable rate – principal payments	(1)	-	-	2,000	-	1,000	x,xxx
Variable rate - estimated interest	(2)	100	110	120	98	109	x,xxx
Total expected cash outflows		2,935	1,247	3,358	1,338	2,152	x,xxx
Variable rate liability balances	(3)	8,000	8,000	6,000	6,000	5,000	x,xxx
Cash outflows and repricings	(4)	10,935	9,247	9,358	7,338	7,152	x,xxx
NET EXPOSURES	(5)	3,165	3,442	2,329	2,362	2,257	x,xxx

(1) The cash flows are estimated using contractual terms and assumptions based on management's intentions and market factors. It is assumed that short-term assets and liabilities will continue to be rolled over in succeeding periods. Assumptions about prepayments and defaults and the withdrawal of deposits are based on market and historical data. It is assumed that principal and interest inflows and outflows will be reinvested and refinanced, respectively, at the end of each period at the then current market interest rates and share the benchmark interest rate risk to which they are exposed.

(2) Forward interest rates obtained from Schedule VI are used to forecast interest payments on variable rate financial instruments and expected rollovers of short-term assets and liabilities. All forecast cash flows are associated with the specific time periods (3 months, 6 months, 9 months and 12 months) in which they are expected to occur. For completeness, the interest cash flows resulting from reinvestments, refinancings and repricings are included in the schedule and shown gross even though only the net margin may actually be reinvested. Some entities may choose to disregard the forecast interest cash flows for risk management purposes because they may be used to absorb operating costs and any remaining amounts would not be significant enough to affect risk management decisions.

(3) The cash flow forecast is adjusted to include the variable rate asset and liability balances in each period in which such variable rate asset and liability balances are repriced. The principal amounts of these assets and liabilities are not actually being paid and, therefore, do not generate a cash flow. However, since interest is computed on the principal amounts each period based on the then current market interest rate, such principal amounts expose the entity to the same interest rate risk as if they were cash flows being reinvested or refinanced.

(4) The forecast cash flow and repricing exposures that are identified in each period represent the principal amounts of cash inflows that will be reinvested or repriced and cash outflows that will be refinanced or repriced at the market interest rates that are in effect when those forecast transactions occur.

(5) The net cash flow and repricing exposure is the difference between the cash inflow and repricing exposures from assets and the cash outflow and repricing exposures from liabilities. In the illustration, the entity is exposed to interest rate declines because the exposure from assets exceeds the exposure from liabilities and the excess (i.e., the net amount) will be reinvested or repriced at the current market rate and there is no offsetting refinancing or repricing of outflows.

Note that some banks regard some portion of their non-interest bearing demand deposits as economically equivalent to long-term debt. However, these deposits do not create a cash flow exposure to interest rates and would therefore be excluded from this analysis for accounting purposes.

Schedule II *Forecast net cash flow and repricing exposures* provides no more than a starting point for assessing cash flow exposure to interest rates and for adjusting hedging positions. The complete analysis includes outstanding hedging positions and is shown in Schedule III *Analysis of expected net exposures and hedging positions*. It compares the forecast net cash flow exposures for each period (developed in Schedule II) with existing hedging positions (obtained from Schedule I), and provides a basis for considering whether adjustment of the hedging relationship should be made.

Schedule III – Analysis of expected net exposures and hedging positions

Quarterly period (units)	*X1* ₹	*X2* ₹	*X3* ₹	*X4* ₹	*X5* ₹	*…n* ₹
Net cash flow and repricing exposures (Schedule II)	3,165	3,442	2,329	2,362	2,257	x,xxx
Pre-existing swaps outstanding:						
Receive-fixed, pay-variable (notional amounts)	2,000	2,000	1,200	1,200	1,200	x,xxx
Pay-fixed, receive-variable (notional amounts)	(1,000)	(1,000)	(500)	(500)	(500)	x,xxx
Net exposure after pre- existing swaps	*2,165*	*2,442*	*1,629*	*1,662*	*1,557*	*x,xxx*
Transactions to adjust outstanding hedging positions:						
Receive-fixed, pay variable swap 1 (notional amount, 10-years)	2,000	2,000	2,000	2,000	2,000	x,xxx
Pay-fixed, receive-variable swap 2 (notional amount, 3-years)			(1,000)	(1,000)	(1,000)	x,xxx
Swaps …X						x,xxx
Unhedged cash flow and repricing exposure	*165*	*442*	*629*	*662*	*557*	*x,xxx*

The notional amounts of the interest rate swaps that are outstanding at the analysis date are included in each of the periods in which the interest rate swaps are outstanding to illustrate the impact of the outstanding interest rate swaps on the identified cash flow exposures. The notional amounts of the outstanding interest rate swaps are included in each period because interest is computed on the notional amounts each period, and the variable rate components of the outstanding swaps are repriced to the current market rate quarterly. The notional amounts create an exposure to interest rates that in part is similar to the principal balances of variable rate assets and variable rate liabilities.

The exposure that remains after considering the existing positions is then evaluated to determine the extent to which adjustments of existing hedging positions are necessary. The bottom portion of

Schedule III shows the beginning of Period X1 using interest rate swap transactions to reduce the net exposures further to within the tolerance levels established under the entity's risk management policy.

Note that in the illustration, the cash flow exposure is not entirely eliminated. Many financial institutions do not fully eliminate risk but rather reduce it to within some tolerable limit.

Various types of derivative instruments could be used to manage the cash flow exposure to interest rate risk identified in the schedule of forecast net cash flows (Schedule II). However, for the purpose of the illustration, it is assumed that interest rate swaps are used for all hedging activities. It is also assumed that in periods in which interest rate swaps should be reduced, rather than terminating some of the outstanding interest rate swap positions, a new swap with the opposite return characteristics is added to the portfolio.

In the illustration in Schedule III above, swap 1, a receive-fixed, pay-variable swap, is used to reduce the net exposure in Periods X1 and X2. Since it is a 10-year swap, it also reduces exposures identified in other future periods not shown. However, it has the effect of creating an over-hedged position in Periods X3-X5. Swap 2, a forward starting pay-fixed, receive-variable interest rate swap, is used to reduce the notional amount of the outstanding receive-fixed, pay-variable interest rate swaps in Periods X3-X5 and thereby reduce the over-hedged positions.

It also is noted that in many situations, no adjustment or only a single adjustment of the outstanding hedging position is necessary to bring the exposure to within an acceptable limit. However, when the entity's risk management policy specifies a very low tolerance of risk a greater number of adjustments to the hedging positions over the forecast period would be needed to further reduce any remaining risk.

To the extent that some of the interest rate swaps fully offset other interest rate swaps that have been entered into for hedging purposes, it is not necessary to include them in a designated hedging relationship for hedge accounting purposes. These offsetting positions can be combined, de-designated as hedging instruments, if necessary, and reclassified for accounting purposes from the hedging portfolio to the trading portfolio. This procedure limits the extent to which the gross swaps must continue to be designated and tracked in a hedging relationship for accounting purposes. For the purposes of this illustration it is assumed that ₹ 500 of the pay-fixed, receive-variable interest rate swaps fully offset ₹ 500 of the receive-fixed, pay-variable interest rate swaps at the beginning of Period X1 and for Periods X1-X5, and are de-designated as hedging instruments and reclassified to the trading account.

After reflecting these offsetting positions, the remaining gross interest rate swap positions from Schedule III are shown in Schedule IV as follows.

Schedule IV – Interest rate swaps designated as hedges

Quarterly period (units)	*X1* ₹	*X2* ₹	*X3* ₹	*X4* ₹	*X5* ₹	*...n* ₹
Receive-fixed, pay-variable (notional amounts)	3,500	3,500	2,700	2,700	2,700	x,xxx
Pay-fixed, receive-variable (notional amounts)	(500)	(500)	(1,000)	(1,000)	(1,000)	x,xxx
Net outstanding swaps positions	*3,000*	*3,000*	*1,700*	*1,700*	*1,700*	*x,xxx*

For the purposes of the illustrations, it is assumed that Swap 2, entered into at the beginning of Period X1, only partially offsets another swap being accounted for as a hedge and therefore continues to be designated as a hedging instrument.

Hedge accounting considerations

Illustrating the designation of the hedging relationship

The discussion and illustrations thus far have focused primarily on economic and risk management considerations relating to the identification of risk in future periods and the adjustment of that risk using interest rate swaps. These activities form the basis for designating a hedging relationship for accounting purposes.

The examples in AS 30 focus primarily on hedging relationships involving a single hedged item and a single hedging instrument, but there is little discussion and guidance on portfolio hedging relationships for cash flow hedges when risk is being managed centrally. In this illustration, the general principles are applied to hedging relationships involving a component of risk in a portfolio having multiple risks from multiple transactions or positions.

Although designation is necessary to achieve hedge accounting, the way in which the designation is described also affects the extent to which the hedging relationship is judged to be effective for accounting purposes and the extent to which the entity's existing system for managing risk will be required to be modified to track hedging activities for accounting purposes. Accordingly, an entity may wish to designate the hedging relationship in a manner that avoids unnecessary systems changes by taking advantage of the information already generated by the risk management system and avoids unnecessary bookkeeping and tracking. In designating hedging relationships, the entity may also consider the extent to which ineffectiveness is expected to be recognised for accounting purposes under alternative designations.

The designation of the hedging relationship needs to specify various matters. These are illustrated and discussed here from the perspective of the hedge of the interest rate risk associated with the cash inflows, but the guidance can also be applied to the hedge of the risk associated with the cash outflows. It is fairly obvious that only a portion of the gross exposures relating to the cash inflows is being hedged by the interest rate swaps. Schedule V *The general hedging relationship* illustrates the designation of the portion of the gross reinvestment risk exposures identified in Schedule II as being hedged by the interest rate swaps.

Schedule V – The general hedging relationship

Quarterly period (units)	*X1* ₹	*X2* ₹	*X3* ₹	*X4* ₹	*X5* ₹	*...n* ₹
Cash inflow repricing exposure (Schedule II)	14,100	12,689	11,687	9,700	9,409	x,xxx
Receive-fixed, pay-variable swaps (Schedule IV)	3,500	3,500	2,700	2,700	2,700	x,xxx
Hedged exposure percentage	*24.8%*	*27.6%*	*23.1%*	*27.8%*	*28.7%*	*xx.x%*

The hedged exposure percentage is computed as the ratio of the notional amount of the receive-fixed, pay-variable swaps that are outstanding divided by the gross exposure. Note that in Schedule V there are sufficient levels of forecast reinvestments in each period to offset more than the notional amount of the receive-fixed, pay-variable swaps and satisfy the accounting requirement that the forecast transaction is highly probable.

It is not as obvious, however, how the interest rate swaps are specifically related to the cash flow interest risks designated as being hedged and how the interest rate swaps are effective in reducing that risk. The more specific designation is illustrated in Schedule VI *The specific hedging relationship* below. It provides a meaningful way of depicting the more complicated narrative designation of the hedge by focusing on the hedging objective to eliminate the cash flow variability associated with future changes

in interest rates and to obtain an interest rate equal to the fixed rate inherent in the term structure of interest rates that exists at the commencement of the hedge.

The expected interest from the reinvestment of the cash inflows and repricings of the assets is computed by multiplying the gross amounts exposed by the forward rate for the period. For example, the gross exposure for Period X2 of ₹ 14,100 is multiplied by the forward rate for Periods X2-X5 of 5.50 per cent, 6.00 per cent, 6.50 per cent and 7.25 per cent, respectively, to compute the expected interest for those quarterly periods based on the current term structure of interest rates. The hedged expected interest is computed by multiplying the expected interest for the applicable three-month period by the hedged exposure percentage.

Schedule VI – The specific hedging relationship

			Term structure of interest rates					
Quarterly period			*X1*	*X2*	*X3*	*X4*	*X5*	*...n*
Spot rates			5.00%	5.25%	5.50%	5.75%	6.05%	x.xx%
Forward rates[56]			5.00%	5.50%	6.00%	6.50%	7.25%	x.xx%
Cash flow exposures and expected interest amounts								
Repricing period	Time to forecast transaction	Gross amounts exposed	Expected interest					
			₹	₹	₹	₹	₹	₹
2	3 months	14,100	→	194	212	229	256	
3	6 months	12,689			190	206	230	xxx
4	9 months	11,687				190	212	xxx
5	12 months	9,700					176	xxx
6	15 months	9,409						xxx
Hedged percentage (Schedule V) in the previous period				24.8%	27.6%	23.1%	27.8%	xx.x%
Hedged expected interest				48	52	44	49	xx

It does not matter whether the gross amount exposed is reinvested in long-term fixed rate debt or variable rate debt, or in short-term debt that is rolled over in each subsequent period. The exposure to changes in the forward interest rate is the same. For example, if the ₹ 14,100 is reinvested at a fixed rate at the beginning of Period X2 for six months, it will be reinvested at 5.75 per cent. The expected interest is based on the forward interest rates for Period X2 of 5.50 per cent and for Period X3 of 6.00 per cent, equal to a blended rate of 5.75 per cent $(1.055 \times 1.060)^{0.5}$, which is the Period X2 spot rate for the next six months.

However, only the expected interest from the reinvestment of the cash inflows or repricing of the gross amount for the first three-month period after the forecast transaction occurs is designated as being hedged. The expected interest being hedged is represented by the shaded cells. The exposure for the subsequent periods is not hedged. In the example, the portion of the interest rate exposure being hedged is the forward rate of 5.50 per cent for Period X2. In order to assess hedge effectiveness and compute actual hedge ineffectiveness on an ongoing basis, the entity may use the information on hedged interest cash inflows in Schedule VI and compare it with updated estimates of expected interest cash inflows (for example, in a table that looks like Schedule II). As long as expected interest cash

[56] The forward interest rates are computed from the spot interest rates and rounded for the purposes of the presentation. Computations that are based on the forward interest rates are made based on the actual computed forward rate and then rounded for the purposes of the presentation.

inflows exceed hedged interest cash inflows, the entity may compare the cumulative change in the fair value of the hedged cash inflows with the cumulative change in the fair value of the hedging instrument to compute actual hedge effectiveness. If there are insufficient expected interest cash inflows, there will be ineffectiveness. It is measured by comparing the cumulative change in the fair value of the expected interest cash flows to the extent they are less than the hedged cash flows with the cumulative change in the fair value of the hedging instrument.

Describing the designation of the hedging relationship

As mentioned previously, there are various matters that should be specified in the designation of the hedging relationship that complicate the description of the designation but are necessary to limit ineffectiveness to be recognised for accounting purposes and to avoid unnecessary systems changes and bookkeeping. The example that follows describes the designation more fully and identifies additional aspects of the designation not apparent from the previous illustrations.

Example designation

Hedging objective

The hedging objective is to eliminate the risk of interest rate fluctuations over the hedging period, which is the life of the interest rate swap, and in effect obtain a fixed interest rate during this period that is equal to the fixed interest rate on the interest rate swap.

Type of hedge

Cash flow hedge.

Hedging instrument

The receive-fixed, pay-variable swaps are designated as the hedging instrument. They hedge the cash flow exposure to interest rate risk.

Each repricing of the swap hedges a three-month portion of the interest cash inflows that results from:

- the forecast reinvestment or repricing of the principal amounts shown in Schedule V.
- unrelated investments or repricings that occur after the repricing dates on the swap over its life and involve different borrowers or lenders.

The hedged item – General

The hedged item is a portion of the gross interest cash inflows that will result from the reinvestment or repricing of the cash flows identified in Schedule V and are expected to occur within the periods shown on such schedule. The portion of the interest cash inflow that is being hedged has three components:

- the principal component giving rise to the interest cash inflow and the period in which it occurs,
- the interest rate component, and
- the time component or period covered by the hedge.

The hedged item – The principal component

The portion of the interest cash inflows being hedged is the amount that results from the first portion of the principal amounts being invested or repriced in each period:

- that is equal to the sum of the notional amounts of the received-fixed, pay-variable interest rate swaps that are designated as hedging instruments and outstanding in the period of the reinvestment or repricing, and
- that corresponds to the first principal amounts of cash flow exposures that are invested or repriced at or after the repricing dates of the interest rate swaps.

The hedged item – The interest rate component

The portion of the interest rate change that is being hedged is the change in both of the following:

- the credit component of the interest rate being paid on the principal amount invested or repriced that is equal to the credit risk inherent in the interest rate swap. It is that portion of the interest rate on the investment that is equal to the interest index of the interest rate swap, such as LIBOR, and
- the yield curve component of the interest rate that is equal to the repricing period on the interest rate swap designated as the hedging instrument.

The hedged item – The hedged period

The period of the exposure to interest rate changes on the portion of the cash flow exposures being hedged is:

- the period from the designation date to the repricing date of the interest rate swap that occurs within the quarterly period in which, but not before, the forecast transactions occur, and
- its effects for the period after the forecast transactions occur equal to the repricing interval of the interest rate swap.

It is important to recognise that the swaps are not hedging the cash flow risk for a single investment over its entire life. The swaps are designated as hedging the cash flow risk from different principal investments and repricings that are made in each repricing period of the swaps over their entire term. The swaps hedge only the interest accruals that occur in the first period following the reinvestment. They are hedging the cash flow impact resulting from a change in interest rates that occurs up to the repricing of the swap. The exposure to changes in rates for the period from the repricing of the swap to the date of the hedged reinvestment of cash inflows or repricing of variable rate assets is not hedged. When the swap is repriced, the interest rate on the swap is fixed until the next repricing date and the accrual of the net swap settlements is determined. Any changes in interest rates after that date that affect the amount of the interest cash inflow are no longer hedged for accounting purposes.

Designation objectives

Systems considerations

Many of the tracking and bookkeeping requirements are eliminated by designating each repricing of an interest rate swap as hedging the cash flow risk from forecast reinvestments of cash inflows and repricings of variable rate assets for only a portion of the lives of the related assets. Much tracking and book-keeping would be necessary if the swaps were instead designated as hedging the cash flow risk from forecast principal investments and repricings of variable rate assets over the entire lives of these assets.

This type of designation avoids keeping track of gains and losses recognised directly in the appropriate equity account after the forecast transactions occur (paragraphs 108 and 109 of AS 30) because the portion of the cash flow risk being hedged is that portion that will be recognised in the statement of profit and loss in the period immediately following the forecast transactions that corresponds with the periodic net cash settlements on the swap. If the hedge were to cover the entire life of the assets being acquired, it would be necessary to associate a specific interest rate swap with the asset being acquired. If a forecast

transaction is the acquisition of a fixed rate instrument, the fair value of the swap that hedged that transaction would be reclassified out of the equity account to adjust the interest income on the asset when the interest income is recognised. The swap would then have to be terminated or redesignated in another hedging relationship. If a forecast transaction is the acquisition of a variable rate asset, the swap would continue in the hedging relationship but it would have to be tracked back to the asset acquired so that any fair value amounts on the swap recognised in the equity account could be recognised in the statement of profit and loss upon the subsequent sale of the asset.

It also avoids the necessity of associating with variable rate assets any portion of the fair value of the swaps that is recognised in the equity account. Accordingly, there is no portion of the fair value of the swap that is recognised in the equity account that should be reclassified out of the equity account when a forecast transaction occurs or upon the sale of a variable rate asset.

This type of designation also permits flexibility in deciding how to reinvest cash flows when they occur. Since the hedged risk relates only to a single period that corresponds with the repricing period of the interest rate swap designated as the hedging instrument, it is not necessary to determine at the designation date whether the cash flows will be reinvested in fixed rate or variable rate assets or to specify at the date of designation the life of the asset to be acquired.

Effectiveness considerations

Ineffectiveness is greatly reduced by designating a specific portion of the cash flow exposure as being hedged.

- Ineffectiveness due to credit differences between the interest rate swap and hedged forecast cash flow is eliminated by designating the cash flow risk being hedged as the risk attributable to changes in the interest rates that correspond with the rates inherent in the swap, such as the AA rate curve. This type of designation prevents changes resulting from changes in credit spreads from being considered as ineffectiveness.
- Ineffectiveness due to duration differences between the interest rate swap and hedged forecast cash flow is eliminated by designating the interest rate risk being hedged as the risk relating to changes in the portion of the yield curve that corresponds with the period in which the variable rate leg of the interest rate swap is repriced.
- Ineffectiveness due to interest rate changes that occur between the repricing date of the interest rate swap and the date of the forecast transactions is eliminated by simply not hedging that period of time. The period from the repricing of the swap and the occurrence of the forecast transactions in the period immediately following the repricing of the swap is left unhedged. Therefore, the difference in dates does not result in ineffectiveness.

Accounting considerations

The ability to qualify for hedge accounting using the methodology described here is founded on provisions in AS 30 and on interpretations of its requirements. Some of those are described in the answer to Question F.6.2 *Hedge accounting considerations when interest rate risk is managed on a net basis*. Some additional and supporting provisions and interpretations are identified below.

Hedging a portion of the risk exposure

The ability to identify and hedge only a portion of the cash flow risk exposure resulting from the reinvestment of cash flows or repricing of variable rate instruments is found in paragraph 90 of AS 30 as interpreted in the answers to Questions F.6.2 Issue (k) and F.2.17 *Partial term hedging*.

Hedging multiple risks with a single instrument

The ability to designate a single interest rate swap as a hedge of the cash flow exposure to interest rates resulting from various reinvestments of cash inflows or repricings of variable rate assets that occur over the life of the swap is founded on paragraph 85 of AS 30 as interpreted in the answer to Question F.1.12 *Hedges of more than one type of risk*.

Hedging similar risks in a portfolio

The ability to specify the forecast transaction being hedged as a portion of the cash flow exposure to interest rates for a portion of the duration of the investment that gives rise to the interest payment without specifying at the designation date the expected life of the instrument and whether it pays a fixed or variable rate is founded on the answer to Question F.6.2 Issue (l), which specifies that the items in the portfolio do not necessarily have to have the same overall exposure to risk, providing they share the same risk for which they are designated as being hedged.

Hedge terminations

The ability to de-designate the forecast transaction (the cash flow exposure on an investment or repricing that will occur after the repricing date of the swap) as being hedged is provided for in paragraph 112 of AS 30 dealing with hedge terminations. While a portion of the forecast transaction is no longer being hedged, the interest rate swap is not de-designated, and it continues to be a hedging instrument for the remaining transactions in the series that have not occurred. For example, assume that an interest rate swap having a remaining life of one year has been designated as hedging a series of three quarterly reinvestments of cash flows. The next forecast cash flow reinvestment occurs in three months. When the interest rate swap is repriced in three months at the then current variable rate, the fixed rate and the variable rate on the interest rate swap become known and no longer provide hedge protection for the next three months. If the next forecast transaction does not occur until three months and ten days, the ten-day period that remains after the repricing of the interest rate swap is not hedged.

