FOR YOUR INFORMATION

INVITATION TO COMMENT ON THE EXPOSURE DRAFT OF AUDITING AND ASSURANCE STANDARD (AAS) ___, THE EXAMINATION OF PROSPECTIVE FINANCIAL INFORMATION[1]

The Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India invites comments on the Exposure Draft of the proposed Auditing and Assurance Standard (AAS) ___, The Examination of Prospective Financial Information.

Comments are most helpful if they indicate the specific paragraph(s) to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing to the Secretary, Auditing and Assurance Standards Board, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002, so as to be received not later than **November 14, 2005.** Comments can also be sent by e-mail at auditing@icai.org.

EXPOSURE DRAFT
AUDITING AND ASSURANCE STANDARD (AAS) _
THE EXAMINATION OF PROSPECTIVE FINANCIAL INFORMATION[1]

The following is the text of the Exposure Draft of the Auditing and Assurance Standard (AAS) ___, "The Examination of Prospective Financial Information", issued by the Institute of Chartered Accountants of India. This Standard should be read in conjunction with the "Preface to the Statements on Standard Auditing Practices" issued by the Institute of Chartered Accountants of India.[2]

INTRODUCTION

1. The purpose of this Auditing and Assurance Standard (AAS) is to establish standards and provide guidance on engagements to examine and report on prospective financial information including examination procedures for best-estimate and hypothetical assumptions. This AAS does not apply to the examination of prospective financial information expressed in general or narrative terms, such as that found in management's discussion and analysis in an entity's annual report, though many of the procedures outlined herein may be suitable for such an examination.[3]

2. **In an engagement to examine prospective financial information, the auditor should obtain sufficient appropriate evidence as to whether:**

(a) management's best-estimate assumptions on which the prospective financial information is based are not unreasonable and, in the case of hypothetical assumptions, such assumptions are consistent with the purpose of the information;

(b) the prospective financial information is properly prepared on the basis of the assumptions;

(c) the prospective financial information is properly presented and all material assumptions are adequately disclosed, including a clear indication as to whether they are best-estimate assumptions or hypothetical assumptions; and

(d) the prospective financial information is prepared on a consistent basis with historical financial statements, using appropriate accounting principles.

1 With the issuance of this Auditing and Assurance Standard, the Guidance Note on Accountant's Report on Profit Forecasts and/or Financial Forecasts shall stand withdrawn.

2 With the formation of the Auditing and Assurance Standards Board {earlier known as the Auditing Practices Committee (APC)}, the Council of the Institute has been issuing a series of Auditing and Assurance Standards (AASs){earlier known as Statements on Standard Auditing Practices (SAPs)}. Auditing and Assurance Standards lay down the principles governing an audit. These principles apply whenever an independent audit is carried out. Auditing and Assurance Standards become mandatory on the date specified in the respective AAS. Their mandatory status implies that, while discharging their attest function, it will be the duty of the members of the Institute to ensure that the AASs are followed in the audit of financial information covered by their audit reports. If, for any reason, a member has not been able to perform an audit in accordance with the AASs, his report should draw attention to the material departures therefrom.

3 The guidance provided in this Standard is in line with the provisions of clause (3) of Part I of the Second Schedule to the Chartered Accountants Act, 1949. This clause provides that a chartered accountant in practice shall be deemed to be guilty of professional misconduct "if he permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that he vouches for the accuracy of the forecast." As per the opinion of the Council while finalising the Guidance Note on Accountant's Report on Profit Forecasts and/or Financial Forecasts at its 100th meeting held on 22nd through 24th July 1982, a chartered accountant can participate in the preparation of profit or financial forecasts and can review them, provided he indicates clearly in his report **the sources of information, the basis of forecasts** and also the **major assumptions** made in arriving at the forecasts and so long as he does not vouch for the accuracy of the forecasts. The Council has further opined that the same opinion would also apply to projections made on the basis of hypothetical assumptions about future events and management actions which are not necessarily expected to take place so long as the auditor does not vouch for the accuracy of the projection. *(emphasis added)*

3. *"Prospective financial information"* means financial information based on assumptions about events that may occur in the future and possible actions by an entity. It is highly subjective in nature and its preparation requires the exercise of considerable judgment. Prospective financial information can be in the form of a forecast, a projection or a combination of both, for example, a one year forecast plus a five year projection.

4. A *"forecast"* means prospective financial information prepared on the basis of assumptions as to future events which management expects to take place and the actions management expects to take as of the date the information is prepared (best-estimate assumptions).

5. A *"projection"* means prospective financial information prepared on the basis of:

(a) hypothetical assumptions about future events and management actions which are not necessarily expected to take place, such as when some entities are in a start-up phase or are considering a major change in the nature of operations; or

(b) a mixture of best-estimate and hypothetical assumptions.

Such information illustrates the possible consequences as of the date the information is prepared if the events and actions were to occur (a "what-if" scenario).

6. Prospective financial information can include financial statements or one or more elements of financial statements and may be prepared:

(a) as an internal management tool, for example, to assist in evaluating a possible capital investment; or

(b) for the distribution/submission to third parties in, for example:

- a prospectus to provide potential investors with information about future expectations.
- an annual report to provide information to shareholders, regulatory bodies and other interested parties.
- a document for the information of lenders which may include, for example, cash flow forecasts.

7. Management is responsible for the preparation and presentation of the prospective financial information, including the identification and disclosure of the underlying assumptions. The auditor may be asked to examine and report on the prospective financial information to enhance its credibility, whether it is intended for use by third parties or for internal purposes.

The Auditor's Assurance Regarding Prospective Financial Information

8. Prospective financial information relates to events and actions that have not yet occurred and may not occur. While evidence may be available to support the assumptions on which the prospective financial information is based, such evidence is itself generally future oriented and, therefore, speculative in nature, as distinct from the evidence ordinarily available in the examination of historical financial information. The auditor is, therefore, not in a position to express an opinion as to whether the results shown in the prospective financial information will be achieved.

9. Further, given the types of evidence available in assessing the assumptions on which the prospective financial information is based, it may be difficult for the auditor to obtain a level of satisfaction sufficient to provide a positive expression of opinion that the assumptions are free of material misstatement. Consequently, in this AAS, when reporting on the reasonableness of management's assumptions, the auditor provides only a moderate level of assurance.

Acceptance of Engagement

10. Before accepting an engagement to examine prospective financial information, the auditor would consider, among other things:

- the intended use of the information.
- whether the information will be for general or limited distribution.
- the nature of the assumptions, that is, whether they are best-estimate or hypothetical assumptions.
- the elements to be included in the information.
- the period covered by the information.
- adequacy of the time available to complete the engagement.
- the economic environment and the industry in which the entity operates.

If the auditor concludes that one or more of these factors is unsatisfactory, consideration needs to be given to the significance of the matters.

11. The auditor should not accept, or should withdraw from, an engagement when the assumptions are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use.

12. In accordance with AAS 26, "Terms of Audit Engagement", it is necessary that the auditor and the client should agree on the terms of the engagement. It is in the interests of both client and auditor that the auditor sends an engagement letter to help in avoiding misunderstandings regarding the engagement. An engagement letter would address the matters in paragraph 10 and set out the management's responsibilities for the assumptions and for providing the auditor with all relevant information and source data used in developing the assumptions.

Knowledge of the Business

13. **The auditor should obtain a sufficient level of knowledge of the business to be able to evaluate whether all significant assumptions required for the preparation of the prospective financial information have been identified.** The auditor would also need to become familiar with the entity's process for preparing prospective financial information, for example, by considering:

(a) the internal controls over the system used to prepare prospective financial information and the expertise and

experience of those persons preparing the prospective financial information.