F.6.4 Hedge accounting: premium or discount on forward exchange contract

A forward exchange contract is designated as a hedging instrument, for example, in a hedge of a net investment in a non-integral foreign operation. Is it permitted to amortise the discount or premium on the forward exchange contract to the statement of profit and loss over the term of the contract?

No. The premium or discount on a forward exchange contract may not be amortised to the statement of profit and loss under AS 30. Derivatives are always measured at fair value in the balance sheet. The gain or loss resulting from a change in the fair value of the forward exchange contract is always recognised in the statement of profit and loss unless the forward exchange contract is designated and effective as a hedging instrument in a cash flow hedge or in a hedge of a net investment in a non-integral foreign operation, in which case the effective portion of the gain or loss is recognised in the appropriate equity account. In that case, the amounts recognised in the equity account are released to the statement of profit and loss when the hedged future cash flows occur or on the disposal of the net investment, as appropriate. Under paragraph 83(b) of AS 30, the interest element (time value) of the fair value of a forward may be excluded from the designated hedge relationship. In that case, changes in the interest element portion of the fair value of the forward exchange contract are recognised in the statement of profit and loss.

F.6.5 AS 30 and AS 11 – Fair value hedge of asset measured at cost

If the future sale of a ship carried at historical cost is hedged against the exposure to currency risk by foreign currency borrowing, does AS 30 require the ship to be remeasured for changes in the exchange rate even though the basis of measurement for the asset is historical cost?

No. In a fair value hedge, the hedged item is remeasured. However, a foreign currency borrowing cannot be classified as a fair value hedge of a ship since a ship does not contain any separately measurable foreign currency risk. If the hedge accounting conditions in paragraph 98 of AS 30 are met, the foreign currency borrowing may be classified as a cash flow hedge of an anticipated sale in that foreign currency. In a cash flow hedge, the hedged item is not remeasured.

To illustrate: a shipping entity in India has a US subsidiary that has the same functional currency (the Indian Rupees). The shipping entity measures its ships at historical cost less depreciation in the consolidated financial statements. In accordance with AS 11, the ships are recognised in Indian Rupees using the historical exchange rate. To hedge, fully or partly, the potential currency risk on the ships at disposal in US dollars, the shipping entity normally finances its purchases of ships with loans denominated in US dollars.

In this case, a US dollar borrowing (or a portion of it) may be designated as a cash flow hedge of the anticipated sale of the ship financed by the borrowing provided the sale is highly probable, for example, because it is expected to occur in the immediate future, and the amount of the sales proceeds designated as being hedged is equal to the amount of the foreign currency borrowing designated as the hedging instrument. The gains and losses on the currency borrowing that are determined to constitute an effective hedge of the anticipated sale are recognised directly in the appropriate equity account in accordance with paragraph 106(a) of AS 30.

Section G: Other

G.1 Disclosure of changes in fair value

AS 30 requires financial assets classified as available for sale (AFS) and financial assets and financial liabilities at fair value through profit or loss to be remeasured to fair value. Unless a financial asset or a financial liability is designated as a cash flow hedging instrument, fair value changes for financial assets and financial liabilities at fair value through profit or loss are recognised in the statement of profit and loss, and fair value changes for AFS assets are recognised in the appropriate equity account. What disclosures are required regarding the amounts of the fair value changes during a reporting period?

AS 32, *Financial Instruments: Disclosures*[57] requires material items of income, expense and gains and losses to be disclosed whether included in the statement of profit and loss or in the appropriate equity account. This disclosure requirement encompasses material items of income, expense and gains and losses that arise on remeasurement to fair value. Therefore, an entity provides disclosures of material fair value changes, distinguishing between changes that are recognised in the statement of profit and loss and changes that are recognised in the equity account. Further breakdown is provided of changes that relate to:

(a) AFS assets;

(b) financial assets and financial liabilities at fair value through profit or loss; and

(c) hedging instruments.

AS 32 neither requires nor prohibits disclosure of components of the change in fair value by the way items are classified for internal purposes. For example, an entity may choose to disclose separately the change in fair value of those derivatives that AS 30 classifies as held for trading but the entity classifies as part of risk management activities outside the trading portfolio.

In addition, AS 32 requires disclosure of the carrying amounts of financial assets and financial liabilities that: (i) are classified as held for trading and (ii) were, upon initial recognition, designated by the entity

[57] A separate Accounting Standard (AS) 32 on *Financial Instruments: Disclosures* is being formulated.

as financial assets and financial liabilities at fair value through profit or loss (i.e., those not financial instruments classified as held for trading).

G.2 AS 30 and AS 3 – Hedge accounting: cash flow statements

How should cash flows arising from hedging instruments be classified in cash flow statements?

Cash flows arising from hedging instruments are classified as operating, investing or financing activities, on the basis of the classification of the cash flows arising from the hedged item. While the terminology in AS 3 has not been updated to reflect AS 30, the classification of cash flows arising from hedging instruments in the cash flow statement should be consistent with the classification of these instruments as hedging instruments under AS 30.

Appendix D

Comparison with IAS 39, Financial Instruments: Recognition and Measurement

Note: This Appendix is not a part of this Accounting Standard. The purpose of this appendix is only to bring out differences between the Accounting Standard and the corresponding International Accounting Standard (IAS) 39.

Comparison with IAS 39, *Financial Instruments: Recognition and Measurement*

Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* is based on International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement* and incorporates IFRIC 9, *Reassessment of Embedded Derivatives* (Re. IAS 39, *Financial Instruments: Recognition and Measurement*), issued by the International Financial Reporting Interpretation Committee (IFRIC) of the International Accounting Standards Board (IASB). There are no material differences between AS 30, and IAS 39 and IFRIC 9.

Limited Revision to Accounting Standard (AS) 2 (revised 1999) Valuation of Inventories

The following is the text of the limited revision to AS 2, Valuation of Inventories, issued by the Institute of Chartered Accountants of India.

In view of Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*, AS 2 (revised 1999) is modified as under (modifications are shown as double-underline/ strike-through):

After the existing paragraph 12, new paragraph 12A is added as below:

12A. An enterprise may purchase inventories on deferred settlement terms. When the arrangement effectively contains a financing element, that element, for example a difference between the purchase price for normal credit terms and the amount paid, is recognised as interest expense over the period of the financing.

The limited revision comes into effect in respect of accounting periods commencing on or after the date on which Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* comes into effect.

Limited Revision to AS 11 (revised 2003) The Effects of Changes in Foreign Exchange Rates

The following is the text of the limited revision to AS 11 (revised 2003), The Effects of Changes in Foreign Exchange Rates, issued by the Institute of Chartered Accountants of India.

In view of Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* AS 11 (revised 2003) is modified as under (modifications are shown as double-underline/strike-through):

1. Scope Paragraphs of the Standard are amended as follows:

Scope

1. This Statement should be applied:

(a) in accounting for transactions and balances in foreign currencies, except for those derivative transactions and balances that are within the scope of AS 30, Financial Instruments: Recognition and Measurement; and

(b) in translating the financial statements of foreign operations.

2. AS 30 applies to many foreign currency derivatives and, accordingly, these are excluded from the scope of this Statement. However, those foreign currency derivatives that are not within the scope of AS 30 (e.g., some foreign currency derivatives that are embedded in other contracts) are within the scope of this Statement.

2A. This Statement does not apply to hedge accounting for foreign currency items, including the hedging of a net investment in a foreign operation. AS 30 applies to hedge accounting.

3. This Statement does not specify the currency in which an enterprise presents its financial statements. However, an enterprise normally uses the currency of the country in which it is domiciled. If it uses a different currency, this Statement requires disclosure of the reason for using that currency. This Statement also requires disclosure of the reason for any change in the reporting currency.

4. This Statement does not deal with the restatement of an enterprise's financial statements from its reporting currency into another currency for the convenience of users accustomed to that currency or for similar purposes.

5. This Statement does not deal with the presentation in a cash flow statement of cash flows arising from transactions in a foreign currency and the translation of cash flows of a foreign operation (see AS 3, *Cash Flow Statements*).

6. This Statement does not deal with exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs (see paragraph 4(e) of AS 16, *Borrowing Costs*).

2. From the definition paragraph, the definitions of the terms 'Forward exchange contract' and 'Forward rate' are deleted.

3. Paragraph 8 is amended as follows:

8. A foreign currency transaction is a transaction which is denominated in or requires settlement in a foreign currency, including transactions arising when an enterprise either:

(a) buys or sells goods or services whose price is denominated in a foreign currency;

(b) borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency; or

(c) otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

4. A new paragraph no. 12A is added under the existing heading 'Recognition of Exchange Differences'. This is the first paragraph under this heading and appears as follows:

12A. As noted in paragraph 2A, AS 30 applies to hedge accounting for foreign currency items. The application of hedge accounting requires an enterprise to account for some exchange differences differently from the treatment of exchange differences required by this Statement. For example, AS 30 requires that exchange differences on monetary items that qualify as hedging instruments in a cash flow hedge are

reported initially in an appropriate equity account, e.g., Hedging Reserve Account, to the extent that the hedge is effective.

5. The heading 'Forward Exchange Contracts' and paragraphs 36 to 39, given under the heading, are deleted.

6. Paragraph 40, given under the heading 'Disclosures', is amended as follows:

40. An enterprise should disclose:

(a) the amount of exchange differences included in the net profit or loss for the period except for those arising on financial instruments measured at fair value through profit or loss in accordance with AS 30; and

(b) net exchange differences accumulated in foreign currency translation reserve as a separate component of shareholders' funds, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

7. The name of AS 21, appearing in paragraphs 29 and 30 of the Standard, is changed to reflect the new name of AS 21, viz., the following:

AS 21, Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements

8. The name of AS 23, appearing in paragraph 30 of the Standard, is changed to reflect the new name of AS 23, viz., the following:

AS 23, Accounting for Investments in Associates

9. Alongwith the proposed Limited Revision to AS 11 (revised 2003), Comparison with IAS 21, *The Effects of Changes in Foreign Exchange Rates* (revised 1993), contained in Appendix to AS 11 (revised 2003) is replaced by the following Comparison with IAS 21, *The Effects of Changes in Foreign Exchange Rates* (revised 2003):

Appendix

Note: This Appendix is not a part of the Accounting Standard. The purpose of this appendix is only to bring out the major differences between Accounting Standard 11 (revised 2003) and corresponding International Accounting Standard (IAS) 21 (revised 2003).

Comparison with IAS 21, *The Effects of Changes in Foreign Exchange Rates* (revised 2003)

AS 11 (revised 2003) is based on the integral and non-integral foreign operations approach, *i.e.*, the approach which was followed in the earlier IAS 21 (revised 1993). The International Accounting Standards Board (IASB) has, in 2003, revised IAS 21 to adopt the functional currency approach. It has been observed that in all except one of the situations there is effectively no difference between the financial statements prepared under IAS 21 and AS 11. The only difference is that IAS 21 also lays down the method where the reporting enterprise's functional currency, *i.e.*, the currency of the primary economic environment in which the enterprise operates, is different as compared to its presentation currency, i.e., the currency in which financial statements are presented, whereas AS 11 only requires certain disclosures in such a case. However, it may be mentioned that in the context of most of the Indian enterprises, the functional currency and the presentation currency will be the same, i.e., the rupees, except there may be some Indian enterprises which are an integral foreign operation of a foreign enterprise. Therefore, only in very limited cases the application of the principles of IAS 21 will make a difference as compared to AS 11.

AS 11 (revised 2003) has recently become effective, i.e., from 1-4-2004. The Indian corporates have recently started applying this Standard. It is, therefore, felt that it is not appropriate to totally revise AS 11 (revised 2003) at this stage to adopt the IAS 21 which became effective from 1-1-2005.

The limited revision comes into effect in respect of accounting periods commencing on or after the date on which Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* comes into effect.

Limited Revision to Accounting Standard (AS) 21 (issued 2001)

The following is the text of the limited revision to AS 21, Consolidated Financial Statements, issued by the Institute of Chartered Accountants of India.

In view of the proposed Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*, AS 21 (issued 2001) is modified as under (modifications are shown as double-underline/strike-through):

1. The name of the Standard is modified as below:

Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements

2. The 'Applicability' paragraph of the Standard is amended as follows:

Accounting Standard (AS) 21 (issued 2001), *Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements*, issued by the Council of the Institute of Chartered Accountants of India, came into effect in respect of accounting periods commencing on or after 1-4-2001. This limited revision to the Standard comes into effect in respect of accounting periods commencing on or after the date on which Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* comes into effect. In respect of separate financial statements of an enterprise, this limited revision comes into effect from the same date. In respect of consolidated financial statements, this Accounting Standard is mandatory[58] where the enterprise prepares and presents consolidated financial statements. In other words, the accounting standard does not mandate an enterprise to present consolidated financial statements but, if the enterprise presents consolidated financial statements, for a period commencing on or after the date on which this Standard first came into effect, i.e., 1-4-2001, for complying with the requirements of any statute or otherwise, it should prepare and present consolidated financial statements in accordance with this Standard.

The following is the text of the Accounting Standard.

3. The 'Objective' paragraph of the Standard is amended as follows:

The objective of this Statement is to lay down principles and procedures for preparation and presentation of consolidated financial statements and for accounting for investments in subsidiaries in separate financial statements. Consolidated financial statements are presented by a parent (also known as holding enterprise) to provide financial information about the economic activities of its group. These statements are intended to present financial information about a parent and its subsidiary (ies) as a single economic entity to show the economic resources controlled by the group, the obligations of the group and results the group achieves with its resources.

[58] This implies that, while discharging their attest function, it will be the duty of the members of the Institute to examine whether this Accounting Standard is complied with in the presentation of financial statements covered by their audit. In the event of any deviation from this Accounting Standard, it will be their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviations.

4. The 'Scope' paragraphs of the Standard are amended as follows:

Scope

1. This Statement should be applied in the preparation and presentation of consolidated financial statements for a group of enterprises under the control of a parent.

2. This Statement should also be applied in accounting for investments in subsidiaries in the separate financial statements of a parent.

3. In the preparation of consolidated financial statements, other Accounting Standards also apply in the same manner as they apply to the separate financial statements.

4. This Statement does not deal with:

(a) methods of accounting for amalgamations and their effects on consolidation, including goodwill arising on amalgamation (see AS 14, *Accounting for Amalgamations*);
(b) accounting for investments in associates (see AS 23, *Accounting for Investments in Associates*); and
(c) accounting for interests in joint ventures (see AS 27, *Financial Reporting of Interests in Joint Ventures*).

5. Paragraph 11 is amended as follows:

11. A subsidiary should be excluded from consolidation when:

(a) control is intended to be temporary because the subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future[59]; or

(b) it operates under severe long-term restrictions which significantly impair its ability to transfer funds to the parent.

In consolidated financial statements, investments in such subsidiaries should be accounted for in accordance with Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement. The reasons for not consolidating a subsidiary should be disclosed in the consolidated financial statements.

6. After paragraph 11, new paragraph 11A is added. New paragraph 11A is as follows:

11A. A subsidiary is not excluded from consolidation simply because the parent is a venture capital organisation or a similar entity.

7. Paragraphs 23 and 24 are amended as follows:

23. An investment in an enterprise should be accounted for in accordance with Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement, from the date that the enterprise ceases to be a subsidiary, provided that it does not become an associate as defined in AS 23 or a jointly controlled entity as described in AS 27.

24. The carrying amount of the investment at the date that the enterprise ceases to be a subsidiary is regarded as the cost on initial measurement of a financial asset in accordance with AS 30.

8. Paragraph 28, appearing under the heading 'Accounting for Investments in Subsidiaries in a Parent's Separate Financial Statements' is amended. New paragraph 28A is added. Amended paragraph 28 and new paragraph 28A are as follows:

Accounting for Investments in Subsidiaries in a Parent's Separate Financial Statements

[59] See also Accounting Standards Interpretations (ASIs) 8 and 25.

28. In a parent's separate financial statements, investments in subsidiaries, except investments in subsidiaries covered under paragraph 11 of this Statement, should be accounted for either:

(a) at cost, or

(b) in accordance with AS 30, Financial Instruments: Recognition and Measurement.

The same accounting should be applied for each category of investments. Investments in subsidiaries covered under paragraph 11 of this Statement should be accounted for in accordance with Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement.

28A. To determine whether an investment in a subsidiary accounted for at cost in accordance with paragraph 28 is impaired, an enterprise applies AS 28, *Impairment of Assets*. AS 28 which explains how an enterprise reviews the carrying amount of its assets, how it determines the recoverable amount of an asset, and when it recognises, or reverses the recognition of, an impairment loss is also applicable to impairment of an investment in a subsidiary.

Limited Revision to Accounting Standard (AS) 23 (issued 2001)

The following is the text of the limited revision to AS 23, Accounting for Investments in Associates in Consolidated Financial Statements, issued by the Institute of Chartered Accountants of India.

In view of Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*, AS 23 (issued 2001) is modified as under (modifications are shown as double-underline/ strike-through):

1. The name of the Standard is modified as below:

Accounting for Investments in Associates

2. The 'Applicability' paragraph of the Standard is amended as follows:

Accounting Standard (AS) 23 (issued 2001), *Accounting for Investments in Associates*, issued by the Council of the Institute of Chartered Accountants of India, came into effect in respect of accounting periods commencing on or after 1-4-2002. This limited revision to the Standard comes into effect in respect of accounting periods commencing on or after the date on which Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* comes into effect. In respect of separate financial statements of an enterprise, this limited revision comes into effect from the same date. In respect of consolidated financial statements, this Standard is mandatory[60] where the enterprise prepares and presents consolidated financial statements. In other words, if an enterprise prepares and presents consolidated financial statements, for a period commencing on or after the date on which this Standard first came into effect, i.e., 1-4-2002, it should account for investments in associates in the consolidated financial statements in accordance with this Standard.

The following is the text of the Accounting Standard.

3. The 'Objective' paragraph of the Standard is amended as follows:

The objective of this Statement is to set out principles and procedures for recognising the effects of the investments in associates on the financial position and operating results in the consolidated financial statements of a group and for accounting for investments in associates in the separate financial statements of an investor.

[60] This implies that, while discharging their attest function, it will be the duty of the members of the Institute to examine whether this Accounting Standard is complied with in the presentation of financial statements covered by their audit. In the event of any deviation from this Accounting Standard, it will be their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviations.

4. The 'Scope' paragraphs of the Standard are amended as follows:

1. This Statement should be applied in accounting for investments in associates in the preparation and presentation of separate as well as consolidated financial statements by an investor. However, it does not apply to investments in associates held by:

(a) venture capital organisations, or
(b) mutual funds, unit trusts and similar entities including investment-linked insurance funds

that upon initial recognition are designated as at fair value through profit or loss and accounted for in accordance with AS 30, Financial Instruments: Recognition and Measurement. Such investments should be measured at fair value in accordance with AS 30, with changes in fair value recognised in the statement of profit and loss in the period of the change.

2. The requirements relating to accounting for investments in associates in consolidated financial statements, contained in this Statement, are applicable only where consolidated financial statements are prepared and presented by the investor.

5. Paragraph 7 is amended as follows:

7. An investment in an associate should be accounted for in consolidated financial statements under the equity method except when:

(a) the investment is acquired and held exclusively with a view to its subsequent disposal in the near future[61]; or
(b) the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor.

Investments in such associates should be accounted for in accordance with Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement. The reasons for not applying the equity method in accounting for investments in an associate should be disclosed in the consolidated financial statements.

6. Paragraph 9 is amended as follows:

9. An investor should discontinue the use of the equity method from the date that:

(a) it ceases to have significant influence in an associate but retains, either in whole or in part, its investment; or
(b) the use of the equity method is no longer appropriate because the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor.

From the date of discontinuing the use of the equity method, investments in such associates should be accounted for in accordance with Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement. For this purpose, the carrying amount of the investment at that date should be regarded as its cost on initial measurement as a financial asset in accordance with AS 30.

7. The existing paragraph 20 is deleted. After the existing paragraph 19, new paragraphs 20, 20A, 20B and 20C under the heading 'Impairment Loss' and new paragraphs 20D and 20E under the heading 'Separate Financial Statements of an Investor' are added. New paragraphs are as follows:

Impairment losses

20. After applying the equity method, including recognising the associate's losses in accordance with paragraph 18, the investor applies the requirements of AS 30 to determine whether it is necessary to recognise any additional impairment loss with respect to the investor's net investment in the associate.

[61] See also Accounting Standards Interpretation (ASI) 8.

20A. The investor also applies the requirements of AS 30 to determine whether any additional impairment loss is recognised with respect to the investor's interest in the associate that does not constitute part of the net investment and the amount of that impairment loss.

20B. Because goodwill included in the carrying amount of an investment in an associate is not separately recognised, it is not tested for impairment separately by applying the requirements for testing of impairment of goodwill in AS 28, *Impairment of Assets*. Instead, the entire carrying amount of the investment is tested under AS 28 for impairment, by comparing its recoverable amount (higher of net selling price and value in use) with its carrying amount, whenever application of the requirements in AS 30 indicates that the investment may be impaired. In determining the value in use of the investment, an enterprise estimates:

(a) its share of the present value of the estimated future cash flows expected to be generated by the associate, including the cash flows from the operations of the associate and the proceeds on the ultimate disposal of the investment; or

(b) the present value of the estimated future cash flows expected to arise from dividends to be received from the investment and from its ultimate disposal.

Under appropriate assumptions, both methods give the same result.

20C. The recoverable amount of an investment in an associate is assessed for each associate, unless the associate does not generate cash inflows from continuing use that are largely independent of those from other assets of the enterprise.

Separate Financial Statements of an Investor

20D. In an investor's separate financial statements, investments in associates, except investments in associates covered under paragraph 7 of this Statement, should be accounted for either:

(a) at cost, or

(b) in accordance with AS 30, Financial Instruments: Recognition and Measurement.

The same accounting should be applied for each category of investments. Investments in associates covered under paragraph 7 of this Statement should be accounted for in accordance with Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement.

20E. To determine whether an investment in an associate accounted for at cost in accordance with paragraph 20D is impaired, an enterprise applies AS 28, *Impairment of Assets*. AS 28 which explains how an enterprise reviews the carrying amount of its assets, how it determines the recoverable amount of an asset, and when it recognises, or reverses the recognition of, an impairment loss is also applicable to impairment of an investment in an associate.

8. Paragraph 21 is amended as follows:

21. In accordance with Accounting Standard (AS) 29, *Provisions, Contingent Liabilities and Contingent Assets*, the investor discloses in the separate as well as the consolidated financial statements:

(a) its share of the contingent liabilities of an associate incurred jointly with other investors; and

(b) those contingent liabilities that arise because the investor is severally liable for all or part of the liabilities of the associate.

9. The name of AS 21, appearing in paragraph 10 of the Standard, is changed to reflect the proposed new name of AS 21, viz., the following:

AS 21, Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements

Limited Revision to Accounting Standard (AS) 26 (issued 2002) Intangible Assets

The following is the text of the limited revision to AS 26, Intangible Assets, issued by the Institute of Chartered Accountants of India.

In view of Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*, AS 26 (issued 2002) is modified as under (modifications are shown as double-underline/ strike-through):

After the existing paragraph 25, new paragraph 25A is added as below:

25A. If payment for an intangible asset is deferred beyond normal credit terms, its cost is the cash price equivalent. The difference between this amount and the total payments is recognised as interest expense over the period of credit unless it is capitalised in accordance with AS 16, *Borrowing Costs*.

The limited revision comes into effect in respect of accounting periods commencing on or after the date on which Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* comes into effect.

Limited Revision to Accounting Standard (AS) 27 (issued 2002)

Financial Reporting of Interests in Joint Ventures

The following is the text of the limited revision to AS 27, Financial Reporting of Interests in Joint Ventures, issued by the Institute of Chartered Accountants of India.

In view of Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*, AS 27 (issued 2002) is modified as under (modifications are shown as double-underline/ strike-through):

1. The 'Scope' paragraphs of the Standard are amended as follows:

Scope

1. This Statement should be applied in accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors, regardless of the structures or forms under which the joint venture activities take place. However, it does not apply to venturer's interests in jointly controlled entities held by:

(a) venture capital organisations, or

(b) mutual funds, unit trusts and similar entities including investment-linked insurance funds

that upon initial recognition are designated as at fair value through profit or loss and accounted for in accordance with AS 30, Financial Instruments: Recognition and Measurement. Such investments should be measured at fair value in accordance with AS 30, with changes in fair value recognised in the statement of profit and loss in the period of the change.

2. The requirements relating to accounting for joint ventures in consolidated financial statements, contained in this Statement, are applicable only where consolidated financial statements are prepared and presented by the venturer.

2. Paragraph 27, appearing under the heading 'Separate Financial Statements of a Venturer' is amended. New paragraphs 28A is added. Amended paragraph 27 and new paragraphs 28A are as follows:

Separate Financial Statements of a Venturer

27. In a venturer's separate financial statements, interests in jointly controlled entities, except interests covered under paragraph 29 of this Statement, should be accounted for either:

(a) at cost, or

(b) in accordance with AS 30, Financial Instruments: Recognition and Measurement.

The same accounting should be applied for each category of interest in jointly controlled entities. Interests in jointly controlled entities covered under paragraph 29 of this Statement should be accounted for as an investment in accordance with Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement.

28. Each venturer usually contributes cash or other resources to the jointly controlled entity. These contributions are included in the accounting records of the venturer and are recognised in its separate financial statements as an investment in the jointly controlled entity.

28A. To determine whether an interest in a jointly controlled entity accounted for at cost in accordance with paragraph 27 is impaired, an enterprise applies AS 28, *Impairment of Assets*. AS 28 which explains how an enterprise reviews the carrying amount of its assets, how it determines the recoverable amount of an asset, and when it recognises, or reverses the recognition of, an impairment loss is also applicable to impairment of an interest in a jointly controlled entity.

3. Paragraph 29 is amended as follows:

29. In its consolidated financial statements, a venturer should report its interest in a jointly controlled entity using proportionate consolidation except

(a) an interest in a jointly controlled entity which is acquired and held exclusively with a view to its subsequent disposal in the near future[62]; and

(b) an interest in a jointly controlled entity which operates under severe long-term restrictions that significantly impair its ability to transfer funds to the venturer.

Interest in such a jointly controlled entity should be accounted for as an investment in accordance with Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement.

4. Paragraph 40 is amended as follows:

40. From the date of discontinuing the use of the proportionate consolidation, interest in a jointly controlled entity should be accounted for:

(a) in accordance with Accounting Standard (AS) 21, Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements, if the venturer acquires unilateral control over the entity and becomes parent within the meaning of that Standard; and

(b) in all other cases, as an investment in accordance with Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement, or in accordance with Accounting Standard (AS) 23, Accounting for Investments in Associates, as appropriate. For this purpose, cost of the investment should be determined as under:

(i) the venturer's share in the net assets of the jointly controlled entity as at the date of discontinuance of proportionate consolidation should be ascertained, and

[62] See also Accounting Standards Interpretation (ASI) 8.

(ii) the amount of net assets so ascertained should be adjusted with the carrying amount of the relevant goodwill/capital reserve (see paragraph 37) as at the date of discontinuance of proportionate consolidation.

5. Paragraphs 46 and 47 are amended as follows:

46. An investor in a joint venture, which does not have joint control, should report its interest in a joint venture in its consolidated financial statements in accordance with Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement, Accounting Standard (AS) 21, Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements or Accounting Standard (AS) 23, Accounting for Investments in Associates, as appropriate.

47. In the separate financial statements of an investor, the interests in joint ventures should be accounted for in accordance with Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement.

6. The name of AS 21, appearing in paragraphs 6 and 31 of the Standard, is changed to reflect the new name of AS 21, viz., the following:

AS 21, Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements

7. The name of AS 23, appearing in paragraph 5 of the Standard, is changed to reflect the new name of AS 23, viz., the following:

AS 23, Accounting for Investments in Associates

The limited revision comes into effect in respect of accounting periods commencing on or after the date on which Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* comes into effect.

Limited Revision to Accounting Standard (AS) 28 (issued 2002) Impairment of Assets

The following is the text of the limited revision to AS 28, Impairment of Assets, issued by the Institute of Chartered Accountants of India.

Accounting Standard (AS) 13, *Accounting for Investments*, which deals with accounting for investments including an investment in a subsidiary, associate or joint venture, also contains specific requirements for recognising impairment on such investments. On Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*, becoming mandatory, AS 13 would stand withdrawn except to the extent it relates to accounting for investment properties. Thus, accounting for an investment in a subsidiary, associate and joint venture would no longer be covered by AS 13. The same would be dealt with in AS 21, AS 23 and AS 27. Accordingly, with the issuance of AS 30, Limited Revisions are also made to AS 21, AS 23 and AS 27. The impairment of an investment in a subsidiary, associate or joint venture in separate financial statements would be covered under AS 28, *Impairment of Assets*. With a view to require the same, AS 28 (issued 2002) is modified as under (modifications are shown as double-underline/ strike-through):

Under the heading 'Scope', paragraph 1 is amended and a new paragraph 2A is added after paragraph 2 as below:

1. This Statement should be applied in accounting for the impairment of all assets, other than:

(a) *inventories (see AS 2, Valuation of Inventories);*

(b) *assets arising from construction contracts (see AS 7, Accounting for Construction Contracts*[6]*);*
(c) *financial assets, that are within the scope of AS 30, Financial Instruments: Recognition and Measurement; and*

(d) *deferred tax assets (see AS 22, Accounting for Taxes on Income).*

2A. This Statement applies to financial assets classified as investments in:

(a) subsidiaries, as defined in AS 21, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements*;
(b) associates, as defined in AS 23, *Accounting for Investments in Associates*; and
(c) joint ventures, as defined in AS 27, *Financial Reporting of Interests in Joint Ventures.*

For impairment of other financial assets, refer to AS 30, *Financial Instruments: Recognition and Measurement*.

The limited revision comes into effect in respect of accounting periods commencing on or after the date on which Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* comes into effect.

Limited Revision to Accounting Standard (AS) 29 (issued 2003)

Provisions, Contingent Liabilities and Contingent Assets

The following is the text of the limited revision to AS 29, Provisions, Contingent Liabilities and Contingent Assets, issued by the Institute of Chartered Accountants of India.

In view of Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*, AS 29 (issued 2003) is modified as under (modifications are shown as double-underline/ strike-through):

1. Paragraphs 1 and 2, given under the heading 'Scope', are amended as below:

1. This Statement should be applied in accounting for provisions and contingent liabilities and in dealing with contingent assets, except:

(a) [Deleted];
(b) those resulting from executory contracts, except where the contract is onerous[63]*;*
(c) those arising in insurance enterprises from contracts with policy-holders; and
(d) those covered by another Accounting Standard.

2. This Statement does not apply to financial instruments (including guarantees) that are within the scope of Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*.

2. Example 7: A Single Guarantee, given in Appendix C is deleted.

The limited revision comes into effect in respect of accounting periods commencing on or after the date on which Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* comes into effect.

[6] This Standard has been revised and titled as 'Construction Contacts'. The revised AS 7 is published elsewhere in this Compendium.
[63] The meaning of the term 'onerous contracts' and the application of the recognition and measurement principles of this Statement to such contracts are given in the Accounting Standards Interpretation (ASI) 30 on 'Applicability of AS 29 to Onerous Contracts'.

Accounting Standard (AS) 31
Financial Instruments: Presentation

*(This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective and the Preface to the Statements of Accounting Standards [64].)*

Accounting Standard (AS) 31, *Financial Instruments: Presentation*, issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years. This Accounting Standard will become mandatory[65] in respect of accounting periods commencing on or after 1-4-2011 for all commercial, industrial and business entities except to a Small and Medium-sized Entity, as defined below:

(vi) Whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;
(vii) which is not a bank (including co-operative bank), financial institution or any entity carrying on insurance business;
(viii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;
(ix) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and
(x) which is not a holding or subsidiary entity of an entity which is not a small and medium-sized entity.

For the above purpose, an entity would qualify as a Small and Medium-sized Entity, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

Where, in respect of an entity there is a statutory requirement for presenting any financial instrument in a particular manner as liability or equity and/ or for presenting interest, dividend, losses and gains relating to a financial instrument in a particular manner as income/ expense or as distribution of profits, the entity should present that instrument and/ or interest, dividend, losses and gains relating to the instrument in accordance with the requirements of the statute governing the entity. Untill the relevant statute is amended, the entity presenting that instrument and/ or interest, dividend, losses and gains relating to the instrument in accordance with the requirements thereof will be considered to be complying with this Accounting Standard, in view of paragraph 4.1 of the *Preface to the Statements of Accounting Standards* which recognises that where a requirement of an Accounting Standard is different from the applicable law, the law prevails[66].

---

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which accounting standards are intended to apply only to items which are material.

[65] This implies that, while discharging their attest function, it will be the duty of the members of the Institute to examine whether this Accounting Standard is complied with in the presentation of financial statements covered by their audit. In the event of any deviation from this Accounting Standard, it will be their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviations.

[66] To illustrate, as per paragraph 35(a) of the Standard, a preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, is a financial liability. However, at present, Schedule VI to the Companies Act, 1956, *inter alia*, requires that all preference shares should be disclosed as a part of the 'Share Capital'. Untill Schedule VI is amended, a company classifying the preference shares as share capital will be considered to be complying with this Accounting Standard even in a case where as per this Standard the preference shares are to be shown as a liability. In the latter case, as a corollary to this, dividend on such

The following is the text of the Accounting Standard.

Objective

1. The objective of this Standard is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset.

2. The principles in this Standard complement the principles for recognising and measuring financial assets and financial liabilities in Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement* and for disclosing information about them in Accounting Standard (AS) 32, *Financial Instruments: Disclosures*[67].

Scope

3. This Standard should be applied by all entities to all types of financial instruments except:

(a) those interests in subsidiaries, associates and joint ventures that are accounted for in accordance with AS 21, Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements, AS 23, Accounting for Investments in Associates, or AS 27, Financial Reporting of Interests in Joint Ventures. However, in some cases, AS 21, AS 23 or AS 27 permits or requires an entity to account for an interest in a subsidiary, associate or joint venture using Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement[68]; in those cases, entities should apply the disclosure requirements in AS 21, AS 23 or AS 27 in addition to those in this Standard. Entities should also apply this Standard to all derivatives linked to interests in subsidiaries, associates or joint ventures.

(b) employers' rights and obligations under employee benefit plans, to which AS 15, Employee Benefits, applies.

(c) contracts for contingent consideration in a business combination[69]. This exemption applies only to the acquirer.

(d) insurance contracts as defined in the Accounting Standard on Insurance Contracts[70]. However, this Standard applies to derivatives that are embedded in insurance contracts if

---

preference shares treated as a distribution to holders thereof and not as an expense will also be considered as a compliance with this Accounting Standard. Similarly, in case of a co-operative entity those requirements of paragraphs 40 to 47 and Appendix B to the Standard would not apply which are contrary to the law governing such an entity.

[67] A separate Accounting Standard (AS) 32 on *Financial Instruments: Disclosures* is being formulated.

[68] It may be noted that AS 21, AS 23 and AS 27, at present, make reference to Accounting Standard (AS) 13, *Accounting for Investments*, with regard to the accounting for an investment in a subsidiary, associate and joint venture, respectively. On Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* becoming mandatory, AS 13 would stand withdrawn except to the extent it relates to accounting for investment properties. In other words, accounting for investments in a subsidiary, associate and joint venture would no longer be covered by AS 13. Keeping this in view, with the issuance of the proposed AS 30, Limited Revisions have been made to AS 21, AS 23 and AS 27 to replace the references to AS 13 with those to AS 30. Pursuant to these Limited Revisions, the titles of AS 21 and AS 23 are also modified.

[69] 'Business combination' is the bringing together of separate entities or businesses into one reporting entity.

At present, Accounting Standard (AS) 14, *Accounting for Amalgamations*, deals with accounting for contingent consideration in an amalgamation, which is a form of business combination.

[70] A separate Accounting Standard on *Insurance Contracts* will specify the requirements relating to insurance contracts.

Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement requires the entity to account for them separately. Moreover, an issuer should apply this Standard to financial guarantee contracts if the issuer applies AS 30 in recognising and measuring the contracts, but should apply the Accounting Standard on Insurance Contracts if the issuer elects, in accordance with the Accounting Standard on Insurance Contracts, to apply that Standard in recognising and measuring them.

(e) financial instruments that are within the scope of the Accounting Standard on Insurance Contracts[71] because they contain a discretionary participation feature. The issuer of these instruments is exempt from applying to these features paragraphs 32-67 of this Standard regarding the distinction between financial liabilities and equity instruments. However, these instruments are subject to all other requirements of this Standard. Furthermore, this Standard applies to derivatives that are embedded in these instruments (see Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement).

(f) financial instruments, contracts and obligations under share-based payment transactions[72] except for

(i) contracts within the scope of paragraphs 4-6 of this Standard, to which this Standard applies.

(ii) paragraphs 68, 69 and 70 of this Standard, which should be applied to treasury shares, purchased, sold, issued or cancelled in connection with employee share option plans, employees share purchase plans, and all other share-based payment arrangements.

4. This Standard should be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements.

5. There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:

(a) when the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;

(b) when the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument, or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);

(c) when, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and

(d) when the non-financial item that is the subject of the contract is readily convertible to cash.

---

[71] See footnote 7.

[72] Employee share based payment, which is one of the share-based payment transactions, is accounted for as per the Guidance Note on Employee Share-based Payment, issued by the ICAI. Further, some other pronouncements of the ICAI deal with other share-based payments, e.g., AS 10, *Accounting for Fixed Assets*.

A contract to which (b) or (c) applies is not entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements, and, accordingly, is within the scope of this Standard. Other contracts to which paragraph 4 applies are evaluated to determine whether they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirement, and accordingly, whether they are within the scope of this Standard.

6. A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, in accordance with paragraph 5(a) or (d) is within the scope of this Standard. Such a contract cannot be entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements.

Definitions

7. The following terms are used in this Standard with the meanings specified:

7.1 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.

7.2 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) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

(d) a contract that will or may be settled in the entity's own equity instruments and is:

(i) 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

(ii) 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 instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

7.3 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) a contract that will or may be settled in the entity's own equity instruments and is

(i) 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

(ii) 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

instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

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

7.5 Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

8. The following terms are defined in paragraph 8 of Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement* and are used in this Standard with the meaning specified in AS 30.

- amortised cost of a financial asset or financial liability
- available-for-sale financial assets
- derecognition
- derivative
- effective interest method
- financial asset or financial liability at fair value through profit or loss
- financial guarantee contract
- firm commitment
- forecast transaction
- hedge effectiveness
- hedged item
- hedging instrument
- held-to-maturity investments
- loans and receivables
- regular way purchase or sale
- transaction costs.

9. In this Standard, 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.

10. In this Standard, 'entity' includes individuals, partnerships, incorporated bodies, trusts and government agencies.

Financial Assets and Financial Liabilities

11. Currency (cash) is a financial asset because it represents the medium of exchange and is therefore the basis on which all transactions are measured and recognised in financial statements. A deposit of cash with a bank or similar financial institution is a financial asset because it represents the contractual right of the depositor to obtain cash from the institution or to draw a cheque or similar instrument against the balance in favour of a creditor in payment of a financial liability.

12. Common examples of financial assets representing a contractual right to receive cash in the future and corresponding financial liabilities representing a contractual obligation to deliver cash in the future are:

(a) trade accounts receivable and payable;

(b) bills receivable and payable;

(c) loans receivable and payable;

(d) bonds receivable and payable; and

(e) deposits and advances.

In each case, one party's contractual right to receive (or obligation to pay) cash is matched by the other party's corresponding obligation to pay (or right to receive).

13. Another type of financial instrument is one for which the economic benefit to be received or given up is a financial asset other than cash. For example, a promissory note payable in government bonds gives the holder the contractual right to receive and the issuer the contractual obligation to deliver government bonds, not cash. The bonds are financial assets because they represent obligations of the issuing government to pay cash. The promissory note is, therefore, a financial asset of the promissory note holder and a financial liability of the promissory note issuer.

14. 'Perpetual' debt instruments normally provide the holder with the contractual right to receive payments on account of interest at fixed dates extending into the indefinite future, either with no right to receive a return of principal or a right to a return of principal under terms that make it very unlikely or very far in the future. For example, an entity may issue a financial instrument requiring it to make annual payments in perpetuity equal to a stated interest rate of 8 per cent applied to a stated par or principal amount of ₹ 1,000. Assuming 8 per cent to be the market rate of interest for the instrument when issued, the issuer assumes a contractual obligation to make a stream of future interest payments having a fair value (present value) of ₹ 1,000 on initial recognition. The holder and issuer of the instrument have a financial asset and a financial liability, respectively.

15. A contractual right or contractual obligation to receive, deliver or exchange financial instruments is itself a financial instrument. A chain of contractual rights or contractual obligations meets the definition of a financial instrument if it will ultimately lead to the receipt or payment of cash or to the acquisition or issue of an equity instrument.

16. The ability to exercise a contractual right or the requirement to satisfy a contractual obligation may be absolute, or it may be contingent on the occurrence of a future event. For example, a financial guarantee is a contractual right of the lender to receive cash from the guarantor, and a corresponding contractual obligation of the guarantor to pay the lender, if the borrower defaults. The contractual right and obligation exist because of a past transaction or event (assumption of the guarantee), even though the lender's ability to exercise its right and the requirement for the guarantor to perform under its obligation are both contingent on a future act of default by the borrower. A contingent right and obligation meet the definition of a financial asset and a financial liability, even though such assets and liabilities are not always recognised in the financial statements. Some of the contingents rights and obligations may be insurance contracts within the scope of the Accounting Standard on *Insurance Contracts*[73].

17. Under AS 19, *Leases*, a finance lease is regarded as primarily an entitlement of the lessor to receive, and an obligation of the lessee to pay, a stream of payments that are substantially the same as

[73] See footnote 7.

blended payments of principal and interest under a loan agreement. The lessor accounts for its investment in the amount receivable under the lease contract rather than the leased asset itself. An operating lease, on the other hand, is regarded as primarily an uncompleted contract committing the lessor to provide the use of an asset in future periods in exchange for consideration similar to a fee for a service. The lessor continues to account for the leased asset itself rather than any amount receivable in the future under the contract. Accordingly, a finance lease is regarded as a financial instrument and an operating lease is not regarded as a financial instrument (except as regards individual payments currently due and payable).

18. Physical assets (such as inventories, property, plant and equipment), leased assets and intangible assets (such as patents and trademarks) are not financial assets. Control of such physical and intangible assets creates an opportunity to generate an inflow of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset.

19. Assets (such as prepaid expenses) for which the future economic benefit is the receipt of goods or services, rather than the right to receive cash or another financial asset, are not financial assets. Similarly, items such as deferred revenue and most warranty obligations are not financial liabilities because the outflow of economic benefits associated with them is the delivery of goods and services rather than a contractual obligation to pay cash or another financial asset.

20. Liabilities or assets that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial liabilities or financial assets. Accounting for income taxes is dealt with in AS 22, *Accounting for Taxes on Income*.

Equity Instruments

21. Examples of equity instruments include non-puttable equity shares, some types of preference shares (see paragraphs 38 and 39) and warrants or written call options that allow the holder to subscribe for or purchase a fixed number of non-puttable equity shares in the issuing entity in exchange for a fixed amount of cash or another financial asset. An obligation of an entity to issue or purchase a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument of the entity. However, if such a contract contains an obligation for the entity to pay cash or another financial asset, it also gives rise to a liability for the present value of the redemption amount (see paragraph 52(a)). An issuer of non-puttable equity shares assumes a liability when it formally acts to make a distribution and becomes legally obligated to the shareholders to do so. This may be the case following the declaration of a dividend or when the entity is being wound up and any assets remaining after the satisfaction of liabilities become distributable to shareholders.

22. A purchased call option or other similar contract acquired by an entity that gives it the right to reacquire a fixed number of its own equity instruments in exchange for delivering a fixed amount of cash or another financial asset is not a financial asset of the entity. Instead, any consideration paid for such a contract is deducted from equity.

Derivative Financial Instruments

23. Financial instruments include primary instruments (such as receivables, payables and equity instruments) and derivative financial instruments (such as financial options, futures and forwards, interest rate swaps and currency swaps). Derivative financial instruments meet the definition of a financial instrument and, accordingly, are within the scope of this Standard.

24. Derivative financial instruments create rights and obligations that have the effect of transferring between the parties to the instrument one or more of the financial risks inherent in an underlying primary financial instrument. On inception, derivative financial instruments give one party a contractual

right to exchange financial assets or financial liabilities with another party under conditions that are potentially favourable, or a contractual obligation to exchange financial assets or financial liabilities with another party under conditions that are potentially unfavourable. However, they generally[74] do not result in a transfer of the underlying primary financial instrument on inception of the contract, nor does such a transfer necessarily take place on maturity of the contract. Some instruments embody both a right and an obligation to make an exchange. Because the terms of the exchange are determined on inception of the derivative instrument, as prices in financial markets change those terms may become either favourable or unfavourable.