(b) the nature of the documentation prepared by the entity supporting management's assumptions.

(c) the extent to which statistical, mathematical and computer-assisted techniques are used.

(d) the methods used to develop and apply assumptions.

(e) the accuracy of prospective financial information prepared in prior periods, if any, and the reasons for any significant variances therein.

14. The auditor should consider the extent to which reliance on the entity's historical financial information is justified. The auditor requires a knowledge of the entity's historical financial information to assess whether the prospective financial information has been prepared on a basis consistent with the historical financial information and to provide a historical yardstick for considering management's assumptions. The auditor will need to establish, for example, whether relevant historical information was audited or reviewed and whether acceptable accounting principles were used in its preparation.

15. If the examination or review report on prior period historical financial information was other than unmodified or if the entity is in a start-up/expansion phase, the auditor would consider the surrounding facts and the effect on the examination of the prospective financial information.

Period Covered

16. The auditor should consider the period of time covered by the prospective financial information. Since assumptions become more speculative as the length of the period covered increases, as that period lengthens, the ability of management to make best-estimate assumptions decreases. The period would not extend beyond the time for which management has a reasonable basis for the assumptions. The following are some of the factors that are relevant to the auditor's consideration of the period of time covered by the prospective financial information:

(a) the operating cycle, for example, in the case of a major construction project, the time required to complete the project may dictate the period covered.

(b) the degree of reliability of assumptions, for example, if the entity is introducing a new product, the prospective period covered could be short and broken into small segments, such as weeks or months. Alternatively, if, for example, the entity's sole business is owning a property under long-term lease, a relatively long prospective period might be reasonable.

(c) the needs of users, for example, prospective financial information may be prepared in connection with an application for a loan for the period of time required to generate sufficient funds for repayment. Alternatively, the information may be prepared for investors in connection with the issue of securities to illustrate the intended use of the proceeds in the subsequent period.

Examination Procedures

17. When determining the nature, timing and extent of examination procedures, the auditor should consider matters such as:

(a) the likelihood of material misstatement;

(b) the knowledge obtained during any previous engagements;

(c) management's competence regarding the preparation of prospective financial information;

(d) the extent to which the prospective financial information is affected by the management's judgment;

(e) the adequacy and reliability of the underlying data;

(f) the stability of entity's business;

(g) the engagement team's experience with the business and the industry in which the entity operates and with reporting on prospective financial information; and

(h) The availability of data derived from third parties to support the assumptions, such as industry statistics.

18. The auditor would assess the source and reliability of the evidence supporting management's best-estimate assumptions. Sufficient appropriate evidence supporting such assumptions would be obtained from internal and external sources including consideration of the assumptions in the light of historical information and an evaluation of whether they are based on plans that are within the entity's capacity. Examples of external sources are government publications, industry publications, economic forecast, existing or proposed legislation, and reports of changing technology. Examples of internal sources are budgets, the economic substance and viability of the entity and/or transaction or project of the entity, reputation of management responsible for assumptions underlying the prospective financial information, wage agreements, patents, royalty agreements and records, sales backlog records, debt agreements, and actions of the board of directors involving entity plans, etc.

19. The auditor would consider whether, when hypothetical assumptions are used, all significant implications of such assumptions have been taken into consideration. For example, if sales are assumed to grow beyond the entity's current plant capacity, the prospective financial information will need to include the necessary investment in the additional plant capacity or the costs of alternative means of meeting the anticipated sales, such as subcontracting production.

20. Although evidence supporting hypothetical assumptions need not be obtained, the auditor would need to be satisfied that they are consistent with the purpose of the prospective financial information and that there is no reason to believe they are clearly unrealistic.

21. The auditor will need to be satisfied that the prospective financial information is properly prepared from management's assumptions by, for example, making clerical checks such as recomputation and reviewing internal consistency, that is, the actions management intends to take are compatible with each other and there are no inconsistencies in the determination of

the amounts that are based on common variables such as interest rates.

22. The auditor would focus on the extent to which those areas that are particularly sensitive to variation will have a material effect on the results shown in the prospective financial information. This will influence the extent to which the auditor will seek appropriate evidence. It will also influence the auditor's evaluation of the appropriateness and adequacy of disclosure.

23. When engaged to examine one or more elements of prospective financial information, such as an individual financial statement, it is important that the auditor considers the interrelationship of other components in the financial statements.

24. When any elapsed portion of the current period is included in the prospective financial information, the auditor would consider the extent to which procedures need to be applied to the historical information. Procedures will vary depending on the circumstances, for example, how much of the prospective period has elapsed.

25. **The auditor should obtain written representations from management regarding the intended use of the prospective financial information, the completeness of significant management assumptions and management's acceptance of its responsibility for the prospective financial information.** The management is also responsible for identification and disclosure of uncontrollable factors, outstanding litigations, commitments or any other material factors that are likely to affect the prospective financial information.

Presentation and Disclosure

26. When assessing the presentation and disclosure of the prospective financial information and the underlying assumptions, in addition to the specific requirements of any relevant statutes, regulations or professional pronouncements by the regulatory body, the auditor will need to consider whether:

(a) the presentation of prospective financial information is informative and not misleading;

(b) the accounting policies are clearly disclosed in the notes to the prospective financial information;

(c) the assumptions are adequately disclosed in the notes to the prospective financial information. It needs to be clear whether assumptions represent management's best-estimates or are hypothetical and, when assumptions are made in areas that are material and are subject to a high degree of uncertainty, this uncertainty and the resulting sensitivity of results needs to be adequately disclosed;

(d) the date as of which the prospective financial information was prepared is disclosed. Management needs to confirm that the assumptions are appropriate as of this date, even though the underlying information may have been accumulated over a period of time;

(e) the basis of establishing points in a range is clearly indicated and the range is not selected in a biased or misleading manner when results shown in the prospective financial information are expressed in terms of a range; and

(f) there is any change in the accounting policy of the entity from that disclosed in the most recent historical financial statements and whether reason for the change and the effect of such change on the prospective financial information has been adequately disclosed.

Documentation

27. The auditor should document matters which are important in providing evidence to support his report on examination of prospective financial information, and evidence that such examination was carried out in accordance with this AAS. The working papers should contain the sources of information, basis of forecasts and the assumptions made in arriving the forecasts including hypothetical assumptions, evidences supporting the assumptions, management representations regarding the intended use and distribution of the information, completeness of material assumptions, management's acceptance of its responsibility for the information, audit plan, the nature, timing and extent of examination procedures performed, and, in case the auditor expresses qualified or adverse opinion or withdraws from the engagement, the reasons forming the basis of such decision.

Report on Examination of Prospective Financial Information

28. The report by an auditor on an examination of prospective financial information should contain the following:

(a) the title;

(b) the addressee;

(c) identification of the prospective financial information;

(d) a reference to the Auditing and Assurance Standard applicable to the examination of prospective financial information;

(e) a statement that management is responsible for the prospective financial information including the underlying assumptions;

(f) identification of the sources of information considered by the management for the purpose of prospective financial information;

(g) when applicable, a reference to the purpose and/or restricted distribution of the prospective financial information;

(h) a statement that the examination procedures included examination, on a test basis, of evidence supporting the assumptions, amounts and other disclosures in the forecast or projection;

(i) a statement of negative assurance as to whether the assumptions provide a reasonable basis for the prospective financial information;

(j) an opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework;

(k) appropriate caveats concerning the achievability of the results indicated by the prospective financial information;

(l) date of report;

(m) place of signature; and

(n) signature.