25. A put or call option to exchange financial assets or financial liabilities (i.e. financial instruments other than an entity's own equity instruments) gives the holder a right to obtain potential future economic benefits associated with changes in the fair value of the financial instrument underlying the contract. Conversely, the writer of an option assumes an obligation to forgo potential future economic benefits or bear potential losses of economic benefits associated with changes in the fair value of the underlying financial instrument. The contractual right of the holder and obligation of the writer meet the definition of a financial asset and a financial liability, respectively. The financial instrument underlying an option contract may be any financial asset, including shares in other entities and interest-bearing instruments. An option may require the writer to issue a debt instrument, rather than transfer a financial asset, but the instrument underlying the option would constitute a financial asset of the holder if the option were exercised. The option-holder's right to exchange the financial asset under potentially favourable conditions and the writer's obligation to exchange the financial asset under potentially unfavourable conditions are distinct from the underlying financial asset to be exchanged upon exercise of the option. The nature of the holder's right and of the writer's obligation are not affected by the likelihood that the option will be exercised.

26. Another example of a derivative financial instrument is a forward contract to be settled in six months' time in which one party (the purchaser) promises to deliver ₹ 1,000,000 cash in exchange for ₹ 1,000,000 face amount of fixed rate government bonds, and the other party (the seller) promises to deliver ₹ 1,000,000 face amount of fixed rate government bonds in exchange for ₹ 1,000,000 cash. During the six months, both parties have a contractual right and a contractual obligation to exchange financial instruments. If the market price of the government bonds rises above ₹ 1,000,000, the conditions will be favourable to the purchaser and unfavourable to the seller; if the market price falls below ₹ 1,000,000, the effect will be the opposite. The purchaser has a contractual right (a financial asset) similar to the right under a call option held and a contractual obligation (a financial liability) similar to the obligation under a put option written; the seller has a contractual right (a financial asset) similar to the right under a put option held and a contractual obligation (a financial liability) similar to the obligation under a call option written. As with options, these contractual rights and obligations constitute financial assets and financial liabilities separate and distinct from the underlying financial instruments (the bonds and cash to be exchanged). Both parties to a forward contract have an obligation to perform at the agreed time, whereas performance under an option contract occurs only if and when the holder of the option chooses to exercise it.

27. Many other types of derivative instruments embody a right or obligation to make a future exchange, including interest rate and currency swaps, interest rate caps, collars and floors, loan commitments[75], and letters of credit. An interest rate swap contract may be viewed as a variation of a forward contract in which the parties agree to make a series of future exchanges of cash amounts, one

[74] This is true of most, but not all derivatives, e.g. in some cross-currency interest rate swaps principal is exchanged on inception (and re-exchanged on maturity).

[75] Loan commitment is firm commitment of an entity to provide credit under pre-specified terms and conditions.

amount calculated with reference to a floating interest rate and the other with reference to a fixed interest rate. Futures contracts are another variation of forward contracts, differing primarily in that the contracts are standardised and traded on an exchange.

Contracts to Buy or Sell Non-Financial Items

28. Contracts to buy or sell non-financial items do not meet the definition of a financial instrument because the contractual right of one party to receive a non-financial asset or service and the corresponding obligation of the other party do not establish a present right or obligation of either party to receive, deliver or exchange a financial asset. For example, contracts that provide for settlement only by the receipt or delivery of a non-financial item (e.g. an option, futures or forward contract on silver) are not financial instruments. Many commodity contracts are of this type. Some are standardised in form and traded on organised markets in much the same fashion as some derivative financial instruments. For example, a commodity futures contract may be bought and sold readily for cash because it is listed for trading on an exchange and may change hands many times. However, the parties buying and selling the contract are, in effect, trading the underlying commodity. The ability to buy or sell a commodity contract for cash, the ease with which it may be bought or sold and the possibility of negotiating a cash settlement of the obligation to receive or deliver the commodity do not alter the fundamental character of the contract in a way that creates a financial instrument. Nevertheless, some contracts to buy or sell non-financial items that can be settled net or by exchanging financial instruments, or in which the non-financial item is readily convertible to cash, are within the scope of the Standard as if they were financial instruments (see paragraph 4).

29. A contract that involves the receipt or delivery of physical assets does not give rise to a financial asset of one party and a financial liability of the other party unless any corresponding payment is deferred past the date on which the physical assets are transferred. Such is the case with the purchase or sale of goods on trade credit.

30. Some contracts are commodity-linked, but do not involve settlement through the physical receipt or delivery of a commodity. They specify settlement through cash payments that are determined according to a formula in the contract, rather than through payment of fixed amounts. For example, the principal amount of a bond may be calculated by applying the market price of oil prevailing at the maturity of the bond to a fixed quantity of oil. The principal is indexed by reference to a commodity price, but is settled only in cash. Such a contract constitutes a financial instrument.

31. The definition of a financial instrument also encompasses a contract that gives rise to a non-financial asset or non-financial liability in addition to a financial asset or financial liability. Such financial instruments often give one party an option to exchange a financial asset for a non-financial asset. For example, an oil-linked bond may give the holder the right to receive a stream of fixed periodic interest payments and a fixed amount of cash on maturity, with the option to exchange the principal amount for a fixed quantity of oil. The desirability of exercising this option will vary from time to time depending on the fair value of oil relative to the exchange ratio of cash for oil (the exchange price) inherent in the bond. The intentions of the bondholder concerning the exercise of the option do not affect the substance of the component assets. The financial asset of the holder and the financial liability of the issuer make the bond a financial instrument, regardless of the other types of assets and liabilities also created.

Presentation

Liabilities and Equity

32. The issuer of a financial instrument should classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in

accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.

33. When an issuer applies the definitions in paragraph 7 to determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met.

(a) The instrument includes no 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 issuer.

(b) If the instrument will or may be settled in the issuer's own equity instruments, it is

  (i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or

  (ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose the issuer's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the issuer's own equity instruments.

A contractual obligation, including one arising from a derivative financial instrument that will or may result in the future receipt or delivery of the issuer's own equity instruments, but does not meet conditions (a) and (b) above, is not an equity instrument.

No Contractual Obligation to Deliver Cash or Another Financial Asset (paragraph 33(a))

34. A critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of one party to the financial instrument (the issuer) either to deliver cash or another financial asset to the other party (the holder) or to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer. Although the holder of an equity instrument may be entitled to receive a pro rata share of any dividends or other distributions of equity, the issuer does not have a contractual obligation to make such distributions because it cannot be required to deliver cash or another financial asset to another party.

35. The substance of a financial instrument, rather than its legal form, governs its classification on the entity's balance sheet. Substance and legal form are commonly consistent, but not always. Some financial instruments take the legal form of equity but are liabilities in substance and others may combine features associated with equity instruments and features associated with financial liabilities. For example:

(a) a preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, is a financial liability.

(b) a financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability. This is so even when the amount of cash or other financial assets is determined on the basis of an index or other item that has the potential to increase or decrease, or when the legal form of the puttable instrument gives the holder a right to a residual interest in the assets of an issuer. The existence of an option for the holder to put the instrument back to the issuer for cash or another financial asset means that the puttable instrument meets the definition of a financial liability. For example, open-ended mutual funds, unit trusts and some

co-operative entities may provide their unitholders or members with a right to redeem their interests in the issuer at any time for cash equal to their proportionate share of the asset value of the issuer. However, classification as a financial liability does not preclude the use of descriptors such as 'net asset value attributable to unitholders' and 'change in net asset value attributable to unitholders' on the face of the financial statements of an entity that has no equity capital (such as some mutual funds and unit trusts, see Illustrative Example 1 of Appendix A) or the use of additional disclosure to show that total members' interests comprise items such as reserves that meet the definition of equity and puttable instruments that do not (see Illustrative Example 2 of Appendix A).

36. If an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability. For example:

(a) a restriction on the ability of an entity to satisfy a contractual obligation, such as lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, does not negate the entity's contractual obligation or the holder's contractual right under the instrument.

(b) a contractual obligation that is conditional on a counterparty exercising its right to redeem is a financial liability because the entity does not have the unconditional right to avoid delivering cash or another financial asset.

37. A financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may establish an obligation indirectly through its terms and conditions. For example:

(a) a financial instrument may contain a non-financial obligation that must be settled if, and only if, the entity fails to make distributions or to redeem the instrument. If the entity can avoid a transfer of cash or another financial asset only by settling the non-financial obligation, the financial instrument is a financial liability.

(b) a financial instrument is a financial liability if it provides that on settlement the entity will deliver either:

   (i) cash or another financial asset; or

   (ii) its own shares whose value is determined to exceed substantially the value of the cash or other financial asset.

   Although the entity does not have an explicit contractual obligation to deliver cash or another financial asset, the value of the share settlement alternative is such that the entity will settle in cash. In any event, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option (see paragraph 53).

38. Preference shares may be issued with various rights. In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability. For example, a preference share that provides for redemption on a specific date or at the option of the holder contains a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share. The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves, does not negate the obligation. An option of the issuer to redeem the shares for cash does not satisfy the definition of a financial liability because the issuer does not have a present obligation to transfer financial assets to the shareholders. In this case, redemption of the shares is solely at the discretion of the issuer. An obligation may arise, however, when the issuer of the shares exercises its option, usually by formally notifying the shareholders of an intention to redeem the shares.

39. When preference shares are non-redeemable, the appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument. When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments. The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:

(a) a history of making distributions;

(b) an intention to make distributions in the future;

(c) a possible negative impact on the price of equity shares of the issuer if distributions are not made (because of restrictions on paying dividends on the equity shares if dividends are not paid on the preference shares);

(d) the amount of the issuer's reserves;

(e) an issuer's expectation of a profit or loss for a period; or

(f) an ability or inability of the issuer to influence the amount of its profit or loss for the period.

40. The contractual right of the holder of a financial instrument (including members' shares in co-operative entities) to request redemption does not, in itself, require that financial instrument to be classified as a financial liability. Rather, the entity must consider all of the terms and conditions of the financial instrument in determining its classification as a financial liability or equity. Those terms and conditions include relevant laws, regulations and the governing rules or bye-laws of the entity in effect at the date of classification, but not expected future amendments to those laws, regulations or bye-laws.

41. Members' shares in co-operative entities that would be classified as equity if the members did not have a right to request redemption are equity if either of the conditions described in paragraphs 42 and 43 is present. Demand deposits, including current accounts, deposit accounts and similar contracts that arise when members act as customers are financial liabilities of the entity.

42. Members' shares are equity if the entity has an unconditional right to refuse redemption of the members' shares.

43. Law, regulation or the governing rules or bye-laws of the entity can impose various types of prohibitions on the redemption of members' shares, *e.g.*, unconditional prohibitions or prohibitions based on liquidity criteria. If redemption is unconditionally prohibited by law, regulation or the governing rules or bye-laws of the entity, members' shares are equity. However, provisions in law, regulation or the governing rules or bye-laws of the entity that prohibit redemption only if conditions — such as liquidity constraints — are met (or are not met) do not result in members' shares being equity.

44. An unconditional prohibition may be absolute, in that all redemptions are prohibited. An unconditional prohibition may be partial, in that it prohibits redemption of members' shares if redemption would cause the number of members' shares or amount of paid-up capital from members' shares to fall below a specified level. Members' shares in excess of the prohibition against redemption are liabilities, unless the entity has the unconditional right to refuse redemption as described in paragraph 42. In some cases, the number of shares or the amount of paid-up capital subject to a redemption prohibition may change from time to time. Such a change in the redemption prohibition leads to a transfer between financial liabilities and equity. In such a case, the entity should disclose separately the amount, timing and reason for the transfer.

45. Equity is the residual interest in the assets after deducting all liabilities. Therefore, at initial recognition, the entity should measure the equity component in the member's shares at the residual

amount after deducting from the total amount of the shares as a whole the value separately determined for its financial liabilities for redemption. The entity measures its financial liability for redemption at fair value. In the case of members' shares with a redemption feature, the fair value of the financial liability for redemption is measured at no less than the maximum amount payable under the redemption provisions of its governing bye-laws or applicable law discounted from the first date that the amount could be required to be paid (see Example 3 of Appendix B).

46. As required by paragraph 71, distributions to holders of equity instruments (net of any income tax benefits) are recognised directly in the revenue reserves and surplus. Interest, dividends and other returns relating to financial instruments classified as financial liabilities are expenses, regardless of whether those amounts paid are legally characterised as dividends, interest or otherwise.

47. Appendix B, which is an integral part of the Standard, illustrates the application of paragraphs 40 to 46.

Settlement in the Entity's Own Equity Instruments (paragraph 33(b))

48. A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. An entity may have a contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instruments to be received or delivered equals the amount of the contractual right or obligation. Such a contractual right or obligation may be for a fixed amount or an amount that fluctuates in part or in full in response to changes in a variable other than the market price of the entity's own equity instruments (e.g. an interest rate, a commodity price or a financial instrument price). Two examples are (a) a contract to deliver as many of the entity's own equity instruments as are equal in value to ₹100, and (b) a contract to deliver as many of the entity's own equity instruments as are equal in value to the value of 100 grams of gold. Such a contract is a financial liability of the entity even though the entity must or can settle it by delivering its own equity instruments. It is not an equity instrument because the entity uses a variable number of its own equity instruments as a means to settle the contract. Accordingly, the contract does not evidence a residual interest in the entity's assets after deducting all of its liabilities.

49. A contract that will be settled by the entity (receiving or) delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument. For example, an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond is an equity instrument. Changes in the fair value of a contract arising from variations in market interest rates that do not affect the amount of cash or other financial assets to be paid or received, or the number of equity instruments to be received or delivered, on settlement of the contract do not preclude the contract from being an equity instrument. Any consideration received (such as the premium received for a written option or warrant on the entity's own shares) is added directly to equity in an appropriate account. Any consideration paid (such as the premium paid for a purchased option) is deducted directly from an appropriate equity account. Changes in the fair value of an equity instrument are not recognised in the financial statements.

50. A contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability for the present value of the redemption amount (for example, for the present value of the forward repurchase price, option exercise price or other redemption amount). This is the case even if the contract itself is an equity instrument. One example is an entity's obligation under a forward contract to purchase its own equity instruments for cash. When the financial liability is recognised initially under AS 30, its fair value (the present value of the redemption amount) is reclassified from equity. Subsequently, the financial liability is measured in

accordance with AS 30. If the contract expires without delivery, the carrying amount of the financial liability is reclassified to equity. An entity's contractual obligation to purchase its own equity instruments gives rise to a financial liability for the present value of the redemption amount even if the obligation to purchase is conditional on the counterparty exercising a right to redeem (eg a written put option that gives the counterparty the right to sell an entity's own equity instruments to the entity for a fixed price).

51. A contract that will be settled by the entity delivering or receiving a fixed number of its own equity instruments in exchange for a variable amount of cash or another financial asset is a financial asset or financial liability. An example is a contract for the entity to deliver 100 of its own equity instruments in return for an amount of cash calculated to equal the value of 100 grams of gold.

52. The following examples illustrate how to classify different types of contracts on an entity's own equity instruments:

(a) A contract that will be settled by the entity receiving or delivering a fixed number of its own shares for no future consideration, or exchanging a fixed number of its own shares for a fixed amount of cash or another financial asset, is an equity instrument. Accordingly, any consideration received or paid for such a contract is added directly to or deducted directly from equity. One example is an issued share option that gives the counterparty a right to buy a fixed number of the entity 's shares for a fixed amount of cash. However, if the contract requires the entity to purchase (redeem) its own shares for cash or another financial asset at a fixed or determinable date or on demand, the entity also recognises a financial liability for the present value of the redemption amount. One example is an entity' s obligation under a forward contract to repurchase a fixed number of its own shares for a fixed amount of cash.

(b) An entity' s obligation to purchase its own shares for cash gives rise to a financial liability for the present value of the redemption amount even if the number of shares that the entity is obliged to repurchase is not fixed or if the obligation is conditional on the counterparty exercising a right to redeem. One example of a conditional obligation is an issued option that requires the entity to repurchase its own shares for cash if the counterparty exercises the option.

(c) A contract that will be settled in cash or another financial asset is a financial asset or financial liability even if the amount of cash or another financial asset that will be received or delivered is based on changes in the market price of the entity's own equity. One example is a net cash-settled share option.

(d) A contract that will be settled in a variable number of the entity's own shares whose value equals a fixed amount or an amount based on changes in an underlying variable (eg a commodity price) is a financial asset or a financial liability. An example is a written option to buy gold that, if exercised, is settled net in the entity's own instruments by the entity delivering as many of those instruments as are equal to the value of the option contract. Such a contract is a financial asset or financial liability even if the underlying variable is the entity's own share price rather than gold. Similarly, a contract that will be settled in a fixed number of the entity's own shares, but the rights attaching to those shares will be varied so that the settlement value equals a fixed amount or an amount based on changes in an underlying variable, is a financial asset or a financial liability.

Contingent Settlement Provisions

53. A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, or the issuer's future revenues, net income or debt-to-equity ratio). The issuer of such an instrument does not have the

unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer unless:

(a) the part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not genuine; or

(b) the issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer.

54. Paragraph 53 requires that if a part of a contingent settlement provision that could require settlement in cash or another financial asset (or in another way that would result in the instrument being a financial liability) is not genuine, the settlement provision does not affect the classification of a financial instrument. Thus, a contract that requires settlement in cash or a variable number of the entity's own shares only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur is an equity instrument. Similarly, settlement in a fixed number of an entity's own shares may be contractually precluded in circumstances that are outside the control of the entity, but if these circumstances have no genuine possibility of occurring, classification as an equity instrument is appropriate.

Settlement Options

55. When a derivative financial instrument gives one party a choice over how it is settled (eg the issuer or the holder can choose settlement net in cash or by exchanging shares for cash), it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument.

56. An example of a derivative financial instrument with a settlement option that is a financial liability is a share option that the issuer can decide to settle net in cash or by exchanging its own shares for cash. Similarly, some contracts to buy or sell a non-financial item in exchange for the entity' s own equity instruments are within the scope of this Standard because they can be settled either by delivery of the non-financial item or net in cash or another financial instrument (see paragraphs 4-6). Such contracts are financial assets or financial liabilities and not equity instruments.

Treatment in Consolidated Financial Statements

57. In consolidated financial statements, an entity presents minority interests - i.e. the interests of other parties in the equity and income of its subsidiaries in accordance with AS 1 (revised)[76], *Presentation of Financial Statements*, and AS 21, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements*[77]. When classifying a financial instrument (or a component of it) in consolidated financial statements, an entity considers all terms and conditions agreed between members of the group and the holders of the instrument in determining whether the group as a whole has an obligation to deliver cash or another financial asset in respect of the instrument or to settle it in a manner that results in liability classification. When a subsidiary in a group issues a financial instrument and a parent or other group entity agrees additional terms directly with the holders of the instrument (e.g. a guarantee), the group may not have discretion over distributions or redemption. Although the subsidiary may appropriately classify the instrument without regard to these additional terms in its individual financial statements, the effect of other agreements between members of the group and the holders of the instrument is considered in order to ensure that consolidated financial statements reflect the contracts and transactions entered into by the group as a

[76] AS 1 is presently under revision.

[77] A limited revision has been made to AS 21 with the issuance of the Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*. Pursuant to the limited revision, the title of AS 21 is also modified.

whole. To the extent that there is such an obligation or settlement provision, the instrument (or the component of it that is subject to the obligation) is classified as a financial liability in consolidated financial statements.

Compound Financial Instruments

(see also Illustrative Examples 3-6 of Appendix A)

58. The issuer of a non-derivative financial instrument should evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components should be classified separately as financial liabilities or equity instruments in accordance with paragraph 32.

59. Paragraph 58 applies only to issuers of non-derivative compound financial instruments. Paragraph 58 does not deal with compound financial instruments from the perspective of holders. Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement* deals with the separation of embedded derivatives from the perspective of holders of compound financial instruments that contain debt and equity features.

60. An entity recognises separately the components of a financial instrument that (a) creates a financial liability of the entity and (b) grants an option to the holder of the instrument to convert it into an equity instrument of the entity. For example, a debenture or similar instrument convertible by the holder into a fixed number of equity shares of the entity is a compound financial instrument. From the perspective of the entity, such an instrument comprises two components: a financial liability (a contractual arrangement to deliver cash or another financial asset) and an equity instrument (a call option granting the holder the right, for a specified period of time, to convert it into a fixed number of equity shares of the entity). The economic effect of issuing such an instrument is substantially the same as issuing simultaneously a debt instrument with an early settlement provision and warrants to purchase equity shares, or issuing a debt instrument with detachable share purchase warrants. Accordingly, in all cases, the entity presents the liability and equity components separately on its balance sheet.

61. Classification of the liability and equity components of a convertible instrument is not revised as a result of a change in the likelihood that a conversion option will be exercised, even when exercise of the option may appear to have become economically advantageous to some holders. Holders may not always act in the way that might be expected because, for example, the tax consequences resulting from conversion may differ among holders. Furthermore, the likelihood of conversion will change from time to time. The entity's contractual obligation to make future payments remains outstanding until it is extinguished through conversion, maturity of the instrument or some other transaction.

62. Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement* deals with the measurement of financial assets and financial liabilities. Equity instruments are instruments that evidence a residual interest in the assets of an entity after deducting all of its liabilities. Therefore, when the initial carrying amount of a compound financial instrument is allocated to its equity and liability components, the equity component is assigned the residual amount after deducting from the fair value of the instrument as a whole the amount separately determined for the liability component. The value of any derivative features (such as a call option) embedded in the compound financial instrument other than the equity component (such as an equity conversion option) is included in the liability component. The sum of the carrying amounts assigned to the liability and equity components on initial recognition is always equal to the fair value that would be ascribed to the instrument as a whole. No gain or loss arises from initially recognising the components of the instrument separately.

63. A common form of compound financial instrument is a debt instrument with an embedded conversion option, such as a debenture convertible into equity shares of the issuer, and without any other embedded derivative features. Paragraph 58 requires the issuer of such a financial instrument to present the liability component and the equity component separately on the balance sheet, as follows:

(a) The issuer's obligation to make scheduled payments of interest and principal is a financial liability that exists as long as the instrument is not converted. Accordingly, the issuer of a debenture convertible into equity shares first determines the carrying amount of the liability component by measuring the fair value of a similar liability (including any embedded non-equity derivative features) that does not have an associated equity component. Thus, on initial recognition, the fair value of the liability component is the present value of the contractually determined stream of future cash flows discounted at the rate of interest applied at that time by the market to instruments of comparable credit status and providing substantially the same cash flows, on the same terms, but without the conversion option.

(b) The equity instrument is an embedded option to convert the liability into equity of the issuer. The fair value of the option comprises its time value and its intrinsic value, if any. This option has value on initial recognition even when it is out of the money. The carrying amount of the equity instrument represented by such option is determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole.

64. On conversion of a convertible instrument at maturity, the entity derecognises the liability component and recognises it as equity. The original equity component remains as equity (although it may be transferred from one line item within equity to another). There is no gain or loss on conversion at maturity.

65. When an entity extinguishes a convertible instrument before maturity through an early redemption or repurchase in which the original conversion privileges are unchanged, the entity allocates the consideration paid and any transaction costs for the repurchase or redemption to the liability and equity components of the instrument at the date of the transaction. The method used in allocating the consideration paid and transaction costs to the separate components is consistent with that used in the original allocation to the separate components of the proceeds received by the entity when the convertible instrument was issued, in accordance with paragraphs 58-63.

66. Once the allocation of the consideration is made, any resulting gain or loss is treated in accordance with accounting principles applicable to the related component, as follows:

(a) the amount of gain or loss relating to the liability component is recognised in the statement of profit and loss; and

(b) the amount of consideration relating to the equity component is adjusted in equity against the original equity component and the balance, if any, against the reserves and surplus.

67. An entity may amend the terms of a convertible instrument to induce early conversion, for example by offering a more favourable conversion ratio or paying other additional consideration in the event of conversion before a specified date. The difference, at the date the terms are amended, between the fair value of the consideration the holder receives on conversion of the instrument under the revised terms and the fair value of the consideration the holder would have received under the original terms is recognised as a loss in the statement of profit and loss.

Treasury shares

68. If an entity reacquires its own equity instruments, those instruments ('treasury shares') should be deducted from equity. No gain or loss should be recognised in statement of profit and 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 should be recognised directly in equity.

69. The amount of treasury shares held is disclosed separately either on the face of the balance sheet or in the notes, in accordance with AS 1[78] (Revised), *Presentation of Financial Statements*. An entity provides disclosure in accordance with AS 18, *Related Party Disclosures,* if the entity reacquires its own equity instruments from related parties.

70. An entity's own equity instruments are not recognised as a financial asset regardless of the reason for which they are reacquired. Paragraph 68 requires an entity that reacquires its own equity instruments to deduct those equity instruments from equity. However, when an entity holds its own equity on behalf of others, eg, a financial institution holding its own equity on behalf of a client, there is an agency relationship and as a result those holdings are not included in the entity's balance sheet.

Interest, Dividends, Losses and Gains

71. *Interest, dividends, losses and gains relating to a financial instrument or a component of financial instrument that is a financial liability should be recognised as income or expense in the statement of profit and loss. Distributions to holders of an equity instrument should be debited by the entity directly to an appropriate equity account, net of any related income tax benefit. Transaction costs of an equity transaction should be accounted for as a deduction from equity net of any related income tax benefit.*

72. The classification of a financial instrument as a financial liability or an equity instrument determines whether interest, dividends, losses and gains relating to that instrument are recognised as expense or income in the statement of profit and loss or are recognised directly in the revenue reserves and surplus. Thus, dividend payments on shares wholly recognised as liabilities are recognised as expenses in the same way as interest on a bond/ debenture. Similarly, gains and losses associated with redemptions or refinancings of financial liabilities are recognised in the statement of profit and loss, whereas redemptions or refinancings of equity instruments are recognised as changes in equity. Changes in the fair value of an equity instrument are not recognised in the financial statements.

73. An entity typically incurs various costs in issuing or acquiring its own equity instruments. Those costs might include regulatory fees, amounts paid to legal, accounting and other professional advisers, printing costs and stamp duties. The transaction costs (net of any related income tax benefit) of an equity transaction are recognised directly in the appropriate equity account to the extent they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided. The costs of an equity transaction that is abandoned are recognised as an expense.

74. Transaction costs that relate to the issue of a compound financial instrument are allocated to the liability and equity components of the instrument in proportion to the allocation of proceeds. Transaction costs that relate jointly to more than one transaction are allocated to those transactions using a basis of allocation that is rational and consistent with similar transactions.

75. The amount of transaction costs recognised in the revenue reserves and surplus is disclosed separately under AS 1 (revised)[79].

76. The following example illustrates the application of paragraph 71 to a compound financial instrument. Assume that a non-cumulative preference share is mandatorily redeemable for cash in five years, but that dividends are payable at the discretion of the entity before the redemption date. Such an instrument is a compound financial instrument, with the liability component being the present value

[78] See footnote 13.
[79] See footnote 13.

of the redemption amount. The unwinding of the discount on this component is recognised in statement of profit and loss and classified as interest expense. Any dividends paid relate to the equity component and, accordingly, are recognised directly in the revenue reserves and surplus. A similar treatment would apply if the redemption was not mandatory but at the option of the holder, or if the share was mandatorily convertible into a variable number of equity shares calculated to equal a fixed amount or an amount based on changes in an underlying variable (e.g., commodity). However, if any unpaid dividends are added to the redemption amount, the entire instrument is a liability. In such a case, any dividends are classified as interest expense.

77. Dividends classified as an expense are presented in the statement of profit and loss as a separate item. In addition to the requirements of this Standard, disclosure of interest and dividends is subject to the requirements of AS 1 (revised)[80] and Accounting Standard (AS) 32, *Financial Instruments: Disclosures*[81].

78. Gains and losses related to changes in the carrying amount of a financial liability are recognised as income or expense in the statement of profit and loss even when they relate to an instrument that includes a right to the residual interest in the assets of the entity in exchange for cash or another financial asset (see paragraph 35(b)). Under AS 1 (revised)[82], the entity presents any gain or loss arising from remeasurement of such an instrument separately on the face of the statement of profit and loss when it is relevant in explaining the entity's performance.

Offsetting a Financial Asset and a Financial Liability

79. A financial asset and a financial liability should be offset and the net amount presented in the balance sheet when, and only when, an entity:

(a) currently has a legally enforceable right to set off the recognised amounts; and
(b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

In accounting for a transfer of a financial asset that does not qualify for derecognition, the entity should not offset the transferred asset and the associated liability (see Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement).

80. This Standard requires the presentation of financial assets and financial liabilities on a net basis when doing so reflects an entity's expected future cash flows from settling two or more separate financial instruments. When an entity has the right to receive or pay a single net amount and intends to do so, it has, in effect, only a single financial asset or financial liability. In other circumstances, financial assets and financial liabilities are presented separately from each other consistently with their characteristics as resources or obligations of the entity.

81. Offsetting a recognised financial asset and a recognised financial liability and presenting the net amount differs from the derecognition of a financial asset or a financial liability. Although offsetting does not give rise to recognition of a gain or loss, the derecognition of a financial instrument not only results in the removal of the previously recognised item from the balance sheet but also may result in recognition of a gain or loss.

82. A right of set-off is a debtor's legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor. In unusual circumstances, a debtor may have a legal right to apply an amount due from a third

[80] See footnote 13.
[81] See footnote 4.
[82] See footnote 13.

party against the amount due to a creditor provided that there is an agreement between the three parties that clearly establishes the debtor's right of set-off. Because the right of set-off is a legal right, the conditions supporting the right may vary from one legal jurisdiction to another and the laws applicable to the relationships between the parties need to be considered.

83. The existence of an enforceable right to set off a financial asset and a financial liability affects the rights and obligations associated with a financial asset and a financial liability and may affect an entity's exposure to credit and liquidity risk. However, the existence of the right, by itself, is not a sufficient basis for offsetting. In the absence of an intention to exercise the right or to settle simultaneously, the amount and timing of an entity's future cash flows are not affected. When an entity intends to exercise the right or to settle simultaneously, presentation of the asset and liability on a net basis reflects more appropriately the amounts and timing of the expected future cash flows, as well as the risks to which those cash flows are exposed. An intention by one or both parties to settle on a net basis without the legal right to do so is not sufficient to justify offsetting because the rights and obligations associated with the individual financial asset and financial liability remain unaltered.

84. An entity's intentions with respect to settlement of particular assets and liabilities may be influenced by its normal business practices, the requirements of the financial markets and other circumstances that may limit the ability to settle net or to settle simultaneously. When an entity has a right of set-off, but does not intend to settle net or to realise the asset and settle the liability simultaneously, the effect of the right on the entity's credit risk exposure is disclosed in accordance with Accounting Standard (AS) 32, *Financial Instruments: Disclosures*[83].

85. Simultaneous settlement of two financial instruments may occur through, for example, the operation of a clearing house in an organised financial market or a face-to-face exchange. In these circumstances the cash flows are, in effect, equivalent to a single net amount and there is no exposure to credit or liquidity risk. In other circumstances, an entity may settle two instruments by receiving and paying separate amounts, becoming exposed to credit risk for the full amount of the asset or liquidity risk for the full amount of the liability. Such risk exposures may be significant even though relatively brief. Accordingly, realisation of a financial asset and settlement of a financial liability are treated as simultaneous only when the transactions occur at the same moment.

86. The conditions set out in paragraph 79 are generally not satisfied and offsetting is usually inappropriate when:

(a) several different financial instruments are used to emulate the features of a single financial instrument (a 'synthetic instrument');

(b) financial assets and financial liabilities arise from financial instruments having the same primary risk exposure (for example, assets and liabilities within a portfolio of forward contracts or other derivative instruments) but involve different counterparties;

(c) financial or other assets are pledged as collateral for non-recourse financial liabilities;

(d) financial assets are set aside in trust by a debtor for the purpose of discharging an obligation without those assets having been accepted by the creditor in settlement of the obligation (for example, a sinking fund arrangement); or

(e) obligations incurred as a result of events giving rise to losses are expected to be recovered from a third party by virtue of a claim made under an insurance contract.

[83]See footnote 4.

87. To offset a financial asset and a financial liability, an entity must have a currently enforceable legal right to set off the recognised amounts. An entity may have a conditional right to set off recognised amounts. An entity that undertakes a number of financial instrument transactions with a single counterparty may enter into a 'master netting arrangement' with that counterparty. Such an agreement provides for a single net settlement of all financial instruments covered by the agreement in the event of default on, or termination of, any one contract. These arrangements are commonly used by financial institutions to provide protection against loss in the event of bankruptcy or other circumstances that result in a counterparty being unable to meet its obligations. A master netting arrangement commonly creates a right of set-off that becomes enforceable and affects the realisation or settlement of individual financial assets and financial liabilities only following a specified event of default or in other circumstances not expected to arise in the normal course of business. A master netting arrangement does not provide a basis for offsetting unless both of the criteria in paragraph 79 are satisfied. When financial assets and financial liabilities subject to a master netting arrangement are not offset, the effect of the arrangement on an entity's exposure to credit risk is disclosed in accordance with Accounting Standard (AS) 32, *Financial Instruments: Disclosures*[84].

88. The Standard does not provide special treatment for so-called 'synthetic instruments', which are groups of separate financial instruments acquired and held to emulate the characteristics of another instrument. For example, a floating rate long-term debt combined with an interest rate swap that involves receiving floating payments and making fixed payments synthesises a fixed rate long-term debt. Each of the individual financial instruments that together constitute a 'synthetic instrument' represents a contractual right or obligation with its own terms and conditions and each may be transferred or settled separately. Each financial instrument is exposed to risks that may differ from the risks to which other financial instruments are exposed. Accordingly, when one financial instrument in a 'synthetic instrument' is an asset and another is a liability, they are not offset and presented on an entity's balance sheet on a net basis unless they meet the criteria for offsetting in paragraph 79.

Appendix A

Illustrative Examples

These examples accompany, but are not part of the Accounting Standard (AS) 31, *Financial Instruments: Presentation*.

Entities such as Mutual Funds and Co-operatives whose Share Capital is not Equity as defined in AS 31

Example 1: Entities with no equity

A1. The following example illustrates a statement of profit and loss and balance sheet format that may be used by entities such as mutual funds that do not have equity as defined in AS 31. Other formats are possible.

Statement of profit and loss for the year ended 31 March 20x6

		20x5-20x6 ₹	*20x4-20x5* ₹
Revenue		2,956	1,718
Expenses (appropriately classified)		(644)	(614)
Profit from operating activities		2,312	1,104
Finance costs -distributions to unitholders		(47)	(47)

[84] See footnote 4.

- other finance costs	(50)	(50)
Change in net assets attributable to unitholders	2,215	1,007

Balance sheet at 31 March 20x6

	₹	*20x5-20x6* Rs	Rs	*20x4-20x5* Rs
ASSETS				
Non-current assets (appropriately classified)	91,374		78,484	
Total non-current assets		91,374		78,484
Current assets (appropriately classified)	1,422		1,769	
Total current assets		1,422		1,769
Total assets		92,796		80,253
LIABILITIES				
Current liabilities (appropriately classified)	647		66	
Total current liabilities		(647)		(66)
Non-current liabilities excluding net assets attributable to unitholders (appropriately classified)	280		136	
		(280)		(136)
Net assets attributable to unitholders		91,869		80,051

Example 2: Entities with some equity

A2. The following example illustrates a statement of profit and loss and balance sheet format that may be used by entities whose share capital is not equity as defined in AS 31, because the entity has an obligation to repay the share capital on demand. Other formats are possible.

Statement of profit and loss for the year ended 31 March 20x6

	20x5-20x6 ₹	*20x4-20x5* ₹
Revenue	472	498
Expenses (appropriately classified)	(367)	(396)
Profit from operating activities	105	102
Finance costs – distributions to members	(50)	(50)
– other finance costs	(4)	(4)
Change in net assets attributable to members	51	48

Balance sheet at 31 March 20x6

	₹	*20x5-20x6* ₹	₹	*20x4-20x5* ₹
ASSETS				
Non-current assets (appropriately classified)	908		830	
Total non-current assets		908		830
Current assets (appropriately classified)	383		350	
Total current assets		383		350
Total assets		1,291		1,180

LIABILITIES				
Current liabilities				
(appropriately classified)	372		338	
Share capital repayable on demand	202		161	
Total current liabilities		(574)		(499)
Total assets less current liabilities		717		681
Non-current liabilities				
(appropriately classified)	187		196	
		187		196
RESERVES[85]				
Reserves e.g. revaluation reserve, retained earnings etc	530		485	
		530		485
		717		681
MEMORANDUM NOTE - TOTAL MEMBERS' INTERESTS				
Share capital repayable on demand		202		161
Reserves		530		485
		732		646

Accounting for Compound Financial Instruments

Example 3: Separation of a compound financial instrument on initial recognition

A3. Paragraph 58 describes how the components of a compound financial instrument are separated by the entity on initial recognition. The following example illustrates how such a separation is made.

A4. An entity issues 2,000 convertible debentures at the start of year 1. The debentures have a three-year term, and are issued at par with a face value of ₹ 1,000 per debenture, giving total proceeds of ₹ 2,000,000. Interest is payable annually in arrears at a nominal annual interest rate of 6 per cent. Each debenture is convertible at any time up to maturity into 250 equity shares. When the debentures are issued, the prevailing market interest rate for similar debt without conversion options is 9 per cent.

A5. The liability component is measured first, and the difference between the proceeds of the debenture issue and the fair value of the liability is assigned to the equity component. The present value of the liability component is calculated using a discount rate of 9 per cent, the market interest rate for similar debentures having no conversion rights, as shown below.

	₹
Present value of the principal - ₹ 2,000,000 payable at the end of three years	1,544,367
Present value of the interest – ₹ 120,000 payable annually in arrears for three years	303,755
Total liability component	1,848,122
Equity component (balancing figure)	151,878
Proceeds of the debenture issue	2,000,000

[85] In this example, the entity has no obligation to deliver a share of its reserves to its members.

Example 4: Separation of a compound financial instrument with multiple embedded derivative features

A6. The following example illustrates the application of paragraph 62 to the separation of the liability and equity components of a compound financial instrument with multiple embedded derivative features.

A7. Assume that the proceeds received on the issue of a callable convertible debenture are ₹ 60. The value of a similar debenture without a call or equity conversion option is ₹ 57. Based on an option pricing model, it is determined that the value to the entity of the embedded call feature in a similar debenture without an equity conversion option is ₹ 2. In this case, the value allocated to the liability component under paragraph 62 is ₹ 55 (₹ 57 – ₹ 2) and the value allocated to the equity component is ₹ 5 (₹ 60 – ₹ 55).

Example 5: Repurchase of a convertible instrument

A8. The following example illustrates how an entity accounts for a repurchase of a convertible instrument. For simplicity, at inception, the face amount of the instrument is assumed to be equal to the aggregate carrying amount of its liability and equity components in the financial statements, i.e. no original issue premium or discount exists. Also, for simplicity, tax considerations have been omitted from the example.

A9. On 1 January 1999, Entity A issued a 10 per cent convertible debenture with a face value of ₹ 1,000 maturing on 31 December 2008. The debenture is convertible into equity shares of Entity A at a conversion price of ₹25 per share. Interest is payable half-yearly in cash. At the date of issue, Entity A could have issued non-convertible debt with a ten-year term bearing a coupon interest rate of 11 per cent.

A10. In the financial statements of Entity A the carrying amount of the debenture was allocated on issue as follows:

	₹
Liability component	
Present value of 20 half-yearly interest payments of ₹ 50, Discounted at 11%	597
Present value of ₹ 1,000 due in 10 years, discounted at 11%, Compounded half-yearly	343
	940
Equity component	
(Difference between ₹ 1,000 total proceeds and ₹ 940 allocated above)	60
Total proceeds	1,000

A11. On 1 January 2004, the convertible debenture has a fair value of ₹ 1,700.

A12. Entity A makes a tender offer to the holder of the debenture to repurchase the debenture for ₹ 1,700, which the holder accepts. At the date of repurchase, Entity A could have issued non-convertible debt with a five-year term bearing a coupon interest rate of 8 per cent.

A13. The repurchase price is allocated as follows:

Liability component:	Carrying Value ₹	Fair Value ₹	Difference ₹
Present value of 10 remaining half-yearly interest Payments of ₹ 50, discounted at 11% and 8%, Respectively	377	405	
Present value of ₹ 1,000 due in 5 years, discounted at 11% and 8%, compounded half-yearly, respectively	585	676	
	962	1,081	(119)

Equity component	60	619[86]	(559)
Total	1,022	1,700	(678)

A14. Entity A recognises the repurchase of the debenture as follows:

Dr	Liability component	₹ 962	
Dr	Debt settlement expense (statement of profit and loss)	₹ 119	
	Cr Cash		₹ 1,081
	To recognise the repurchase of the liability component.		
Dr	Equity component	₹ 60	
Dr.	Reserves and Surplus	₹ 559	
	Cr Cash		₹ 619
	To recognise the cash paid for the equity component.		

Example 6: Amendment of the terms of a convertible instrument to induce early conversion

A15. The following example illustrates how an entity accounts for the additional consideration paid when the terms of a convertible instrument are amended to induce early conversion.

A16. On 1 January 2005, Entity A issued a 10 per cent convertible debenture with a face value of ₹ 1,000 with the same terms as described in Example 5. On 1 January 2006, to induce the holder to convert the convertible debenture promptly, Entity A reduces the conversion price to ₹20 if the debenture is converted before 1 March 2006 (i.e. within 60 days).

A17. Assume the market price of Entity A's equity shares on the date the terms are amended is ₹40 per share. The fair value of the incremental consideration paid by Entity A is calculated as follows:

Number of equity shares to be issued to debenture holders under ***amended*** *conversion terms:*		
Face amount	₹ 1,000	
New conversion price	/₹ 20	per share
Number of equity shares to be issued on conversion	50	shares
Number of equity shares to be issued to debenture holders under ***original*** *conversion terms:*		
Face amount	₹ 1,000	
Original conversion price	/₹25	per share
Number of equity shares issued upon conversion	40	shares
Number of ***incremental*** *equity shares issued upon conversion*	10	Shares
Value of incremental equity shares issued upon conversion		
₹40 per share x 10 incremental shares	₹400	

A18. The incremental consideration of ₹ 400 is recognised as a loss in the statement of profit and loss.

Appendix B

Examples of Application of Paragraphs 40-46

This appendix is an integral part of AS 31.

B1. This appendix sets out seven examples of the application of paragraphs 40-46. The examples do not constitute an exhaustive list; other fact patterns are possible. Each example assumes that there are

[86] This amount represents the difference between the fair value amount allocated to the liability component and the repurchase price of Rs. 1,700.

no conditions other than those set out in the facts of the example that would require the financial instrument to be classified as a financial liability.

Unconditional Right to Refuse Redemption (Paragraph 42)

Example 1

Facts

B2. The governing bye-laws of the entity state that redemptions are made at the sole discretion of the entity. The bye-laws do not provide further elaboration or limitation on that discretion. In its history, the entity has never refused to redeem members' shares, although the governing board of the entity has the right to do so.

Classification

B3. The entity has the unconditional right to refuse redemption and the members' shares are equity. The Standard establishes principles for classification that are based on the terms of the financial instrument and notes that a history of, or intention to make, discretionary payments does not trigger liability classification. Paragraph 39 of the Standard states:

> "When preference shares are non-redeemable, the appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument. When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments. The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:

(a) a history of making distributions;

(b) an intention to make distributions in the future;

(c) a possible negative impact on the price of equity shares of the issuer if distributions are not made (because of restrictions on paying dividends on the equity shares if dividends are not paid on the preference shares);

(d) the amount of the issuer's reserves;

(e) an issuer's expectation of a profit or loss for a period; or

(f) an ability or inability of the issuer to influence the amount of its profit or loss for the period."

Example 2

Facts

B4. The governing bye-laws of the entity state that redemptions are made at the sole discretion of the entity. However, the bye-laws further state that approval of a redemption request is automatic unless the entity is unable to make payments without violating regulations regarding liquidity or reserves.

Classification

B5. The entity does not have the unconditional right to refuse redemption and the members' shares are a financial liability. The restrictions described above are based on the entity's ability to settle its liability. They restrict redemptions only if the liquidity or reserve requirements are not met and then only until such time as they are met. Hence, they do not, under the principles established in the Standard, result in the classification of the financial instrument as equity. Paragraph 38 of the Standard states:

> "Preference shares may be issued with various rights. In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability. For example, a

preference share that provides for redemption on a specific date or at the option of the holder is a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share. *The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves, does not negate the obligation.* [Emphasis added]"

Prohibitions Against Redemption (Paragraphs 43 and 44)

Example 3

Facts

B6. A co-operative entity has issued shares to its members at different dates and for different amounts in the past as follows:

(a) 1 January 20X1: 100,000 shares at ₹ 10 each (₹ 1,000,000);

(b) 1 January 20X2: 100,000 shares at ₹ 20 each (a further ₹ 2,000,000, so that the total for shares issued is ₹ 3,000,000).