29. Such a report would:

- State whether, based on the examination of the evidence supporting the assumptions, anything has come to the auditor's attention which causes the auditor to believe that the assumptions do not provide a reasonable basis for the prospective financial information.
- Express an opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework.
- State that:
  - Actual results are likely to be different from the prospective financial information since anticipated events frequently do not occur as expected and the variation could be material. Likewise, when the prospective financial information is expressed as a range, it would be stated that there can be no assurance that actual results will fall within the range, and
  - In the case of a projection, the prospective financial information has been prepared for (intended use), using a set of assumptions that include hypothetical assumptions about future events and management's actions that are not necessarily expected to occur. Consequently, readers are cautioned that the prospective financial information is not used for the stated purposes. Appendices 1 and 2 of this Standard contain the example of extract from an unmodified report on a projection and forecast, respectively.

30. When the auditor believes that the presentation and disclosure of the prospective financial information is not adequate, the auditor should express a qualified or adverse opinion in the report on the prospective financial information, or withdraw from the engagement as appropriate. An example would be where financial information fails to disclose adequately the consequences of any assumptions which are highly sensitive.

31. When the auditor believes that one or more significant assumptions do not provide a reasonable basis for the prospective financial information prepared on the basis of best-estimate assumptions or that one or more significant assumptions do not provide a reasonabl e basis for the prospective financial information given the hypothetical assumptions, the auditor should either express an adverse opinion setting out the reasons in the report on the prospective financial information, or withdraw from the engagement.

32. When the examination is affected by conditions that preclude application of one or more procedures considered necessary in the circumstances, the auditor should either withdraw from the engagement or disclaim the opinion and describe the scope limitation in the report on the prospective financial information.

33. The duty of the auditor is to convey information and not merely arouse enquiry. Whenever the auditor expresses a qualified opinion, the examination report would contain:

(a) a clear description of all the substantive reasons for expressing a qualified opinion ;

(b) a quantification of the effects or possible effects on the amounts and other disclosures contained in, or omitted from, the financial statements; or

(c) if the effects or possible effects are incapable of being measured reliably, a statement to that effect and the reasons thereof.

Effective Date

34. This AAS is effective in relation to reports prepared on or after _____. However, earlier application of the Standard is encouraged.

Compatibility with International Standard on Assurance Engagement (ISAE 3400)

Except for the matters noted below, the basic principles and essential procedures of this AAS and International Standard on Assurance Engagement (ISAE) 3400 "The Examination of Prospective Financial Information", are consistent in all material respects:

(a) AAS precludes the auditor from expressing positive assurance regarding the assumptions as it may tantamount to vouching for the accuracy of the forecast/ projection/ hypothetical assumptions. Whereas, the ISAE 3400 permits the auditor to express positive assurance when in his judgment an appropriate level of satisfaction has been obtained.

(b) In line with requirement of AAS 28 – "The Auditor's Report on Financial Statements" this AAS requires the auditor to include a scope section in the examination report to explain the nature and extent of the auditor's work. ISAE 3400 does not contain an equivalent requirement.

(c) AAS specifically provides for the documentation required to be done by the auditor in regard to any engagement of examination of prospective financial information. However, ISAE 3400 does not contain such explicit provision.

Appendix 1

Example of an Extract from a Unmodified Report on a Projection

Report on Examination of Prospective Financial Information

To the …(addressee)……

We have examined the projection of __(project)___for the period from ___ to ___ as given in Annexure– to this report in accordance with Auditing and Assurance Standard ___, The Examination of Prospective Financial Information. The preparation and presentation of the projection including the underlying assumptions, set out in Appendix = to this report, is the responsibility of the Management. Our examination of the projection has been carried out in accordance with Auditing and Assurance Standard (AAS)___, The Examination of Prospective Financial Information, issued by the Institute of Chartered Accountants of India, applicable to examination of prospective financial information. The sources of information are set out in Annexure = to this report. Our responsibility is to express our opinion on the projection based on our examination.

This projection has been prepared for *(intended use)*. We disclaim any assumption of responsibility for any reliance on this report or on the projection to which it relates for any purposes other than for which it is prepared. In addition, as the entity is in a start-up phase the projection has been prepared using a set of assumptions that include hypothetical assumptions about future events and management's actions that are not necessarily expected to occur. Consequently, readers are cautioned that this projection may not be appropriate for purposes other than that described above.

Our procedures included examination, on a test basis, of evidence supporting the assumptions, amounts and other disclosures in the projection.

Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe that these assumptions do not provide a reasonable basis for preparation of the projection, assuming that *(state or refer to the hypothetical assumptions)*. Further, in our opinion the projection is properly prepared on the basis of the assumptions as set out in Annexure – to this report and is presented in accordance with *(relevant financial reporting framework)*.

Even if the events anticipated under the hypothetical assumptions described above occur, actual results are still likely to be different from the projection since other anticipated events frequently do not occur as expected and the variation may be material.

For ABC & Co.,
Chartered Accountants

Signature
(Name of the member signing the report)
Date : (Designation) [4]
Place of Signature : Membership Number

Appendix 2

Example of an Extract from an Unmodified Report on a Forecast

Report on Examination of Prospective Financial Information

To the ……. (Addressee).....

We have examined the forecast of __(project)___for the period from ___ to ___ in accordance with Auditing and Assurance Standard ___, The Examination of Prospective Financial Information. The preparation and presentation of the forecast including the underlying assumptions, set out in Annexure = to this report, is the responsibility of the management. The sources of information are set out in Annexure =. Our responsibility is to express our opinion on the forecast based on our examination.

This forecast has been prepared for *(intended use)*. We disclaim any assumption of responsibility for any reliance on this report or on the forecast to which it relates for any purposes other than for which it is prepared.

Our procedures included examination, on a test basis, of evidence supporting the assumptions, amounts and other disclosures in the forecast.

Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe that assumptions do not provide a reasonable basis for the forecast. Further, in our opinion the forecast is properly prepared on the basis of the assumptions as set out in Annexure = and is presented in accordance with *(relevant financial reporting framework)*.

Actual results are likely to be different from the forecast since anticipated events might not occur as expected and the variation might be material.

For ABC & Co.,
Chartered Accountants

Signature
(Name of the member signing the report)
Date : (Designation)[5]
Place of Signature: Membership Number

[4] **Partner or proprietor, as the case may be.**
[5] **Partner or proprietor, as the case may be.**

FOR YOUR INFORMATION

INVITATION TO COMMENT ON THE EXPOSURE DRAFT OF THE PROPOSED ACCOUNTING STANDARD ON FINANCIAL INSTRUMENTS: PRESENTATION

The Accounting Standards Board of the Institute of Chartered Accountants of India invites comments on any aspect of the Exposure Draft of the proposed Accounting Standard on Financial Instruments: Presentation, published hereinafter. The Board would particularly welcome answers to the questions set out below. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing to the Secretary, Accounting Standards Board, The Institute of Chartered Accountants of India, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002, so as to be received not later than ***November 10, 2005****. Comments can also be sent by e-mail at tdte@icai.org.*

Question 1 – Preference Shares

International Accounting Standard (IAS) 32, *Financial Instruments: Presentation*, as well as, this Exposure Draft provide that the issuer of a financial instrument should classify the instrument, or its component parts, on initial recognition as a financial liability or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability and an equity instrument. The application of this principle may result into classifying preference shares that provide for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or give the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, as a financial liability. The Exposure Draft, however, in a footnote, recognises that, 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', irrespective of their substance. It also recognises that until Schedule VI is amended, a company classifying the preference shares as share capital, irrespective of their substance, will be considered to be complying with this Accounting Standard. This is because as per paragraph 4.10 of the *Preface to the Statements of Accounting Standards*, where a requirement of an accounting standard is different from the applicable law, the law prevails.

Do you agree with the above proposal? If not, why not?

Question 2 – 'Puttable Instrument' – Considered as a Financial Liability

The Exposure Draft deals with 'puttable instrument' which is a financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset. The Exposure Draft proposes to consider the 'puttable instrument' as 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 enterprise that has no equity capital (such as some mutual funds and unit trusts, see Illustrative Example 1) 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).

Do you agree with the above proposal? If not, why not?

Question 3 – Separate presentation of the elements of the Compound Instruments

The Exposure Draft proposes that 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. The Exposure Draft proposes that such components should be classified separately as financial liabilities or equity instruments. It is more a matter of form than substance that both liabilities and equity interests are created by a single financial instrument rather than two or more separate instruments. A debenture or similar instrument convertible by the holder into a fixed number of equity shares of the issuer is an example of such an instrument (see paragraphs 43-52 of the Exposure Draft).

Do you agree with the above proposal? If not, why not?

Question 4- Presentation of Interest, Dividends, Losses, and Gains

The Exposure Draft proposes that interest and losses relating to a financial instrument or a component of financial instrument that is a financial liability should be recognised as expense in the statement of profit and loss and gains relating to it should be recognised as income in the statement of profit and loss. Distributions to holders of an equity instrument should be recognised by the enterprise in the statement of profit and loss after determination of net profit after tax for the current year.

In other words, the classification of a financial instrument as liability or equity in the balance sheet determines whether interest, losses or gains relating to that instrument are classified as expense or income and recognised in the statement of profit and loss or are recognised after the determination of the net profit after tax for the current year (See paragraphs 56-62 of the Exposure Draft).

Do you agree with the above proposal? If not, why not?

Question 5 – Transaction Costs of an Equity Instrument

The Exposure Draft proposes that transaction costs, net of any related income tax benefit, of an equity transaction should be recognised in the statement of profit and loss after determination of net profit after

tax for the current year. (Paragraph 56 of the Exposure Draft). This proposal is consistent with the proposal covered under Question 4 above, as per which the losses relating to a financial instrument classified as equity of the issuer are recognised in the statement of profit and loss after determination of net profit after tax for the current year. The underlying principle is that the costs incurred in connection with the issuance or buy-back of equity should not affect the current year's profit or loss.

Do you agree with the above proposal, particularly considering the fact that at present in India, 'share issue expenses' are disclosed under the head 'Miscellaneous expenditure to the extent not written off or adjusted' in the balance sheet of the companies and amortised over a period of time?

If not, why not?

Question 6 - Other comments

Do you have any other comments on the Exposure Draft of proposed Accounting Standard on Financial Instruments: Presentation?

Exposure Draft
Proposed Accounting Standard
Financial Instruments: Presentation

(This Exposure Draft of the proposed 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 Exposure Draft of the proposed Accounting Standard should be read in the context of its objective and the Preface to the Statements of Accounting Standards.[1])*

Accounting Standard (AS) ___, Financial Instruments: Presentation, would come into effect in respect of accounting periods commencing on or after ____ *(date to be decided later)* and would be mandatory in nature[2] from that date.

The following is the text of the Exposure Draft of the Accounting Standard.

OBJECTIVE

1. The objective of this Statement 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 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 Statement complement the principles for recognising and measuring financial assets and financial liabilities in Accounting Standard on *Financial Instruments: Recognition and Measurement*[3] and for disclosing information about them in Accounting Standard on *Financial Instruments: Disclosures*.[3]

SCOPE

3. This Statement should be applied to all types of financial instruments except:

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

(b) contracts for contingent consideration in an amalgamation (see paragraph 41 of AS 14, Accounting for Amalgamations). This exemption applies only to the acquirer.

(c) rights and obligations arising under insurance contracts. However, enterprises should apply this Statement to a financial instrument that takes the form of an insurance (or reinsurance) contract as described in paragraph 4, but principally involves the transfer of financial risks. In addition, enterprises should apply this Statement to derivatives that are embedded in insurance contracts.

(d) financial instruments, contracts and obligations under share-based payment transactions[4] except for contracts within the scope of paragraphs 6-8 of this Statement, to which this Statement applies.

(e) contracts that require a payment based on climatic, geological or other physical variables (see Accounting Standard on Financial Instruments: Recognition and Measurement). However, this Statement should be applied to other types of derivatives that are embedded in such contracts (for example, if an interest rate swap is contingent on a climatic variable such as heating degree days, the interest rate swap element is an embedded derivative that is within the scope of this Statement - see Accounting Standard on Financial Instruments: Recognition and Measurement)[5] .

4. For the purposes of this Statement, an insurance contract is a contract that exposes the insurer to identified risks of loss from events or circumstances occurring or discovered within a specified period,

[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] Separate accounting standards on Financial Instruments: Recognition and Measurement, and Financial Instruments: Disclosures, are under preparation. It is proposed that this Standard and the Standards dealing with recognition and measurement aspects of financial instruments would become applicable from the same date.

[4] Certain share-based payment transactions are dealt with in other pronouncements issued by the ICAI, e.g., *Guidance Note on Accounting for Employee Share-based Payments* and Accounting Standard (AS) 10, *Accounting for Fixed Assets*.

[5] See footnote 3.

including death (or in the case of an annuity, the survival of the annuitant), sickness, disability, property damage, injury to others and business interruption. This Statement does not apply to rights and obligations arising under insurance contracts. Enterprises that have obligations under insurance contracts are encouraged to consider the appropriateness of applying the provisions of this Statement in presenting information about such obligations. The provisions of this Statement apply when a financial instrument takes the form of an insurance contract but principally involves the transfer of financial risks, for example, some types of financial reinsurance and guaranteed investment contracts issued by insurance and other enterprises.

5. Enterprises should apply the requirements relating to offsetting of a financial asset and a financial liability contained in this Statement to an interest in a subsidiary, associate or joint venture that according to AS 21, AS 23 or AS 27 is accounted for under Accounting Standard on Financial Instruments: Recognition and Measurement.[6]

6. This Statement 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 enterprise's expected purchase, sale or usage requirements.

7. 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 enterprise 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 enterprise 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 enterprise's expected purchase, sale or usage requirements, and, accordingly, is within the scope of this Statement. Other contracts to which paragraph 6 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 enterprise's expected purchase, sale or usage requirement, and accordingly, whether they are within the scope of this Statement.

8. 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 7(a) or (d) is within the scope of this Statement. Such a contract cannot be entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the enterprise's expected purchase, sale or usage requirements.

DEFINITIONS

9. The following terms are used in this Statement with the meanings specified:

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

A financial asset is any asset that is:

(a) cash;

(b) an equity instrument of another enterprise;

(c) a contractual right:

(i) to receive cash or another financial asset from another enterprise; or

(ii) to exchange financial assets or financial liabilities with another enterprise under conditions that are potentially favourable to the enterprise.

A financial liability is any liability that is:

(a) a contractual obligation:

(i) to deliver cash or another financial asset to another enterprise; or

(ii) to exchange financial assets or financial liabilities with another enterprise under conditions that are potentially unfavourable to the enterprise; or

(b) a contract[7] that will or may be settled in the enterprise's own equity instruments and is a non-derivative for which the enterprise is or may be obliged to deliver a variable number of the enterprise's own equity instruments.

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

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.