Shares are redeemable on demand at the amount for which they were issued.

B7. The governing bye-laws of the entity state that cumulative redemptions cannot exceed 20 per cent of the highest number of its members' shares ever outstanding. At 31 December 20X2, the entity has 200,000 of outstanding shares, which is the highest number of members' shares ever outstanding and no shares have been redeemed in the past. On 1 January 20X3, the entity amends its governing bye-laws and increases the permitted level of cumulative redemptions to 25 per cent of the highest number of its members' shares ever outstanding.

Classification

Before the governing bye-laws are amended

B8. Members' shares in excess of the prohibition against redemption are financial liabilities. The co-operative entity measures this financial liability at fair value at initial recognition. Because these shares are redeemable on demand, the co-operative entity determines the fair value of such financial liabilities as required by paragraph 55 of AS 30, which states: 'The fair value of a financial liability with a demand feature (*e.g.*, a demand deposit) is not less than the amount payable on demand…'. Accordingly, the co-operative entity classifies as financial liabilities the maximum amount payable on demand under the redemption provisions.

B9. On 1 January 20X1, the maximum amount payable under the redemption provisions is 20,000 shares at ₹ 10 each and, accordingly, the entity classifies ₹ 200,000 as financial liability and ₹ 800,000 as equity. However, on 1 January 20X2, because of the new issue of shares at ₹ 20, the maximum amount payable under the redemption provisions increases to 40,000 shares at ₹ 20 each. The issue of additional shares at ₹ 20 creates a new liability that is measured on initial recognition at fair value. The liability after these shares have been issued is 20 per cent of the total shares in issue (200,000), measured at ₹ 20, or ₹ 800,000. This requires recognition of an additional liability of ₹ 600,000. In this example no gain or loss is recognised. Accordingly, the entity now classifies ₹ 800,000 as financial liabilities and ₹ 2,200,000 as equity. This example assumes these amounts are not changed between 1 January 20X1 and 31 December 20X2.

After the governing bye-laws are amended

B10. Following the change in its governing bye-laws, the co-operative entity can now be required to redeem a maximum of 25 per cent of its outstanding shares or a maximum of 50,000 shares at ₹ 20 each. Accordingly, on 1 January 20X3, the co-operative entity classifies as financial liabilities an amount of ₹ 1,000,000 being the maximum amount payable on demand under the redemption provisions, as determined in accordance with paragraph 55 of AS 30. It, therefore, transfers on 1

January 20X3 from equity to financial liabilities an amount of ₹ 200,000, leaving ₹ 2,000,000 classified as equity. In this example, the entity does not recognise a gain or loss on the transfer.

Example 4

Facts

B11. Law governing the operations of co-operatives, or the terms of the governing bye-laws of the entity, prohibit an entity from redeeming members' shares if, by redeeming them, it would reduce paid-in capital from members' shares below 75 per cent of the highest amount of paid-in capital from members' shares. The highest amount for a particular co-operative is ₹ 1,000,000. At the balance sheet date, the balance of paid-in capital is ₹ 900,000.

Classification

B12. In this case, ₹ 750,000 would be classified as equity and ₹ 150,000 would be classified as financial liabilities. In addition to the paragraphs already cited, paragraph 35(b) of the Standard states in part:

> "…a financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability. This is so even when the amount of cash or other financial assets is determined on the basis of an index or other item that has the potential to increase or decrease, or when the legal form of the puttable instrument gives the holder a right to a residual interest in the assets of an issuer. The existence of an option for the holder to put the instrument back to the issuer for cash or another financial asset means that the puttable instrument meets the definition of a financial liability. …"

B13. The redemption prohibition described in this example is different from the restrictions described in paragraphs 36 and 38 of the Standard. Those restrictions are limitations on the ability of the entity to pay the amount due on a financial liability, *i.e.*, they prevent payment of the liability only if specified conditions are met. In contrast, this example describes an unconditional prohibition on redemptions beyond a specified amount, regardless of the entity's ability to redeem members' shares (*e.g.*, given its cash resources, profits or distributable reserves). In effect, the prohibition against redemption prevents the entity from incurring any financial liability to redeem more than a specified amount of paid-up capital. Therefore, the portion of shares subject to the redemption prohibition is not a financial liability. While each member's shares may be redeemable individually, a portion of the total shares outstanding is not redeemable in any circumstances other than liquidation of the entity.

Example 5

Facts

B14. The facts of this example are as stated in example 4. In addition, at the balance sheet date, liquidity requirements imposed in the jurisdiction prevent the entity from redeeming any members' shares unless its holdings of cash and short-term investments are greater than a specified amount. The effect of these liquidity requirements at the balance sheet date is that the entity cannot pay more than ₹ 50,000 to redeem the members' shares.

Classification

B15. As in example 4, the entity classifies ₹ 750,000 as equity and ₹ 150,000 as a financial liability. This is because the amount classified as a liability is based on the entity's unconditional right to refuse redemption and not on conditional restrictions that prevent redemption only if liquidity or other conditions are not met and then only until such time as they are met. The provisions of paragraphs 36 and 38 of the Standard apply in this case.

Example 6

Facts

B16. The governing bye-laws of the entity prohibit it from redeeming members' shares, except to the extent of proceeds received from the issue of additional members' shares to new or existing members

during the preceding three years. Proceeds from issuing members' shares must be applied to redeem shares for which members have requested redemption. During the three preceding years, the proceeds from issuing members' shares have been ₹ 12,000 and no member's shares have been redeemed.

Classification

B17. The entity classifies ₹ 12,000 of the members' shares as financial liabilities. Consistently with the conclusions described in example 4, members' shares subject to an unconditional prohibition against redemption are not financial liabilities. Such an unconditional prohibition applies to an amount equal to the proceeds of shares issued before the preceding three years, and accordingly, this amount is classified as equity. However, an amount equal to the proceeds from any shares issued in the preceding three years is not subject to an unconditional prohibition on redemption. Accordingly, proceeds from the issue of members' shares in the preceding three years give rise to financial liabilities until they are no longer available for redemption of members' shares. As a result the entity has a financial liability equal to the proceeds of shares issued during the three preceding years, net of any redemptions during that period.

Example 7

Facts

B18. The bye-laws governing the operations of a co-operative entity state that atleast 50 per cent of the entity's total 'outstanding liabilities' (a term defined in the byelaws to include members' share accounts) has to be in the form of members' paid-up capital. The effect of the bye-laws is that if all of a co-operative's outstanding liabilities are in the form of members' shares, it is able to redeem them all. On 31 December 20X1, the entity has total outstanding liabilities of ₹ 200,000, of which ₹ 125,000 represent members' share accounts. The terms of the members' share accounts permit the holder to redeem them on demand and there are no limitations on redemption in the governing byelaws of the entity.

Classification

B19. In this example, members' shares are classified as financial liabilities. The redemption prohibition is similar to the restrictions described in paragraphs 36 and 38 of the Standard. The restriction is a conditional limitation on the ability of the entity to pay the amount due on a financial liability, *i.e.*, they prevent payment of the liability only if specified conditions are met. More specifically, the entity could be required to redeem the entire amount of members' shares (₹ 125,000) if it repaid all of its other liabilities (₹ 75,000). Consequently, the prohibition against redemption does not prevent the entity from incurring a financial liability to redeem more than a specified number of members' shares or amount of paid-in capital. It allows the entity only to defer redemption until a condition is met, i.e., the repayment of other liabilities. Members' shares in this example are not subject to an unconditional prohibition against redemption and are therefore classified as financial liabilities.

Appendix C

Comparison with IAS 32, *Financial Instruments: Presentation*

Note: This Appendix is not a part of Accounting Standard (AS) 31, Financial Instruments: Presentation. The purpose of this appendix is only to bring out the major differences between AS 31 and the corresponding International Accounting Standard (IAS) 32.

Comparison with IAS 32, *Financial Instruments: Presentation*

The Accounting Standard is based on International Accounting Standard (IAS) 32, *Financial Instruments: Presentation* and incorporates IFRIC 2, *Members' Shares in Co-operative Entities and Similar Instruments* (Re. IAS 32, *Financial Instruments: Presentation*), issued by the International Financial Reporting Interpretation Committee (IFRIC) of the International Accounting Standards Board (IASB). There is no major difference between AS 31, and IAS 32 and IFRIC 2.

Accounting Standard (AS) 32
Financial Instruments: Disclosures

*(This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective and the Preface to the Statements of Accounting Standards[87].)*

Accounting Standard (AS) 32, *Financial Instruments: Disclosures*, issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years. This Accounting Standard will become mandatory[88] in respect of accounting periods commencing on or after 1-4-2011 for all commercial, industrial and business entities except to a Small and Medium-sized Entity, as defined below:

(i) Whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

(ii) which is not a bank (including a co-operative bank), financial institution or any entity carrying on insurance business;

(iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;

(iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and

(v) which is not a holding or subsidiary entity of an entity which is not a small and medium-sized entity.

For the above purpose an entity would qualify as a Small and Medium-sized Entity, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

Where in respect of an entity there is a statutory requirement for disclosing any financial instrument in a particular manner as asset, liability or equity and/or for disclosing income, expenses, gains or losses relating to a financial instrument in a particular manner as income/expense or as distribution of profits, the entity should disclose that instrument and/or income, expenses, gains or losses relating to the instrument in accordance with the requirements of the statute governing the entity. Until the relevant statute is amended, the entity disclosing that instrument and/ or income, expenses, gains or losses relating to the instrument in accordance with the requirements thereof will be considered to be complying with this Accounting Standard, in view of paragraph 4.1 of the *Preface to the Statements of Accounting Standards* which recognises that where a requirement of an Accounting Standard is different from the applicable law, the law prevails.

The following is the text of the Accounting Standard.

Objective

1. The objective of this Standard is to require entities to provide disclosures in their financial statements that enable users to evaluate:

[87] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

[88] This implies that, while discharging their attest function, it will be the duty of the members of the Institute to examine whether this Accounting Standard is complied with in the presentation of financial statements covered by their audit. In the event of any deviation from this Accounting Standard, it will be their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviations.

(a) the significance of financial instruments for the entity's financial position and performance; and

(b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.

2. The principles in this Accounting Standard complement the principles for recognising, measuring and presenting financial assets and financial liabilities in Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement* and Accounting Standard (AS) 31, *Financial Instruments: Presentation*.

Scope

3. This Accounting Standard should be applied by all entities to all types of financial instruments, except:

(a) those interests in subsidiaries, associates and joint ventures that are accounted for in accordance with AS 21, Consolidated Financial Statements and Accounting for Investment in Subsidiaries in Separate Financial Statements, AS 23, Accounting for Investments in Associates[89], or AS 27, Financial Reporting of Interests in Joint Ventures. However, in some cases, AS 21, AS 23 or AS 27 permits or requires an entity to account for an interest in a subsidiary, associate or joint venture using Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement; in those cases, entities should apply the disclosure requirements in AS 21, AS 23 or AS 27 in addition to those in this Accounting Standard. Entities should also apply this Accounting Standard to all derivatives linked to interests in subsidiaries, associates or joint ventures unless the derivative meets the definition of an equity instrument in AS 31.

(b) employers' rights and obligations arising from employee benefit plans, to which AS 15, Employee Benefits, applies.

(c) contracts for contingent consideration in a business combination[90]. This exemption applies only to the acquirer.

(d) insurance contracts as defined in Accounting Standard on Insurance Contracts[91]. However, this Accounting Standard applies to derivatives that are embedded in insurance contracts if Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement, requires the entity to account for them separately. Moreover, an issuer should apply this Accounting Standard to financial guarantee contracts if the issuer applies AS 30 in recognising and measuring the contracts, but should apply the Accounting Standard on Insurance Contracts if the issuer elects, in accordance with the Accounting Standard on Insurance Contracts, to apply that Accounting Standard in recognising and measuring them.

(e) financial instruments, contracts and obligations under share-based payment transactions[92] except that this Accounting Standard applies to contracts within the scope of paragraphs 4 to 6 of AS 30.

---

[89] The titles of AS 21 and AS 23 have been changed by making Limited Revisions thereto pursuant to the issuance of AS 30, *Financial Instruments: Recognition and Measurement.*

[90] 'Business combination' is the bringing together of separate entities or businesses into one reporting entity.

At present, Accounting Standard (AS) 14, *Accounting for Amalgamations*, deals with accounting for contingent consideration in an amalgamation, which is a form of business combination.

[91] A separate Accounting Standard on *Insurance Contracts*, which is being formulated, will specify the requirements relating to insurance contracts.

[92] Employee share based payment, which is one of the share-based payment transactions, is accounted for as per the Guidance Note on Accounting for Employee Share-based Payments, issued by the ICAI. Further, some other pronouncements of the ICAI deal with other share-based payments, e.g., AS 10, *Accounting for Fixed Assets*.

4. This Accounting Standard applies to recognised and unrecognised financial instruments. Recognised financial instruments include financial assets and financial liabilities that are within the scope of AS 30. Unrecognised financial instruments include some financial instruments that, although outside the scope of AS 30, are within the scope of this Accounting Standard (such as some loan commitments).

5. This Accounting Standard applies to contracts to buy or sell a non-financial item that are within the scope of AS 30 (see paragraphs 4-6 of AS 30).

Classes of financial instruments and level of disclosure

6. When this Accounting Standard requires disclosures by class of financial instrument, an entity should group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. An entity should provide sufficient information to permit reconciliation to the line items presented in the balance sheet.

Significance of financial instruments for financial position and performance

7. An entity should disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance.

Balance sheet

Categories of financial assets and financial liabilities

8. The carrying amounts of each of the following categories, as defined in AS 30, should be disclosed either on the face of the balance sheet or in the notes:

(a) financial assets at fair value through profit or loss, showing separately (i) those designated as such upon initial recognition and (ii) those classified as held for trading in accordance with AS 30;
(b) held-to-maturity investments;
(c) loans and receivables;
(d) available-for-sale financial assets;
(e) financial liabilities at fair value through profit or loss, showing separately (i) those designated as such upon initial recognition and (ii) those classified as held for trading in accordance with AS 30; and
(f) financial liabilities measured at amortised cost.

Financial assets or financial liabilities at fair value through profit or loss

9. If the entity has designated a loan or receivable (or group of loans or receivables) as at fair value through profit or loss, it should disclose:

(a) the maximum exposure to *credit risk* (see paragraph 36(a)) of the loan or receivable (or group of loans or receivables) at the reporting date.
(b) the amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk.
(c) the amount of change, during the period and cumulatively, in the fair value of the loan or receivable (or group of loans or receivables) that is attributable to changes in the credit risk of the financial asset determined either:
    (i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to *market risk*; or
    (ii) using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset.

Changes in market conditions that give rise to market risk include changes in an observed (benchmark) interest rate, commodity price, foreign exchange rate or index of prices or rates.

(d) the amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the loan or receivable was designated.

10. If the entity has designated a financial liability as at fair value through profit or loss in accordance with paragraph 8.2 of AS 30, it should disclose:

(a) the amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability determined either:

(i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk (See Appendix B, paragraph B4); or

(ii) using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the liability.

Changes in market conditions that give rise to market risk include changes in a benchmark interest rate, the price of another entity's financial instrument, a commodity price, a foreign exchange rate or an index of prices or rates. For contracts that include a unit-linking feature, changes in market conditions include changes in the performance of the related internal or external investment fund.

(b) the difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

11. The entity should disclose:

(a) the methods used to comply with the requirements in paragraphs 9(c) and 10(a).

(b) if the entity believes that the disclosure it has given to comply with the requirements in paragraph 9(c) or 10(a) does not faithfully represent the change in the fair value of the financial asset or financial liability attributable to changes in its credit risk, the reasons for reaching this conclusion and the factors it believes are relevant.

Reclassification

12. If the entity has reclassified a financial asset as one measured:

(a) at cost or amortised cost, rather than at fair value; or

(b) at fair value, rather than at cost or amortised cost,

it should disclose the amount reclassified into and out of each category and the reason for that reclassification (see paragraphs 57-60 of AS 30).

Derecognition

13. An entity may have transferred financial assets in such a way that part or all of the financial assets do not qualify for derecognition (see paragraphs 15-37 of AS 30). The entity should disclose for each class of such financial assets:

(a) the nature of the assets;

(b) the nature of the risks and rewards of ownership to which the entity remains exposed;

(c) when the entity continues to recognise all of the assets, the carrying amounts of the assets and of the associated liabilities; and

(d) when the entity continues to recognise the assets to the extent of its continuing involvement, the total carrying amount of the original assets, the amount of the assets that the entity continues to recognise, and the carrying amount of the associated liabilities.

Collateral

14. An entity should disclose:

(a) the carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities, including amounts that have been reclassified in accordance with paragraphs 37(a) of AS 30; and

(b) the terms and conditions relating to its pledge.

15. When an entity holds collateral (of financial or non-financial assets) and is permitted to sell or repledge the collateral in the absence of default by the owner of the collateral, it should disclose:

(a) the fair value of the collateral held;

(b) the fair value of any such collateral sold or repledged, and whether the entity has an obligation to return it; and

(c) the terms and conditions associated with its use of the collateral.

Allowance account for credit losses

16. When financial assets are impaired by credit losses and the entity records the impairment in a separate account (eg an allowance account used to record individual impairments or a similar account used to record a collective impairment of assets) rather than directly reducing the carrying amount of the asset, it should disclose a reconciliation of changes in that account during the period for each class of financial assets.

Compound financial instruments with multiple embedded derivatives

17. If an entity has issued an instrument that contains both a liability and an equity component (see paragraph 58 of AS 31) and the instrument has multiple embedded derivatives whose values are interdependent (such as a callable convertible debt instrument), it should disclose the existence of those features.

Defaults and breaches

18. For *loans payable* recognised at the reporting date, an entity should disclose:

(a) details of any defaults during the period of principal, interest, sinking fund, or redemption terms of those loans payable;

(b) the carrying amount of the loans payable in default at the reporting date; and

(c) whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue.

19. If, during the period, there were breaches of loan agreement terms other than those described in paragraph 18, an entity should disclose the same information as required by paragraph 18 if those breaches permitted the lender to demand accelerated repayment (unless the breaches were remedied, or the terms of the loan were renegotiated, on or before the reporting date).

Statement of profit and loss and equity

Items of income, expense, gains or losses

20. An entity should disclose the following items of income, expense, gains or losses either on the face of the financial statements or in the notes:

(a) net gains or net losses on:

  (i) financial assets or financial liabilities at fair value through profit or loss, showing separately those on financial assets or financial liabilities designated as such upon initial recognition,

and those on financial assets or financial liabilities that are classified as held for trading in accordance with AS 30;

(ii) available-for-sale financial assets, showing separately the amount of gain or loss recognised directly in equity during the period and the amount removed from equity and recognised in the statement of profit and loss for the period;

(iii) held-to-maturity investments;

(iv) loans and receivables; and

(v) financial liabilities measured at amortised cost.

(b) total interest income and total interest expense (calculated using the effective interest method) for financial assets or financial liabilities that are not at fair value through profit or loss;

(c) fee income and expense (other than amounts included in determining the effective interest rate) arising from:

(i) financial assets or financial liabilities that are not at fair value through profit or loss; and

(ii) trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions;

(d) interest income on impaired financial assets accrued in accordance with paragraph A113 of AS 30; and

(e) the amount of any impairment loss for each class of financial asset.

Other disclosures

Accounting policies

21. In accordance with AS 1, *Presentation of Financial Statements*[93], an entity discloses, in the summary of significant accounting policies, the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements.

Hedge accounting

22. An entity should disclose the following separately for each type of hedge described in AS 30 (i.e. fair value hedges, cash flow hedges, and hedges of net investments in foreign operations):

(a) a description of each type of hedge;

(b) a description of the financial instruments designated as hedging instruments and their fair values at the reporting date; and

(c) the nature of the risks being hedged.

23. For cash flow hedges, an entity should disclose:

(a) the periods when the cash flows are expected to occur and when they are expected to affect profit or loss;

(b) a description of any forecast transaction for which hedge accounting had previously been used, but which is no longer expected to occur;

(c) the amount that was recognised in the appropriate equity account (Hedging Reserve Account) during the period;

(d) the amount that was removed from the appropriate equity account (Hedging Reserve Account) and included in the statement of profit and loss for the period, showing the amount included in each line item in the statement; and the amount that was removed from appropriate equity account (Hedging Reserve Account) during the period and included in the initial cost or other carrying amount of a non-

[93] Revised AS 1 is under preparation.

financial asset or non-financial liability whose acquisition or incurrence was a hedged highly probable forecast transaction.

24. An entity should disclose separately:

(a) in fair value hedges, gains or losses:

(i) on the hedging instrument; and
(ii) on the hedged item attributable to the hedged risk.

(b) the ineffectiveness recognised in the statement of profit and loss that arises from cash flow hedges; and

(c) the ineffectiveness recognised in the statement of profit and loss that arises from hedges of net investments in foreign operations.

Fair value

25. Except as set out in paragraph 29, for each class of financial assets and financial liabilities (see paragraph 6), an entity should disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount.\

26. In disclosing fair values, an entity should group financial assets and financial liabilities into classes, but should offset them only to the extent that their carrying amounts are offset in the balance sheet.

27. An entity should disclose:

(a) the methods and, when a valuation technique is used, the assumptions applied in determining fair values of each class of financial assets or financial liabilities. For example, if applicable, an entity discloses information about the assumptions relating to prepayment rates, rates of estimated credit losses, and interest rates or discount rates.

(b) whether fair values are determined, in whole or in part, directly by reference to published price quotations in an active market or are estimated using a valuation technique (see paragraphs A90 –A99 of AS 30).

(c) whether the fair values recognised or disclosed in the financial statements are determined in whole or in part using a valuation technique based on assumptions that are not supported by prices from observable current market transactions in the same instrument (i.e. without modification or repackaging) and not based on available observable market data. For fair values that are recognised in the financial statements, if changing one or more of those assumptions to reasonably possible alternative assumptions would change fair value significantly, the entity should state this fact and disclose the effect of those changes. For this purpose, significance should be judged with respect to profit or loss, and total assets or total liabilities, or, when changes in fair value are recognised in equity, total equity.

(d) if (c) applies, the total amount of the change in fair value estimated using such a valuation technique that was recognised in the statement of profit and loss during the period.

28. If the market for a financial instrument is not active, an entity establishes its fair value using a valuation technique (see paragraphs A93-A99 of AS 30). Nevertheless, the best evidence of fair value at initial recognition is the transaction price (i.e. the fair value of the consideration given or received), unless conditions described in paragraph A95 of AS 30 are met. It follows that there could be a difference between the fair value at initial recognition and the amount that would be determined at that date using the valuation technique. If such a difference exists, an entity should disclose, by class of financial instrument:

(a) its accounting policy for recognising that difference in the statement of profit and loss to reflect a change in factors (including time) that market participants would consider in setting a price (see paragraph A96 of AS 30); and
(b) the aggregate difference yet to be recognised in the statement of profit and loss at the beginning and end of the period and a reconciliation of changes in the balance of this difference.

29. Disclosures of fair value are not required:

(a) when the carrying amount is a reasonable approximation of fair value, for example, for financial instruments such as short-term trade receivables and payables;
(b) for an investment in equity instruments that do not have a quoted market price in an active market, or derivatives linked to such equity instruments, that is measured at cost in accordance with AS 30 because its fair value cannot be measured reliably; or
(c) for a contract containing a discretionary participation feature (as described in the Accounting Standard on *Insurance Contracts*[94]) if the fair value of that feature cannot be measured reliably.

30. In the cases described in paragraph 29(b) and (c), an entity should disclose information to help users of the financial statements make their own judgments about the extent of possible differences between the carrying amount of those financial assets or financial liabilities and their fair value, including:

(a) the fact that fair value information has not been disclosed for these instruments because their fair value cannot be measured reliably;
(b) a description of the financial instruments, their carrying amount, and an explanation of why fair value cannot be measured reliably;
(c) information about the market for the instruments;
(d) information about whether and how the entity intends to dispose of the financial instruments; and
(e) if financial instruments whose fair value previously could not be reliably measured are derecognised, that fact, their carrying amount at the time of derecognition, and the amount of gain or loss recognised.

Nature and extent of risks arising from financial instruments

31. An entity should disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the reporting date.

32. The disclosures required by paragraphs 33–42 focus on the risks that arise from financial instruments and how they have been managed. These risks typically include, but are not limited to, credit risk, *liquidity risk* and market risk.

Qualitative disclosures

33. For each type of risk arising from financial instruments, an entity should disclose:

(a) the exposures to risk and how they arise;
(b) its objectives, policies and processes for managing the risk and the methods used to measure the risk; and
(c) any changes in (a) or (b) from the previous period.

Quantitative disclosures

34. For each type of risk arising from financial instruments, an entity should disclose:

(a) summary quantitative data about its exposure to that risk at the reporting date. This disclosure should be based on the information provided internally to key management personnel of the entity (as defined

[94] See footnote 5.

in AS 18 *Related Party Disclosures*), for example the entity's board of directors or chief executive officer.

(b) the disclosures required by paragraphs 36–42, to the extent not provided in (a), unless the risk is not material (see AS 1 (Revised)[95] for a discussion of materiality).

(c) Concentrations of risk if not apparent from (a) and (b).

35. If the quantitative data disclosed as at the reporting date are unrepresentative of an entity's exposure to risk during the period, an entity should provide further information that is representative.

Credit risk

36. An entity should disclose by class of financial instrument:

(a) the amount that best represents its maximum exposure to credit risk at the reporting date without taking account of any collateral held or other credit enhancements (eg netting agreements that do not qualify for offset in accordance with AS 31);

(b) in respect of the amount disclosed in (a), a description of collateral held as security and other credit enhancement;

(c) information about the credit quality of financial assets that are neither past due nor impaired; and

(d) the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated.

Financial assets that are either past due or impaired

37. An entity should disclose by class of financial asset:

(a) an analysis of the age of financial assets that are past due as at the reporting date but not impaired;

(b) an analysis of financial assets that are individually determined to be impaired as at the reporting date, including the factors the entity considered in determining that they are impaired; and

(c) for the amounts disclosed in (a) and (b), a description of collateral held by the entity as security and other credit enhancements and, unless impracticable, an estimate of their fair value.

Collateral and other credit enhancements obtained

38. When an entity obtains financial or non-financial assets during the period by taking possession of collateral it holds as security or calling on other credit enhancements (eg guarantees), and such assets meet the recognition criteria in other Standards, an entity should disclose:

(a) the nature and carrying amount of the assets obtained; and

(b) when the assets are not readily convertible into cash, its policies for disposing of such assets or for using them in its operations.

Liquidity risk

39. An entity should disclose:

(a) a maturity analysis for financial liabilities that shows the remaining contractual maturities; and

(b) a description of how it manages the liquidity risk inherent in (a).

Market risk

Sensitivity analysis

40. Unless an entity complies with paragraph 41, it should disclose:

(a) a sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date;

---

[95] See footnote 7.

(b) the methods and assumptions used in preparing the sensitivity analysis; and
(c) changes from the previous period in the methods and assumptions used, and the reasons for such changes.

41. If an entity prepares a sensitivity analysis, such as value-at-risk, that reflects interdependencies between risk variables (eg interest rates and exchange rates) and uses it to manage financial risks, it may use that sensitivity analysis in place of the analysis specified in paragraph 40. The entity should also disclose:

(a) an explanation of the method used in preparing such a sensitivity analysis, and of the main parameters and assumptions underlying the data provided; and

(b) an explanation of the objective of the method used and of limitations that may result in the information not fully reflecting the fair value of the assets and liabilities involved.

Other market risk disclosures

42. When the sensitivity analyses disclosed in accordance with paragraph 40 or 41 are unrepresentative of a risk inherent in a financial instrument (for example because the year-end exposure does not reflect the exposure during the year), the entity should disclose that fact and the reason it believes the sensitivity analyses are unrepresentative.

Appendix A

Defined terms

This appendix is an integral part of AS 32, Financial Instruments: Disclosures.

credit risk

The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

currency risk

The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

interest rate risk

The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

liquidity risk

The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities.

loans payable

Loans payable are financial liabilities, other than short-term trade payables on normal credit terms.

market risk

The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: **currency risk**, **interest rate risk** and **other price risk**.

other price risk

The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from **interest rate risk** or **currency risk**), whether

those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.

past due

A financial asset is past due when a counterparty has failed to make a payment when contractually due.

The following terms are defined in paragraph 8 of AS 30, *Financial Instruments: Recognition and Measurement,* or paragraph 7 of AS 31*, Financial Instruments: Presentation,* and are used in this Standard with the meaning specified in AS 30 and AS 31.

- amortised cost of a financial asset or financial liability
- available-for-sale financial assets
- derecognition
- derivative
- effective interest method
- equity instrument
- fair value
- financial asset
- financial instrument
- financial liability
- financial asset or financial liability at fair value through profit or loss
- financial guarantee contract
- financial asset or financial liability held for trading
- forecast transaction
- hedging instrument
- held-to-maturity investments
- loans and receivables
- regular way purchase or sale

Appendix B

Application guidance

This appendix is an integral part of AS 32, Financial Instruments: Disclosures

Classes of financial instruments and level of disclosure (paragraph 6)

B1 Paragraph 6 requires an entity to group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. The classes described in paragraph 6 are determined by the entity and are, thus, distinct from the categories of financial instruments specified in AS 30 (which determine how financial instruments are measured and where changes in fair value are recognised).

B2 In determining classes of financial instrument, an entity should, at a minimum:

(a) distinguish instruments measured at amortised cost from those measured at fair value.
(b) treat as a separate class or classes those financial instruments outside the scope of this AS.

B3 An entity decides, in the light of its circumstances, how much detail it provides to satisfy the requirements of this AS, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information with different characteristics. It is necessary to strike a balance between overburdening financial statements with excessive detail that may not assist users of financial statements and obscuring important information

as a result of too much aggregation. For example, an entity should not obscure important information by including it among a large amount of insignificant detail. Similarly, an entity should not disclose information that is so aggregated that it obscures important differences between individual transactions or associated risks.

Significance of financial instruments for financial position and performance

Financial liabilities at fair value through profit or loss (paragraphs 10 and 11)

B4 If an entity designates a financial liability as at fair value through profit or loss, paragraph 10(a) requires it to disclose the amount of change in the fair value of the financial liability that is attributable to changes in the liability's credit risk. Paragraph 10(a)(i) permits an entity to determine this amount as the amount of change in the liability's fair value that is not attributable to changes in market conditions that give rise to market risk. If the only relevant changes in market conditions for a liability are changes in an observed (benchmark) interest rate, this amount can be estimated as follows:

(a) First, the entity computes the liability's internal rate of return at the start of the period using the observed market price of the liability and the liability's contractual cash flows at the start of the period. It deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return.

(b) Next, the entity calculates the present value of the cash flows associated with the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period and (ii) the instrument-specific component of the internal rate of return as determined in (a).

(c) The difference between the observed market price of the liability at the end of the period and the amount determined in (b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be disclosed.

This example assumes that changes in fair value arising from factors other than changes in the instrument's credit risk or changes in interest rates are not significant. If the instrument in the example contains an embedded derivative, the change in fair value of the embedded derivative is excluded in determining the amount to be disclosed in accordance with paragraph 10(a).

Other disclosure – accounting policies (paragraph 21)

B5 Paragraph 21 requires disclosure of the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements. For financial instruments, such disclosure may include:

(a) for financial assets or financial liabilities designated as at fair value through profit or loss:

  (i) the nature of the financial assets or financial liabilities the entity has designated as at fair value through profit or loss;

  (ii) the criteria for so designating such financial assets or financial liabilities on initial recognition; and

  (iii) how the entity has satisfied the conditions in paragraphs 8, 11 or 12 of AS 30 for such designation. For instruments designated in accordance with paragraph 8.2 (b)(i) of the definition of a financial asset or financial liability at fair value through profit or loss in AS 30, that disclosure includes a narrative description of the circumstances underlying the measurement or recognition inconsistency that would otherwise arise. For instruments designated in accordance with paragraph 8.2 (b)(ii) of the definition of a financial asset or financial liability at fair value through profit or loss in AS 30, that disclosure includes a

narrative description of how designation at fair value through profit or loss is consistent with the entity's documented risk management or investment strategy.

(b) the criteria for designating financial assets as available for sale.

(c) whether regular way purchases and sales of financial assets are accounted for at trade date or at settlement date (see paragraph 38 of AS 30).

(d) when an allowance account is used to reduce the carrying amount of financial assets impaired by credit losses:

  (i) the criteria for determining when the carrying amount of impaired financial assets is reduced directly (or, in the case of a reversal of a write-down, increased directly) and when the allowance account is used; and

  (ii) the criteria for writing off amounts charged to the allowance account against the carrying amount of impaired financial assets (see paragraph 16).

(e) how net gains or net losses on each category of financial instrument are determined (see paragraph 20(a)), for example, whether the net gains or net losses on items at fair value through profit or loss include interest or dividend income.

(f) the criteria the entity uses to determine that there is objective evidence that an impairment loss has occurred (see paragraph 20(e)).

(g) when the terms of financial assets that would otherwise be past due or impaired have been renegotiated, the accounting policy for financial assets that are the subject of renegotiated terms (see paragraph 36(d)).

AS 1 (Revised)[96], also requires entities to disclose, in the summary of significant accounting policies or other notes, the judgments, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

Nature and extent of risks arising from financial instruments (paragraphs 31–42)

B6 The disclosures required by paragraphs 31–42 should be either given in the financial statements or incorporated by cross-reference from the financial statements to some other statement, such as a management commentary or risk report, that is available to users of the financial statements on the same terms as the financial statements and at the same time. Without the information incorporated by cross-reference, the financial statements are incomplete.

Quantitative disclosures (paragraph 34)

B7 Paragraph 34(a) requires disclosures of summary quantitative data about an entity's exposure to risks based on the information provided internally to key management personnel of the entity. When an entity uses several methods to manage a risk exposure, the entity should disclose information using the method or methods that provide the most relevant and reliable information. AS 5*, Accounting Policies, Changes in Accounting Estimates and Errors,*[97] discusses relevance and reliability.

B8 Paragraph 34(c) requires disclosures about concentrations of risk. Concentrations of risk arise from financial instruments that have similar characteristics and are affected similarly by changes in economic or other conditions. The identification of concentrations of risk requires judgement taking into account the circumstances of the entity. Disclosure of concentrations of risk should include:

(a) a description of how management determines concentrations;

[96] See footnote 7.

[97] The revised Standard is under preparation.

(b) a description of the shared characteristic that identifies each concentration (eg counterparty, geographical area, currency or market); and
(c) the amount of the risk exposure associated with all financial instruments sharing that characteristic.

Maximum credit risk exposure (paragraph 36(a))

B9 Paragraph 36(a) requires disclosure of the amount that best represents the entity's maximum exposure to credit risk. For a financial asset, this is typically the gross carrying amount, net of:

(a) any amounts offset in accordance with AS 31; and
(b) any impairment losses recognised in accordance with AS 30.

B10 Activities that give rise to credit risk and the associated maximum exposure to credit risk include, but are not limited to:

(a) granting loans and receivables to customers and placing deposits with other entities. In these cases, the maximum exposure to credit risk is the carrying amount of the related financial assets.
(b) entering into derivative contracts, eg foreign exchange contracts, interest rate swaps and credit derivatives. When the resulting asset is measured at fair value, the maximum exposure to credit risk at the reporting date will equal the carrying amount.
(c) granting financial guarantees. In this case, the maximum exposure to credit risk is the maximum amount the entity could have to pay if the guarantee is called on, which may be significantly greater than the amount recognised as a liability.
(d) making a loan commitment that is irrevocable over the life of the facility or is revocable only in response to a material adverse change. If the issuer cannot settle the loan commitment net in cash or another financial instrument, the maximum credit exposure is the full amount of the commitment. This is because it is uncertain whether the amount of any undrawn portion may be drawn upon in the future. This may be significantly greater than the amount recognised as a liability.

Contractual maturity analysis (paragraph 39(a))

B11 In preparing the contractual maturity analysis for financial liabilities required by paragraph 39(a), an entity uses its judgement to determine an appropriate number of time bands. For example, an entity might determine that the following time bands are appropriate:

(a) not later than one month;
(b) later than one month and not later than three months;
(c) later than three months and not later than one year; and
(d) later than one year and not later than five years.

B12 When a counterparty has a choice of when an amount is paid, the liability is included on the basis of the earliest date on which the entity can be required to pay. For example, financial liabilities that an entity can be required to repay on demand (eg demand deposits) are included in the earliest time band.

B13 When an entity is committed to make amounts available in instalments, each instalment is allocated to the earliest period in which the entity can be required to pay. For example, an undrawn loan commitment is included in the time band containing the earliest date it can be drawn down.

B14 The amounts disclosed in the maturity analysis are the contractual undiscounted cash flows, for example:

(a) gross finance lease obligations (before deducting finance charges);
(b) prices specified in forward agreements to purchase financial assets for cash;
(c) net amounts for pay-floating/receive-fixed interest rate swaps for which net cash flows are exchanged;
(d) contractual amounts to be exchanged in a derivative financial instrument (eg a currency swap) for which gross cash flows are exchanged; and
(e) gross loan commitments.

Such undiscounted cash flows differ from the amount included in the balance sheet because the balance sheet amount is based on discounted cash flows.

B15 If appropriate, an entity should disclose the analysis of derivative financial instruments separately from that of non-derivative financial instruments in the contractual maturity analysis for financial liabilities required by paragraph 39(a). For example, it would be appropriate to distinguish cash flows from derivative financial instruments and non-derivative financial instruments if the cash flows arising from the derivative financial instruments are settled gross. This is because the gross cash outflow may be accompanied by a related inflow.

B16 When the amount payable is not fixed, the amount disclosed is determined by reference to the conditions existing at the reporting date. For example, when the amount payable varies with changes in an index, the amount disclosed may be based on the level of the index at the reporting date.

Market risk – sensitivity analysis (paragraphs 40 and 41)

B17 Paragraph 40(a) requires a sensitivity analysis for each type of market risk to which the entity is exposed. In accordance with paragraph B3, an entity decides how it aggregates information to display the overall picture without combining information with different characteristics about exposures to risks from significantly different economic environments. For example:

(a) an entity that trades financial instruments might disclose this information separately for financial instruments held for trading and those not held for trading.
(b) an entity would not aggregate its exposure to market risks from areas of hyperinflation with its exposure to the same market risks from areas of very low inflation.

If an entity has exposure to only one type of market risk in only one economic environment, it would not show disaggregated information.

B18 Paragraph 40(a) requires the sensitivity analysis to show the effect on profit or loss and equity of reasonably possible changes in the relevant risk variable (eg prevailing market interest rates, currency rates, equity prices or commodity prices). For this purpose:

(a) entities are not required to determine what the profit or loss for the period would have been if relevant risk variables had been different. Instead, entities disclose the effect on profit or loss and equity at the balance sheet date assuming that a reasonably possible change in the relevant risk variable had occurred at the balance sheet date and had been applied to the risk exposures in existence at that date. For example, if an entity has a floating rate liability at the end of the year, the entity would disclose the effect on profit or loss (i.e. interest expense) for the current year if interest rates had varied by reasonably possible amounts.
(b) entities are not required to disclose the effect on profit or loss and equity for each change within a range of reasonably possible changes of the relevant risk variable. Disclosure of the effects of the changes at the limits of the reasonably possible range would be sufficient.

B19 In determining what a reasonably possible change in the relevant risk variable is, an entity should consider:

(a) the economic environments in which it operates. A reasonably possible change should not include remote or 'worst case' scenarios or 'stress tests'. Moreover, if the rate of change in the underlying risk variable is stable, the entity need not alter the chosen reasonably possible change in the risk variable. For example, assume that interest rates are 5 per cent and an entity determines that a fluctuation in interest rates of ±50 basis points is reasonably possible. It would disclose the effect on profit or loss and equity if interest rates were to change to 4.5 per cent or 5.5 per cent. In the next period, interest rates have increased to 5.5 per cent. The entity continues to believe that interest rates may fluctuate by

±50 basis points (i.e. that the rate of change in interest rates is stable). The entity would disclose the effect on profit or loss and equity if interest rates were to change to 5 per cent or 6 per cent. The entity would not be required to revise its assessment that interest rates might reasonably fluctuate by ±50 basis points, unless there is evidence that interest rates have become significantly more volatile.

(b) the time frame over which it is making the assessment. The sensitivity analysis should show the effects of changes that are considered to be reasonably possible over the period until the entity will next present these disclosures, which is usually its next annual reporting period.

B20 Paragraph 41 permits an entity to use a sensitivity analysis that reflects interdependencies between risk variables, such as a value-at-risk methodology, if it uses this analysis to manage its exposure to financial risks. This applies even if such a methodology measures only the potential for loss and does not measure the potential for gain. Such an entity might comply with paragraph 41(a) by disclosing the type of value-at-risk model used (eg whether the model relies on Monte Carlo simulations), an explanation about how the model works and the main assumptions (eg the holding period and confidence level). Entities might also disclose the historical observation period and weightings applied to observations within that period, an explanation of how options are dealt with in the calculations, and which volatilities and correlations (or, alternatively, Monte Carlo probability distribution simulations) are used.

B21 An entity should provide sensitivity analyses for the whole of its business, but may provide different types of sensitivity analysis for different classes of financial instruments.

Interest rate risk

B22 *Interest rate risk* arises on interest-bearing financial instruments recognised in the balance sheet (eg loans and receivables and debt instruments issued) and on some financial instruments not recognised in the balance sheet (eg some loan commitments).

Currency risk

B23 *Currency risk* (or foreign exchange risk) arises on financial instruments that are denominated in a foreign currency, i.e. in a currency other than the functional currency[98] in which they are measured. For the purpose of this Standard, currency risk does not arise from financial instruments that are non-monetary items or from financial instruments denominated in the functional currency.

B24 A sensitivity analysis is disclosed for each currency to which an entity has significant exposure.

Other price risk

B25 *Other price risk* arises on financial instruments because of changes in, for example, commodity prices or equity prices. To comply with paragraph 40, an entity might disclose the effect of a decrease in a specified stock market index, commodity price, or other risk variable. For example, if an entity gives residual value guarantees that are financial instruments, the entity discloses an increase or decrease in the value of the assets to which the guarantee applies.

B26 Two examples of financial instruments that give rise to equity price risk are a holding of equities in another entity, and an investment in a trust, which in turn holds investments in equity instruments. Other examples include forward contracts and options to buy or sell specified quantities of an equity instrument and swaps that are indexed to equity prices. The fair values of such financial instruments are affected by changes in the market price of the underlying equity instruments.

[98] See paragraph 8.16 of AS 30 for definition of 'Functional Currency'.

B27 In accordance with paragraph 40(a), the sensitivity of profit or loss (that arises, for example, from instruments classified as at fair value through profit or loss and impairments of available-for-sale financial assets) is disclosed separately from the sensitivity of equity (that arises, for example, from instruments classified as available for sale).

B28 Financial instruments that an entity classifies as equity instruments are not remeasured. Neither profit or loss nor equity will be affected by the equity price risk of those instruments. Accordingly, no sensitivity analysis is required.

Appendix C

Comparison with IFRS 7, *Financial Instruments: Disclosures*

Note: This Appendix is not a part of the Accounting Standard (AS) 32. The purpose of this appendix is only to bring out the differences between Accounting Standard (AS) 32 and the corresponding International Financial Reporting Standard (IFRS) 7.

Comparison with IFRS 7, *Financial Instruments: Disclosures*

This Accounting Standard is based on International Financial Reporting Standard (IFRS) 7, *Financial Instruments: Disclosures* issued by the International Accounting Standards Board (IASB). There is no material difference between AS 32 and IFRS 7.

Appendix D

GUIDANCE ON IMPLEMENTING AS 32, *FINANCIAL INSTRUMENTS: DISCLOSURES*

Guidance on implementing
AS 32, *Financial Instruments: Disclosures*

This Appendix is not part of AS 32.

Introduction

IG1 This guidance suggests possible ways to apply some of the disclosure requirements in AS 32. The guidance does not create additional requirements.

IG2 For convenience, each disclosure requirement in the AS is discussed separately. In practice, disclosures would normally be presented as an integrated package and individual disclosures might satisfy more than one requirement. For example, information about concentrations of risk might also convey information about exposure to credit or other risk.

Materiality

IG3 Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

IG4 Assessing whether an omission or misstatement could influence economic decisions of users, and so be material, requires consideration of the characteristics of those users. The *Framework for the Preparation and Presentation of Financial Statements* states in paragraph 26 that 'It is assumed that users have a reasonable knowledge of business and economic activities and accounting and study the information with reasonable diligence.' Therefore, the assessment needs to take into account how users with such attributes could reasonably be expected to be influenced in making economic decisions.