[6] Presently, AS 21, AS 23 and AS 27 make a reference to AS 13, Accounting for Investments and not to Accounting Standard on Financial Instruments: Recognition and Measurement. However, with the issuance of Accounting Standard on Financial Instruments: Recognition and Measurement, which is presently under preparation, the reference to AS 13 in AS 21, AS 23 and AS 27, is proposed to be changed to Accounting Standard on Financial Instruments: Recognition and Measurement. Till that time, the reference to Accounting Standard on Financial Instruments: Recognition and Measurement, in this paragraph should be construed to refer to AS 13, Accounting for Investments.

[7] The recognition and measurement of such contracts are expected to be dealt with in the proposed Accounting Standard on Financial Instruments: Recognition and Measurement, which is under preparation.

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

*A **derivative** is a financial instrument or other contract within the scope of this Statement 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.

***Transaction costs** are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial instrument. An incremental cost is one that would not have been incurred if the enterprise had not acquired, issued or disposed of the financial instrument.*

10. In this Statement, '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.

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 enterprise 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 Rs. 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 Rs. 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.

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 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, tangible fixed assets), 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 income 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 equity shares, some types of preference shares (see paragraphs 37 and 38) and warrants or written call options that allow the holder to subscribe for or purchase a fixed number of equity shares in the issuing enterprise in exchange for a fixed amount of cash or another financial asset. An obligation of an enterprise to issue 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 enterprise. An issuer of 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 enterprise is being wound up and any assets remaining after the satisfaction of liabilities become distributable to shareholders.

DERIVATIVE FINANCIAL INSTRUMENTS

22. 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 Statement.

23. 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[8] 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.

24. A put or call option to exchange financial assets or financial liabilities 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 enterprises 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.

25. 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 Rs. 1,000,000 cash in exchange for Rs. 1,000,000 face amount of fixed rate government bonds, and the other party (the seller) promises to deliver Rs. 1,000,000 face amount of fixed rate government bonds in exchange for Rs. 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 Rs. 1,000,000, the conditions will be favourable to the purchaser and unfavourable to the seller; if the market price falls below Rs. 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.

26. 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, 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 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

27. 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

[8] 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).

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 Statement as if they were financial instruments (see paragraph 6).

28. 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.

29. 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.

30. 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

31. The issuer of a financial instrument should classify the instrument, or its component parts, on initial recognition as a financial liability or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability and an equity instrument.

32. An 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 enterprise; or

(ii) to exchange financial assets or financial liabilities with another enterprise 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 a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments.

A contractual obligation that will result in the future 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 32(A))

33. 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.

34. The substance of a financial instrument, rather than its legal form, governs its classification on the enterprise'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.[9]

(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

[9] It may be noted that, 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', irrespective of their substance. It may be mentioned that untill Schedule VI is amended, a company classifying the preference shares as share capital, irrespective of their substance, will be considered to be complying with this Accounting Standard. This is because as per paragraph 4.10 of the *Preface to the Statements of Accounting Standards*, where a requirement of an Accounting Standard is different from the applicable law, the law prevails. As a corollary to this, dividend on all types of preference shares treated as a distribution to holders of the shares and not as an expense would be considered as a compliance with this Accounting Standard.

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 enterprise that has no equity capital (such as some mutual funds and unit trusts, see Illustrative Example 1) 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).

35. If an enterprise 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 enterprise 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 enterprise'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 enterprise does not have the unconditional right to avoid delivering cash or another financial asset.

36. 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 enterprise fails to make distributions or to redeem the instrument. If the enterprise 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 enterprise 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 enterprise 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 enterprise 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 39).

37. 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. 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.

38. 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.

SETTLEMENT IN THE ENTERPRISE'S OWN EQUITY INSTRUMENTS (PARAGRAPH 32(B))

39. A contract is not an equity instrument solely because it will result in the delivery of the enterprise's own equity instruments. An enterprise may have a contractual obligation to deliver a number of its own shares or other equity instruments that varies so that the fair value of the enterprise's own equity instruments to be delivered equals the amount of the contractual obligation. Such a contractual 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 enterprise'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 enterprise's own equity instruments as are equal in value to Rs.100, and (b) a contract to deliver as many of the enterprise'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 enterprise even though the enterprise must or can settle it by delivering its own equity instruments. It is not an

equity instrument because the enterprise 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 enterprise's assets after deducting all of its liabilities.

CONTINGENT SETTLEMENT PROVISIONS

40. A financial instrument may require the enterprise 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.

41. Paragraph 40 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 enterprise'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 enterprise's own shares may be contractually precluded in circumstances that are outside the control of the enterprise, but if these circumstances have no genuine possibility of occurring, classification as an equity instrument is appropriate.

TREATMENT IN CONSOLIDATED FINANCIAL STATEMENTS

42. In consolidated financial statements, an enterprise presents minority interests - i.e. the interests of other parties in the equity and income of its subsidiaries in accordance with AS 21, *Consolidated Financial Statements.* When classifying a financial instrument (or a component of it) in consolidated financial statements, an enterprise 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 enterprise 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 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)

43. 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 31.

44. Paragraph 43 applies only to issuers of non-derivative compound financial instruments. Paragraph 43 does not deal with compound financial instruments from the perspective of holders. Accounting Standard on *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.

45. An enterprise recognises separately the components of a financial instrument that (a) creates a financial liability of the enterprise and (b) grants an option to the holder of the instrument to convert it into an equity instrument of the enterprise. For example, a debenture or similar instrument convertible by the holder into a fixed number of equity shares of the enterprise is a compound financial instrument. From the perspective of the enterprise, 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 enterprise). 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 enterprise presents the liability and equity components separately on its balance sheet.

46. 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 enterprise's contractual obligation to make future payments remains outstanding until it is extinguished through conversion, maturity of the instrument or some other transaction.

47. Accounting Standard on *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 enterprise 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 carrying amount 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 carrying amount of the instrument as a whole. No gain or loss arises from initially recognising the components of the instrument separately.

48. A common form of compound financial instrument is a debt instrument with an embedded conversion option, such as a debentures convertible into equity shares of the issuer, and without any other embedded derivative features. Paragraph 43 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. 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 carrying amount of the compound financial instrument as a whole.

49. On conversion of a convertible instrument at maturity, the enterprise 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.

50. When an enterprise extinguishes a convertible instrument before maturity through an early redemption or repurchase in which the original conversion privileges are unchanged, the enterprise 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 enterprise when the convertible instrument was issued, in accordance with paragraphs 43-48.

51. 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 reserve and surplus.

52. An enterprise 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.

BUY-BACK OF SHARES

53. If an enterprise reacquires (buys-back) its own shares, nominal value of those shares should be deducted from share capital. No gain or loss should be recognised in the statement of profit and loss on the purchase and cancellation of an enterprise's own shares. Difference between the consideration paid and the nominal value of shares should be recognised directly in reserves and surplus.

54. An enterprise provides disclosure in accordance with AS 18, *Related Party Disclosures,* if the enterprise buy-backs its own shares from related parties.

55. Paragraph 53 requires an enterprise that reacquires its own shares to deduct their nominal value from share capital. However, when an enterprise holds its own shares on behalf of others, e.g. 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 enterprise's balance sheet.

INTEREST, DIVIDENDS, LOSSES AND GAINS

56. Interest and losses relating to a financial instrument or a component of financial instrument that is a financial liability should be recognised as expense in the statement of profit and loss and gains relating to it should be recognised as income in the statement of profit and loss. Distributions to holders of an equity instrument should be recognised by the enterprise in the statement of profit and loss after determination of net profit after tax for the current year. Transaction costs, net of any related income tax benefit, of an equity transaction should be recognised in the statement of profit and loss after determination of net profit after tax for the current year.

57. The classification of a financial instrument as a financial liability or an equity instrument determines whether interest, losses and gains relating to that instrument are recognised as expense or income in the statement of profit and loss or are recognised after the determination of the net profit after tax for the current year. Thus, gains and losses associated with redemptions of financial liabilities are recognised in the statement of profit and loss. Changes in the fair value of an equity instrument are not recognised in the financial statements.

58. An enterprise typically incurs various costs in issuing or acquiring (buy-back) 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 in the statement of profit and loss after determination of net profit after tax for the current year 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.

59. 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.

60. The amount of transaction costs recognised in the statement of profit and loss after determination of net profit after tax for the current year is disclosed separately.

61. The following example illustrates the application of paragraph 56 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 enterprise before the redemption date. Such an instrument is a compound financial instrument, with the liability component being the present value of the redemption amount. The unwinding of the discount on this component is recognised in profit or loss and classified as interest expense. Any dividends paid relate to the equity component and, accordingly, are recognised in the statement of profit and loss after determination of net profit after tax for the current year. 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 ordinary 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.

62. Dividends classified as an expense are presented in the statement of profit and loss as a separate item.

OFFSETTING A FINANCIAL ASSET AND A FINANCIAL LIABILITY

63. A financial asset and a financial liability should be offset and the net amount presented in the balance sheet when, and only when, an enterprise:

(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 enterprise should not offset the transferred asset and the associated liability (see Accounting Standard on Financial Instruments: Recognition and Measurement).

64. This Statement requires the presentation of financial assets and financial liabilities on a net basis when doing so reflects an enterprise's expected future cash flows from settling two or more separate financial instruments. When an enterprise 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 enterprise.

65. 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.

66. 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 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.

67. 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 enterprise'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 enterprise's future cash flows are not affected. When an enterprise 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.

68. An enterprise'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 enterprise 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 enterprise's credit risk exposure is disclosed in accordance with Accounting Standard on Financial Instruments: Disclosure.

69. 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 enterprise 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.

70. The conditions set out in paragraph 63 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.

71. An enterprise 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 63 are satisfied. When financial assets and financial liabilities subject to a master netting arrangement are not offset, the effect of the arrangement on an enterprise's exposure to credit risk is disclosed in accordance with Accounting Standard on Financial Instruments: Disclosures.

72. The Statement 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 enterprise's balance sheet on a net basis unless they meet the criteria for offsetting in paragraph 63.

Appendix A

Illustrative Examples

These examples accompany, but are not part of the Exposure Draft of the proposed Accounting Standard on *Financial Instruments: Presentation*.

ENTERPRISES SUCH AS MUTUAL FUNDS AND CO-OPERATIVES WHOSE SHARE CAPITAL IS NOT EQUITY AS DEFINED IN THE EXPOSURE DRAFT OF THE PROPOSED ACCOUNTING STANDARD ON *FINANCIAL INSTRUMENTS: PRESENTATION*

EXAMPLE 1: ENTERPRISES WITH NO EQUITY

IE1. The following example illustrates a statement of profit and loss and balance sheet format that may be used by enterprises such as mutual funds that do not have equity as defined in the Exposure Draft of the proposed Accounting Standard on *Financial Instruments: Presentation*. Other formats are possible.

Statement of profit and loss for the year ended 31 March 20x6

	20x5-20x6	20x4-20x5
	Rs.	Rs.
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)
- other finance costs	(50)	(50)
Change in net assets attributable to unitholders	2,215	1,007

Balance sheet at 31 March 20x6

	20x5-20x6		20x4-20x5	
	Rs.	**Rs**	**Rs**	**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		80,0511

Example 2: Enterprises with some equity

IE2. The following example illustrates a statement of profit and loss and balance sheet format that may be used by enterprises whose share capital is not equity as defined in the Exposure Draft of the proposed Accounting Standard on *Financial Instruments: Presentation*, because the enterprise 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
	Rs.	**Rs.**
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	
	Rs.	Rs	Rs	Rs
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[10]				
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

IE3. Paragraph 43 describes how the components of a compound financial instrument are separated by the enterprise on initial recognition. The following example illustrates how such a separation is made.

IE4. An enterprise 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 Rs. 1,000 per debenture, giving total proceeds of Rs. 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.

IE5. 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.

[10] In this example, the enterprise has no obligation to deliver a share of its reserves to its members.

	Rs.
Present value of the principal - Rs. 2,000,000 payable at the end of three years	1,544,367
Present value of the interest – Rs. 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

EXAMPLE 4: SEPARATION OF A COMPOUND FINANCIAL INSTRUMENT WITH MULTIPLE EMBEDDED DERIVATIVE FEATURES

IE6. The following example illustrates the application of paragraph 47 to the separation of the liability and equity components of a compound financial instrument with multiple embedded derivative features.

IE7. Assume that the proceeds received on the issue of a callable convertible debenture are Rs.60. The value of a similar debenture without a call or equity conversion option is Rs.57. Based on an option pricing model, it is determined that the value to the enterprise of the embedded call feature in a similar debenture without an equity conversion option is Rs.2. In this case, the value allocated to the liability component under paragraph 47 is Rs.55 (Rs.57 – Rs.2) and the value allocated to the equity component is Rs.5 (Rs.60 – Rs.55).

EXAMPLE 5: REPURCHASE OF A CONVERTIBLE INSTRUMENT

IE8. The following example illustrates how an enterprise 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.

IE9. On 1 January 1999, Enterprise A issued a 10 per cent convertible debenture with a face value of Rs. 1,000 maturing on 31 December 2008. The debenture is convertible into equity shares of Enterprise A at a conversion price of Rs.25 per share. Interest is payable half-yearly in cash. At the date of issue, Enterprise A could have issued non-convertible debt with a ten-year term bearing a coupon interest rate of 11 per cent.

IE10. In the financial statements of Enterprise A the carrying amount of the debenture was allocated on issue as follows:

	Rs.
Liability component	
Present value of 20 half-yearly interest payments of Rs. 50, Discounted at 11%	597
Present value of Rs. 1,000 due in 10 years, discounted at 11%, Compounded half-yearly	343
	940
Equity component	
(Difference between Rs. 1,000 total proceeds and Rs. 940 allocated above)	60
Total proceeds	1,000

IE11. On 1 January 2004, the convertible debenture has a fair value of Rs. 1,700.

IE12. Enterprise A makes a tender offer to the holder of the debenture to repurchase the debenture for Rs. 1,700, which the holder accepts. At the date of repurchase, Enterprise A could have issued non-convertible debt with a five-year term bearing a coupon interest rate of 8 per cent.

IE13. The repurchase price is allocated as follows:

	Carrying Value Rs.	Fair Value Rs.	Difference Rs.
Liability component:			
Present value of 10 remaining half-yearly interest Payments of Rs. 50, discounted at 11% and 8%, Respectively	377	405	
Present value of Rs. 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 [11]	(559)
Total	1,022	1,700	(678)

[11] This amount represents the difference between the fair value amount allocated to the liability component and the repurchase price of Rs. 1,700.

IE14. Enterprise A recognises the repurchase of the debenture as follows:

Dr	Liability component	Rs. 962	
Dr	Debt settlement expense (statement of profit and loss)	Rs. 119	
Cr	Cash		Rs. 1,081
	To recognise the repurchase of the liability component.		
Dr	Equity component	Rs. 60	
Dr.	Reserves and Surplus	Rs. 559	
Cr	Cash		Rs. 619
	To recognise the cash paid for the equity component.		

EXAMPLE 6: AMENDMENT OF THE TERMS OF A CONVERTIBLE INSTRUMENT TO INDUCE EARLY CONVERSION

IE15. The following example illustrates how an enterprise accounts for the additional consideration paid when the terms of a convertible instrument are amended to induce early conversion.