Classes of financial instruments and level of disclosure (paragraphs 6 and B1–B3)

IG5 Paragraph B3 states that 'an entity decides in the light of its circumstances how much detail it provides to satisfy the requirements of AS 32, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information with different characteristics.' To satisfy the requirements, an entity may not need to disclose all the information suggested in this guidance.

IG6 AS 1 (Revised)[99] requires an entity to 'provide additional disclosures when compliance with the specific requirements in ASs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.'

Significance of financial instruments for financial position and performance (paragraphs 7–30, B4 and B5)

Financial liabilities at fair value through profit or loss

(paragraphs 10(a)(i) and B4)

IG7 The following example illustrates the calculation that an entity might perform in accordance with paragraph B4 of Appendix B of this AS.

[99] See footnote 7.

IG8 On 1 January 20X1, an entity issues a 10-year bond with a par value of ₹ 150,000 and an annual fixed coupon rate of 8 per cent, which is consistent with market rates for bonds with similar characteristics.

IG9 The entity uses MIBOR as its observable (benchmark) interest rate. At the date of inception of the bond, MIBOR is 5 per cent. At the end of the first year:

(a) MIBOR has decreased to 4.75 per cent.

(b) the fair value for the bond is ₹ 153,811, consistent with an interest rate of 7.6 per cent.[100]

IG10 The entity assumes a flat yield curve, all changes in interest rates result from a parallel shift in the yield curve, and the changes in MIBOR are the only relevant changes in market conditions.

IG11 The entity estimates the amount of change in the fair value of the bond that is not attributable to changes in market conditions that give rise to market risk as follows:

[paragraph B4(a)] First, the entity computes the liability's internal rate of return at the start of the period using the observed market price of the liability and the liability's contractual cash flows at the start of the period. It deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return.	At the start of the period of a 10-year bond with a coupon of 8 per cent, the bond's internal rate of return is 8 per cent. Because the observed (benchmark) interest rate (MIBOR) is 5 per cent, the instrument-specific component of the internal rate of return is 3 per cent.
[paragraph B4(b)] Next, the entity calculates the present value of the cash flows associated with the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period and (ii) the instrument-specific component of the internal rate of return as determined in accordance with paragraph B4(a).	The contractual cash flows of the instrument at the end of the period are: • interest: ₹ 12,000[(a)] per year for each of years 2–10. • principal: ₹ 150,000 in year 10. The discount rate to be used to calculate the present value of the bond is thus 7.75 per cent, which is 4.75 per cent end of period MIBOR rate, plus the 3 per cent instrument-specific component. This gives a present value of ₹ 152,367[(b)].
[paragraph B4(c)] The difference between the observed market price of the liability at the end of the period and the amount determined in accordance with paragraph B4(b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be disclosed.	The market price of the liability at the end of the period is ₹ 153,811.[(c)] Thus, the entity discloses ₹ 1,444, which is ₹ 153,811 – ₹ 152,367 as the increase in fair value of the bond that is not attributable to changes in market conditions that give rise to market risk.
(a) ₹ 150,000 × 8% = ₹ 12,000 (b) PV = [₹ 12,000 × (1 − (1 + 0.0775) $^{-9}$)/0.0775] + ₹ 150,000 × (1 + 0.0775)$^{-9}$ (c) market price = [₹ 12,000 × (1 − (1 + 0.076) $^{-9}$)/0.076] + ₹ 150,000 × (1 + 0.076) $^{-9}$	

[14] This reflects a shift in MIBOR from 5 per cent to 4.75 per cent and a movement of 0.15 per cent which, in the absence of other relevant changes in market conditions, is assumed to reflect changes in credit risk of the instrument.

Defaults and breaches (paragraphs 18 and 19)

IG12 Paragraphs 18 and 19 require disclosures when there are any defaults or breaches of loans payable. Any defaults or breaches may affect the classification of the liability as current or non-current in accordance with AS 1 (Revised)[101].

Total interest expense

(paragraph 20(b))

IG13 The total interest expense disclosed in accordance with paragraph 20(b) is a component of the finance costs, which AS 1 (Revised)[102] requires to be presented separately on the face of the statement of profit and loss. The line item for finance costs may also include amounts associated with non-financial liabilities.

Fair value (paragraph 28)

IG14 The fair value at initial recognition of financial instruments that are not traded in active markets is determined in accordance with paragraph A95 of AS 30. However, when, after initial recognition, an entity will use a valuation technique that incorporates data not obtained from observable markets, there may be a difference between the transaction price at initial recognition and the amount determined at initial recognition using that valuation technique. In these circumstances, the difference will be recognised in the statement of profit and loss in subsequent periods in accordance with AS 30 and the entity's accounting policy. Such recognition reflects changes in factors (including time) that market participants would consider in setting a price (see paragraph A96 of AS 30). Paragraph 28 requires disclosures in these circumstances. An entity might disclose the following to comply with paragraph 28:

Background

On 1 January 20X1 an entity purchases for ₹ 15 crore financial assets that are not traded in an active market. The entity has only one class of such financial assets.

The transaction price of ₹ 15 crore is the fair value at initial recognition.

After initial recognition, the entity will apply a valuation technique to establish the financial assets' fair value. This valuation technique includes variables other than data from observable markets.

At initial recognition, the same valuation technique would have resulted in an amount of ₹ 14 crore, which differs from fair value by ₹ 1 crore.

The entity has existing differences of ₹ 5 crore at 1 January 20X1.

Application of requirements

The entity's 20X2 disclosure would include the following:

Accounting policies

The entity uses the following valuation technique to determine the fair value of financial instruments that are not traded in an active market: [description of technique, not included in this example]. Differences may arise between the fair value at initial recognition (which, in accordance with AS 30, is generally the transaction price) and the amount determined at initial recognition using the valuation technique. Any such differences are [description of the entity's accounting policy].

[101] See footnote 7.
[102] ibid

In the notes to the financial statements

As discussed in note X, the entity uses [name of valuation technique] to measure the fair value of the following financial instruments that are not traded in an active market. However, in accordance with AS 30, the fair value of an instrument at inception is generally the transaction price. If the transaction price differs from the amount determined at inception using the valuation technique, that difference is [description of the entity's accounting policy].

The differences yet to be recognised in the statement of profit and loss are as follows:

	31 Dec X2 ₹ Crore	31 Dec X1 ₹ crore
Balance at beginning of year	5.3	5.0
New transactions	–	1.0
Amounts recognised in the statement of profit and loss during the year	(0.7)	(0.8)
Other increases	–	0.2
Other decreases	(0.1)	(0.1)
Balance at end of year	4.5	5.3

Nature and extent of risks arising from financial instruments
(paragraphs 31–42 and B6–B28)
Qualitative disclosures (paragraph 33)

IG15 The type of qualitative information an entity might disclose to meet the requirements in paragraph 33 includes, but is not limited to, a narrative description of:

(a) the entity's exposures to risk and how they arose. Information about risk exposures might describe exposures both gross and net of risk transfer and other risk-mitigating transactions.

(b) the entity's policies and processes for accepting, measuring, monitoring and controlling risk, which might include:

(i) the structure and organisation of the entity's risk management function(s), including a discussion of independence and accountability;

(ii) the scope and nature of the entity's risk reporting or measurement systems;

(iii) the entity's policies for hedging or mitigating risk, including its policies and procedures for taking collateral; and

(iv) the entity's processes for monitoring the continuing effectiveness of such hedges or mitigating devices.

(c) the entity's policies and procedures for avoiding excessive concentrations of risk.

IG16 Information about the nature and extent of risks arising from financial instruments is more useful if it highlights any relationship between financial instruments that can affect the amount, timing or uncertainty of an entity's future cash flows. The extent to which a risk exposure is altered by such relationships might be apparent to users from the disclosures required by this Standard, but in some cases further disclosures might be useful.

IG17 In accordance with paragraph 33(c), entities disclose any change in the qualitative information from the previous period and explain the reasons for the change. Such changes may result from changes in exposure to risk or from changes in the way those exposures are managed.

Quantitative disclosures (paragraphs 34–42 and B7–B28)

IG18 Paragraph 34 requires disclosure of quantitative data about concentrations of risk. For example, concentrations of credit risk may arise from:

(a) industry sectors. Thus, if an entity's counterparties are concentrated in one or more industry sectors (such as retail or wholesale), it would disclose separately exposure to risks arising from each concentration of counterparties.
(b) credit rating or other measure of credit quality. Thus, if an entity's counterparties are concentrated in one or more credit qualities (such as secured loans or unsecured loans) or in one or more credit ratings (such as investment grade or speculative grade), it would disclose separately exposure to risks arising from each concentration of counterparties.
(c) geographical distribution. Thus, if an entity's counterparties are concentrated in one or more geographical markets (such as Asia or Europe), it would disclose separately exposure to risks arising from each concentration of counterparties.
(d) a limited number of individual counterparties or groups of closely related counterparties.

Similar principles apply to identifying concentrations of other risks, including liquidity risk and market risk. For example, concentrations of liquidity risk may arise from the repayment terms of financial liabilities, sources of borrowing facilities or reliance on a particular market in which to realise liquid assets. Concentrations of foreign exchange risk may arise if an entity has a significant net open position in a single foreign currency, or aggregate net open positions in several currencies that tend to move together.

IG19 In accordance with paragraph B8, disclosure of concentrations of risk includes a description of the shared characteristic that identifies each concentration. For example, the shared characteristic may refer to geographical distribution of counterparties by groups of countries, individual countries or regions within countries.

IG20 When quantitative information at the reporting date is unrepresentative of the entity's exposure to risk during the period, paragraph 35 requires further disclosure. To meet this requirement, an entity might disclose the highest, lowest and average amount of risk to which it was exposed during the period. For example, if an entity typically has a large exposure to a particular currency, but at year-end unwinds the position, the entity might disclose a graph that shows the exposure at various times during the period, or disclose the highest, lowest and average exposures.

Credit risk (paragraphs 36–38, B9 and B10)

IG21 Paragraph 36 requires an entity to disclose information about its exposure to credit risk by class of financial instrument. Financial instruments in the same class share economic characteristics with respect to the risk being disclosed (in this case, credit risk). For example, an entity might determine that residential mortgages, unsecured consumer loans, and commercial loans each have different economic characteristics.

Collateral and other credit enhancements pledged (paragraph 36(b))

IG22 Paragraph 36(b) requires an entity to describe collateral available as security for assets it holds and other credit enhancements obtained. An entity might meet this requirement by disclosing:

(a) the policies and processes for valuing and managing collateral and other credit enhancements obtained;

(b) a description of the main types of collateral and other credit enhancements (examples of the latter being guarantees, credit derivatives, and netting agreements that do not qualify for offset in accordance with AS 31);

(c) the main types of counterparties to collateral and other credit enhancements and their creditworthiness; and

(d) information about risk concentrations within the collateral or other credit enhancements.

Credit quality (paragraph 36(c))

IG23 Paragraph 36(c) requires an entity to disclose information about the credit quality of financial assets with credit risk that are neither past due nor impaired. In doing so, an entity might disclose the following information:

(a) an analysis of credit exposures using an external or internal credit grading system;

(b) the nature of the counterparty;

(c) historical information about counterparty default rates; and

(d) any other information used to assess credit quality.

IG24 When the entity considers external ratings when managing and monitoring credit quality, the entity might disclose information about:

(a) the amounts of credit exposures for each external credit grade;

(b) the rating agencies used;

(c) the amount of an entity's rated and unrated credit exposures; and

(d) the relationship between internal and external ratings.

IG25 When the entity considers internal credit ratings when managing and monitoring credit quality, the entity might disclose information about:

(a) the internal credit ratings process;

(b) the amounts of credit exposures for each internal credit grade; and

(c) the relationship between internal and external ratings.

Financial assets that are either past due or impaired (paragraph 37)

IG26 A financial asset is past due when the counterparty has failed to make a payment when contractually due. As an example, an entity enters into a lending agreement that requires interest to be paid every month. On the first day of the next month, if interest has not been paid, the loan is past due. Past due does not mean that a counterparty will never pay, but it can trigger various actions such as renegotiation, enforcement of covenants, or legal proceedings.

IG27 When the terms and conditions of financial assets that have been classified as past due are renegotiated, the terms and conditions of the new contractual arrangement apply in determining whether the financial asset remains past due.

IG28 Paragraph 37(a) requires an analysis by class of the age of financial assets that are past due but not impaired. An entity uses its judgement to determine an appropriate number of time bands. For example, an entity might determine that the following time bands are appropriate:

(a) not more than three months;

(b) more than three months and not more than six months;

(c) more than six months and not more than one year; and

(d) more than one year.

IG29 Paragraph 37(b) requires an analysis of impaired financial assets by class. This analysis might include:

(a) the carrying amount, before deducting any impairment loss;

(b) the amount of any related impairment loss; and

(c) the nature and fair value of collateral available and other credit enhancements obtained.

Liquidity risk (paragraphs 39 and B11)

Liquidity management (paragraph 39(b))

IG30 If an entity manages liquidity risk on the basis of expected maturity dates, it might disclose a maturity analysis of the expected maturity dates of both financial liabilities and financial assets. If an entity discloses such an expected maturity analysis, it might clarify that expected dates are based on estimates made by management, and explain how the estimates are determined and the principal reasons for differences from the contractual maturity analysis that is required by paragraph 39(a).

IG31 Paragraph 39(b) requires the entity to describe how it manages the liquidity risk inherent in the maturity analysis of financial liabilities required in paragraph 39(a). The factors that the entity might consider in providing this disclosure include, but are not limited to, whether the entity:

(a) expects some of its liabilities to be paid later than the earliest date on which the entity can be required to pay (as may be the case for customer deposits placed with a bank);

(b) expects some of its undrawn loan commitments not to be drawn;

(c) holds financial assets for which there is a liquid market and that are readily saleable to meet liquidity needs;

(d) has committed borrowing facilities (eg commercial paper facilities) or other lines of credit (eg stand-by credit facilities) that it can access to meet liquidity needs;

(e) holds financial assets for which there is not a liquid market, but which are expected to generate cash inflows (principal or interest) that will be available to meet cash outflows on liabilities;

(f) holds deposits at central banks to meet liquidity needs;

(g) has very diverse funding sources; or

(h) has significant concentrations of liquidity risk in either its assets or its funding sources.

Market risk (paragraphs 40–42 and B17–B28)

IG32 Paragraph 40(a) requires a sensitivity analysis for each type of market risk to which the entity is exposed. There are three types of market risk: interest rate risk, currency risk and other price risk. Other price risk may include risks such as equity price risk, commodity price risk, prepayment risk (ie the risk that one party to a financial asset will incur a financial loss because the other party repays earlier or later than expected), and residual value risk (eg a lessor of motor cars that writes residual value guarantees is exposed to residual value risk). Risk variables that are relevant to disclosing market risk include, but are not limited to:

(a) the yield curve of market interest rates. It may be necessary to consider both parallel and non-parallel shifts in the yield curve.

(b) foreign exchange rates.

(c) prices of equity instruments.

(d) market prices of commodities.

IG33 Paragraph 40(a) requires the sensitivity analysis to show the effect on profit or loss and equity of reasonably possible changes in the relevant risk variable. For example, relevant risk variables might include:

(a) prevailing market interest rates, for interest-sensitive financial instruments such as a variable-rate loan; or

(b) currency rates and interest rates, for foreign currency financial instruments such as foreign currency bonds.

IG34 For interest rate risk, the sensitivity analysis might show separately the effect of a change in market interest rates on:

(a) interest income and expense;

(b) other line items of the statement of profit and loss (such as trading gains and losses); and

(c) when applicable, equity.

An entity might disclose a sensitivity analysis for interest rate risk for each currency in which the entity has material exposures to interest rate risk.

IG35 Because the factors affecting market risk vary depending on the specific circumstances of each entity, the appropriate range to be considered in providing a sensitivity analysis of market risk varies for each entity and for each type of market risk.

IG36 The following example illustrates the application of the disclosure requirement in paragraph 40(a):

Interest rate risk

At 31 December 20X2, if interest rates at that date had been 10 basis points lower with all other variables held constant, post-tax profit for the year would have been ₹ 1.7 crore (20X1—₹ 2.4 crore) higher, arising mainly as a result of lower interest expense on variable borrowings, and other components of equity would have been ₹ 2.8 crore (20X1—₹ 3.2 crore) higher, arising mainly as a result of an increase in the fair value of fixed rate financial assets classified as available for sale. If interest rates had been 10 basis points higher, with all other variables held constant, post-tax profit would have been ₹ 1.5 crore (20X1—₹ 2.1 crore) lower, arising mainly as a result of higher interest expense on variable borrowings, and other components of equity would have been ₹ 3.0 crore (20X1—₹ 3.4 crore) lower, arising mainly as a result of a decrease in the fair value of fixed rate financial assets classified as available for sale. Profit is more sensitive to interest rate decreases than increases because of borrowings with capped interest rates. The sensitivity is lower in 20X2 than in 20X1 because of a reduction in outstanding borrowings that has occurred as the entity's debt has matured (see note X)[(a)]

Foreign currency exchange rate risk

At 31 December 20X2, if the Rupee had weakened 10 per cent against the US dollar with all other variables held constant, post-tax profit for the year would have been ₹ 2.8 crore (20X1—₹ 6.4 crore) lower, and other components of equity would have been ₹ 1.2 crore (20X1—₹ 1.1 crore) higher.

Conversely, if the Rupee had strengthened 10 per cent against the US dollar with all other variables held constant, post-tax profit would have been ₹ 2.8 crore (20X1—₹ 6.4 crore) higher, and other components of equity would have been ₹ 1.2 crore (20X1—₹ 1.1 crore) lower. The lower foreign currency exchange rate sensitivity in profit in 20X2 compared with 20X1 is attributable to a reduction in foreign currency denominated debt. Equity is more sensitive in 20X2 than in 20X1 because of the increased use of hedges of foreign currency purchases, offset by the reduction in foreign currency debt.

(a) Paragraph 39(a) requires disclosure of a maturity analysis of liabilities.

Other market risk disclosures (paragraph 42)

IG37 Paragraph 42 requires the disclosure of additional information when the sensitivity analysis disclosed is unrepresentative of a risk inherent in a financial instrument. For example, this can occur when:

(a) a financial instrument contains terms and conditions whose effects are not apparent from the sensitivity analysis, eg options that remain out of (or in) the money for the chosen change in the risk variable;

(b) financial assets are illiquid, eg when there is a low volume of transactions in similar assets and an entity finds it difficult to find a counterparty; or

(c) an entity has a large holding of a financial asset that, if sold in its entirety, would be sold at a discount or premium to the quoted market price for a smaller holding.

IG38 In the situation in paragraph IG37(a), additional disclosure might include:

(a) the terms and conditions of the financial instrument (eg the options);

(b) the effect on profit or loss if the term or condition were met (i.e. if the options were exercised); and

(c) a description of how the risk is hedged.

For example, an entity may acquire a zero-cost interest rate collar that includes an out-of-the-money leveraged written option (eg the entity pays ten times the amount of the difference between a specified interest rate floor and the current market interest rate). The entity may regard the collar as an inexpensive economic hedge against a reasonably possible increase in interest rates. However, an unexpectedly large decrease in interest rates might trigger payments under the written option that, because of the leverage, might be significantly larger than the benefit of lower interest rates. Neither the fair value of the collar nor a sensitivity analysis based on reasonably possible changes in market variables would indicate this exposure. In this case, the entity might provide the additional information described above.

IG39 In the situation described in paragraph IG37(b), additional disclosure might include the reasons for the lack of liquidity and how the entity hedges the risk.

IG40 In the situation described in paragraph IG37(c), additional disclosure might include:

(a) the nature of the security (eg entity name);

(b) the extent of holding (eg 15 per cent of the issued shares);

(c) the effect on profit or loss; and

(d) how the entity hedges the risk.

Limited Revision to Accounting Standard (AS) 19 Leases

The following is the text of the limited revision to AS 19, Leases, issued by the Institute of Chartered Accountants of India.

In view of Accounting Standard (AS) 32, *Financial Instruments: Disclosures*, AS 19 is modified as under (modifications are shown as underline/ strike-through):

1. Paragraph 22 is modified as below:

   "22. The lessee should, in addition to the requirements of AS 10, Accounting for Fixed Assets, AS 6, Depreciation Accounting, AS 32, Financial Instruments: Disclosures, and the governing statute, make the following disclosures for finance leases:

   ……."

2. Paragraph 46 is modified as below:

   "46. The lessor should, in addition to the requirements of AS 6, Depreciation Accounting and AS 10, Accounting for Fixed Assets, AS 32, Financial Instruments: Disclosures, and the governing statute, make the following disclosures for operating leases:

   ……."

The limited revision comes into effect in respect of accounting periods commencing on or after the date on which Accounting Standard (AS) 32, *Financial Instruments: Disclosures*, comes into effect.

ANNOUNCEMENT

ACCOUNTING FOR DERIVATIVES

1. Certain issues have been raised with regard to the foreign currency derivative exposures of various corporates that are not being fully accounted for. These exposures may translate into heavy losses due to fluctuations in the foreign exchange rates. The matter was considered by the Council of the ICAI at its meeting held on March 27-29, 2008. The Council decided to clarify the best practice treatment to be followed for all derivatives, which is contained in the following paragraphs.

2. It may be noted that although the ICAI has issued AS 30, *Financial Instruments: Recognition and Measurement*, which contains accounting for derivatives, it becomes recommendatory from 1.04.2009 and mandatory from 1.04.2011. In this scenario, the Council expressed the view that since the aforesaid Standard contains appropriate accounting for derivatives, the same can be followed by the entities, as the earlier adoption of a standard is always encouraged.

3. In case an entity does not follow AS 30, keeping in view the principle of prudence as enunciated in AS 1, 'Disclosure of Accounting Policies', the entity is required to provide for losses in respect of all outstanding derivative contracts at the balance sheet date by marking them to market.

4. The entity needs to disclose the policy followed with regard to accounting for derivatives in its financial statements. In case AS 30 is followed by the entity, a disclosure of the amounts recognised in the financial statements should be made. In case AS 30 is not followed, the losses provided for as suggested in paragraph 3 above should be separately disclosed by the entity.

5. The auditors should consider making appropriate disclosures in their reports if the aforesaid accounting treatment and disclosures are not made.

6. In case of forward contracts to which AS 11, *'The Effects of Changes in Foreign Exchange Rates'*, applies, the entity needs to fully comply with the requirements of AS 11. Accordingly, this Announcement does not apply to such contracts.

7. This Clarificatory Announcement applies to financial statements for the period ending March 31, 2008, or thereafter.