IE16. On 1 January 2005, Enterprise A issued a 10 per cent convertible debenture with a face value of Rs. 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, Enterprise A reduces the conversion price to Rs.20 if the debenture is converted before 1 March 2006 (i.e. within 60 days).

IE17. Assume the market price of Enterprise A's equity shares on the date the terms are amended is Rs.40 per share. The fair value of the incremental consideration paid by Enterprise A is calculated as follows:

*Number of equity shares to be issued to debenture holders under **amended** conversion terms:*		
Face amount	Rs. 1,000	
New conversion price	/Rs. 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	Rs. 1,000	
Original conversion price	Rs.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*		
Rs.40 per share x 10 incremental shares	Rs.400	

IE18. The incremental consideration of Rs. 400 is recognised as a loss in the statement of profit and loss.

Appendix B

Note :
This Appendix is not a part of the Exposure Draft of the proposed Accounting Standard. The purpose of this appendix is only to bring out the major differences between the Exposure Draft of proposed Accounting Standard and corresponding International Accounting Standard (IAS) 32.

COMPARISON WITH IAS 32, FINANCIAL INSTRUMENTS: PRESENTATION

The Exposure Draft of the proposed Standard differs from International Accounting Standard (IAS) 32, Financial Instruments: Presentation, in the following major respects:

As compared to IAS 32, the Exposure Draft does not deal with certain aspects which are not permitted under the present Indian legal framework, for example, derivatives based on an enterprise's own equity instruments and buy back of shares by the enterprise itself for issuance to employees under Employee Share Option Plans.

56th Annual Report and Audited Annual Accounts of the Institute for the year 2004 - 2005.

Members of the Institute are hereby informed that an abridged version of the 56th Annual Report and Audited Annual Accounts of the Institute for the year 2004 - 2005 (as notified in the Gazette of India) will be published in the October, 2005 issue of the Journal. However, the full text of the said Annual Report and Audited Annual Accounts together with 'Activities in Detail' will be hosted on the Institute's Website (http://www.icai.org) for general information of the Members. With a view to making available, free of cost, the hard copy and/or soft copy of the latter set of Annual Report and Accounts to interested members, it has been decided to seek their consent/willingness. Accordingly, you are requested to kindly indicate your willingness for the same to Shri T. Karthikeyan, Director [email: councilaffairs@icai.org]. In case any member desires to have the Annual Report and Accounts through email, the same can also be supplied, on receipt of an advice to that effect.

Consequences of Non-payment of Fees

1. The annual Membership and Certificate of Practice fees (if member holds certificate of practice) became due and payable on 1st April, 2005. Circulars advising members to pay the membership/certificate of practice fee were sent to individual members in the month of March/April, 2005 and published in April, 2005 issue of the Journal.

2. Attention of all those members who have not paid the annual membership fee/certificate of practice fee by 31st July, 2005 is invited to pay the fees immediately.

3. The non-payment of annual membership/ certificate of practice fee will have the following consequences:

(i) The member will not be eligible to use designatory letters 'ACA'/'FCA' and designation 'chartered accountant'.

(ii) A member in practice will cease his right to practice as a Chartered Accountant

(iii) Such a member will not be eligible to train articled/audit clerks already receiving training under him on or after 1.10.2005.

(iv) The member will not be eligible to train any new articled/audit clerk on or after 1.10.2005.

(v) Such a member will not be eligible to carry out audit/certificate/attest and other functions in view of (i) above.

4. The membership numbers of all the members who have not paid the membership fee till 31st July, 2005 are being displayed on the website of the Regional Councils.

5. For, any other clarification, the members are advised to contact the concerned Decentralised Offices of the Region.

Enroll NOW for Information System Audit (ISA) Course to qualify by March 2005

Members interested in qualifying the Information Systems Audit (ISA) Post Qualification Course (PQC) in March 2006 are requested to enroll immediately and complete their ISA Professional Training by December, 2005. ISA Professional Training batches would be started from October 2005 in all Regional Offices/ Branches where break even batches can be formed. For further details, please refer to ISA Prospectus/ ISA Portal www.isaicai.org or send e-mail to isa@icai.org.

COMMITTEE FOR MEMBERS IN INDUSTRY

COMMITTEE FOR MEMBERS IN INDUSTRY INDUSTR Y FOCUSSED PROGRAMME ON CIVIL AVIATION SECTOR	
Date & Time	**Thursday 20th and Friday 21st October 2005**
Venue	**Raisina Hall, Hotel Le Meridien, Janp ath, New Delhi**
Discussion Sessions	
(i) SWOT Analysis of the Civil Aviation Sector – Indian and International Perspective: To be finalized (ii) Towards transforming the finance function: Emerging areas of financing and working capital management: Shri S. Phunani, Director (Finance), Air India, Mumbai (iii) Issues in Auditing related to Entities involved in Civil Aviation Industry: Shri Amarjit Chopra, FCA, Chairman of Audit and Assurance Standards Board of ICAI (iv) Developments in Direct Taxation Laws with specific application to Civil Aviation Industry: Shri Ved Jain, FCA, Central Council Member, ICAI. (v) Accounting issues related to Entities involved in Civil Aviation Industry: Shri P.R. Ramesh, Chartered Accountant, Mumbai (vi) Developing competitive advantage in Civil Aviation Industry: Role of IT and Business Process Outsourcing: Shri Sivaramakrishnan, Chartered Accountant, Mumbai (vii) Developments in VAT and Service Tax with specific reference to Civil Aviation Industry: Shri Ashok Chandak, Past President of ICAI, Nagpur (viii) Management Information Systems and Management Audit Programme for entities involved in Civil Aviation Industry: Shri R Sundar, Associate Director, Ernst & Young Pvt. Ltd, New Delhi.	
Fees: *Rs.3500/-*	***CPE Hours: 12***
Contact Persons	**Contact Details**
Shri V. Murali, Central Council Member & Chairman, Committee for Members in Industry of ICAI, (Programme Chairman)	09841040010, 09381046952, murali@icai.org
Shri Rajkumar S. Adukia, Central Council Member, ICAI, (Programme Director)	
Dr. T. Paramasivan, Deputy Director (Tech.), ICAI, (Programme Coordinator)	011-30110450, Fax :011-30110583, E-mail: cmii@icai.org
Further Information	www.icai.org/announ/civil_avi_sec_.pdf

COMMITTEE ON INSURANCE

INTERNATIONAL CONFERENCE ON CHANGING PARADIGM OF INSURANCE: PATH AHEAD FOR THE ACCOUNTING PROFESSION

CPE Credit: 10 hrs.

4th November 2005

Inaugural Session: 10:00 AM to 11:00 AM

- Welcome Address and Introduction on Conference Theme. Chairman, Committee on Insurance ☞ Address by President, ICAI. ☞ Key Note Address. ☞ Inaugural Address. ☞ Vote of Thanks.

Technical Session I : 11:15 AM to 1:00 PM

Emerging World of Insurance.
-The as is situation and beyond:

- Industry Perspective
- Professional Perspective
- Regulation Perspective

Technical Session II: 2:00 PM to 3:30 PM

Insurance: Governance Issues: Panel Discussion.

- Accounting
- Investment
- Ombudsman
- Survey
- Marketing

Technical Session III: 4:00 PM to 5:00 PM

Bancassurance and beyond.

5th November 2005

Technical Session IV: 10:00 AM to 11:15 AM

Insurance Markets in India: opportunities & Challenges.

- Varied Insurance Area Firms CFOs

Session V: 11:30 AM to 1:00 PM

Special Address/Key Note Address

- Insurance Industry; Professional Imperatives.

Session VI: 2:00 PM to 3:00 PM

Key Note Address on Changing Scenario of Insurance.

Technical Session VII: 3:00 PM to 4:00 PM

Open House: Emerging Areas for the Profession.

- Consultancy
- Certification
- Inspection
- Investigation
- Reinsurance
- Risk Management
- Actuary
- Broker
- Insurance Arbitrator
- Surveyor & Loss Assessor
- Setting up a Insurance business
- Merger & Amalgamation
- Statutory & Concurrent Audit

Valedictory Session: 4:15 PM to 5:00 PM

- Valedictory Address by Vice President, ICAI.
- Vote of thanks by Vice-Chairman, Committee on Insurance.

Venue: JW Marriott Hotel, Mumbai.
Participation Fee: Rs. 1,900/-

Eminent Speakers from Govt./Regulatory Authorities/Insurance Companies are being invited to deal with various topics in the Technical Sessions.

Last Date of Registration

LAST DATE OF REGISTRATION FOR MAY 2006 PART I EXAMINATIONS FOR POST QUALIFICATION COURSE IN INTERNATIONAL TRADE LAWS & WTO

Attention of the members is drawn to the Post Qualification Course in 'International Trade Laws and World Trade Organisation' of ICAI intended to equip the members with the specialised skills necessary for developing the dedicated practice in the area of services related to International Trade Laws & WTO.

Registration for the Course is open throughout the year. Candidates shall be eligible to appear for Part I Examination to the Course only after six months of registration and specified minimum attendance at PCPs. Therefore, for appearing in the May, 2006 Examinations for Part I of the Course, the last date for taking registration in the Course is OCTOBER 31, 2005.

For obtaining registration, the Prospectus for the Post Qualification Course in 'International Trade Laws and World Trade Organisation', priced at Rs. 150/- (Rs. One Hundred Fifty only), can be obtained from the Institute's sale counters at New Delhi and the Regional Offices at Mumbai, Chennai, Kolkata & Kanpur and the Branches of the Institute. Copy of Prospectus can also be obtained by post from the Joint Secretary, Postal Sales Department of the Institute at C-1, Sector I, NOIDA – 201 301 (U.P.) by sending a Demand Draft of Rs. 150/- plus postal charges (Rs. 9 within New Delhi & Rs. 20 for Rest of India, if required by Courier; or Rs. 40/-, if required by registered post) favouring 'The Secretary, The Institute of Chartered Accountants of India' payable at New Delhi.

For any further information regarding the Course, please visit the website of the Institute at the link http://www.icai.org/knowledge/wto_post_qualification.html .

Secretary, Committee on Trade Laws & WTO

NEW PUBLICATION

Guidance Note on Accounting by Schools

The Institute of Chartered Accountants of India has issued 'Guidance Note on Accounting by Schools'. The Guidance Note primarily focuses to address the various issues involved in accounting and financial reporting of schools by establishing sound accounting practices and recommending uniform formats of income and expenditure account and balance sheet. Specific accounting issues dealt with in the Guidance Note include fees and other charges received from students, salaries, allowances and retirement benefits, grants and donations, depreciation of assets, related party disclosures and transition to the accrual basis of accounting.

Price	**Rs. 50/-**
Postal Charges	**Rs. 19/- (plus Rs. 17/-, if required by registered parcel)**
Available at	***Sale counters of the Institute of Chartered Accountants of India at New Delhi, Chennai, Mumbai, Kolkata and Kanpur***

NON-RECEIPT OF ICAI JOURNAL

This is for the attention of members of the Institute who fail to receive The 'Chartered Accountant' journal dispatched to them either due to un-intimated change of address or postal problems.

The Membership numbers pertaining to all such cases are regularly hosted on ICAI website (www.icai.org) under the 'Announcements' section for information of the respective Members. Please inform the respective regions immediately after you change your address so that we can subsequently update our mailing list and ensure timely and regular delivery of journals to you. Other queries and complaints in this regard can also be sent to journal@icai.org

-Journal Section

PRACTICAL WORKSHOPS ON

Using CAAT Tools / IS Audit/ IS Audit of Banking Applications

Members interested in participating in above workshops are requested to contact their Regional/ Branch Offices to organize the above workshops and send a mail to secyitc@icai.org with subject "Practical Workshop" and Region/ Branch Office name.

EMPANELMENT OF EXAMINERS

The Institute of Chartered Accountants of India requires eminent professionals/academicians/resource persons to act as examiners for the Chartered Accountants Examinations.

The form for empanelment of examiners is available on the website of the Institute: http://www.icai.org/exam/exam.html and can be downloaded and sent to the Joint Secretary (Exams.) duly filled in and signed alongwith the required documents. Persons requiring the said form may also send their requests to the Joint Secretary (Exams.), The Institute of Chartered Accountants of India, Indraprastha Marg, New Delhi – 110002.

ANNOUNCEMENT

Tax effect of expenses/income adjusted directly against the reserves and/or Securities Premium Account

1. It has been noticed that some companies are charging certain expenses, which are otherwise required to be charged to the profit and loss account, directly against reserves and/or Securities Premium Account pursuant to the court orders. In such a case, while the expenses are charged to reserves and/or Securities Premium Account, the tax benefit arising from admissibility of such expenses for tax purposes is not recognised in the reserves and/or Securities Premium Account. Such a situation may also arise where an enterprise adjusts its reserves to give effect to a change, if any, in accounting policy consequent upon adoption of an Accounting Standard, in accordance with the transitional provisions contained

in the standard. Further, a company may adjust an expense against the Securities Premium Account as allowed under the provisions of section 78 of the Companies Act, 1956. A similar situation may arise where, pursuant to a court order or under transitional provisions prescribed in an accounting standard, an income, which should have otherwise been credited to the profit and loss account in accordance with the requirements of generally accepted accounting principles, may have been directly credited to a reserve account or a similar account and the tax effect thereof is not recognised in the reserve account or a similar account.

2. Not recognising the tax benefit, arising from admissibility of expense charged to the reserves and/or Securities Premium Account, in the reserves and/or Securities Premium Account is contrary to the generally accepted accounting principles because it results in recognition and presentation of tax effect of an expense in a manner which is different from the manner in which the expense itself has been recognised and presented. Similarly, recognising and presenting the tax effect of an income in a manner which is different from the manner in which income itself has been recognised and presented is contrary to the generally accepted accounting principles. Accordingly, any expense charged directly to reserves and/or Securities Premium Account should be net of tax benefits expected to arise from the admissibility of such expenses for tax purposes. Similarly, any income credited directly to a reserve account or a similar account should be net of its tax effect.

3. In view of the above, any item of income or expense adjusted directly to reserves and/or Securities Premium Account should be net of its tax effect.

COMMITTEE ON INSURANCE, ICAI

NATIONAL SEMINAR ON INSURANCE

16th October 2005 (Sunday) at Hotel Hardeo, Sitabuldi, Nagpur

(Hosted by Nagpur Branch of WIRC)

-: Fees :-
Members Rs. 350/-
Non members Rs. 500/-

CPE Credit- 6 Hours

Topics Covered

1. Emerging World of Insurance – Industry Perspective, Professional Perspective and Regulator's Perspective
2. Insurance Markets in India : Opportunities & Challenges
3. Insurance Consultancy
4. Surveyor & Loss Assessor

Eminent Speakers shall deliberate on the above subjects.

-: For further Details :-

Kindly contact Chairman Committee on Insurance **Shri Rajkumar Adukia** OR
Shri Jaydeep Shah, Mobile No. 9822202575, Conference Director OR
Host Branch co-ordinator & Chairman Nagpur Branch
Shri Anil B. Mardikar, Mobile No. 9422105733

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