INVITATION TO COMMENT ON THE EXPOSURE DRAFT OF THE PROPOSED ACCOUNTING STANDARD ON FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

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: Recognition and Measurement, 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, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002, so as to be received not later than ***March 31, 2007****. Comments can also be sent by e-mail at tdte@icai.org or at edcommentsasb@icai.org.*

Question 1 – Applicability to Small and Medium-sized Entities (SMEs)

The Exposure Draft of the Accounting Standard is broadly based on the International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement*. As under IAS 39, this Exposure Draft proposes that Financial Instruments should be classified into four categories, viz., 'Financial assets and financial liabilities at fair value through profit or loss', 'Held-to-maturity investments', 'Loans and receivables' and 'Available-for-sale financial assets'. This Exposure Draft also proposes that fair value approach should be followed in respect of 'Financial assets and financial liabilities at fair value through profit or loss' and 'Available-for-sale financial assets' broadly on the same lines as IAS 39. This Exposure Draft also deals with recognition, derecognition of financial assets and financial liabilities; impairment of financial assets and hedge accounting on the same lines as in IAS 39.

Do you feel that exemptions/ relaxations are required to be provided to an SME from the proposed Accounting Standard? If yes, what are the possible areas on which exemptions/ relaxations are required to be provided to an SME? Please also specify the exemptions/ relaxations which may be provided to an SME.

Question 2 – Treatment of Regular Way Purchase or Sale of a Financial Asset

On the lines of IAS 39, the Exposure Draft of the proposed Accounting Standard provides an option to recognise and derecognise regular way purchase or sale of financial assets using either trade date accounting or settlement date accounting. The trade date is the date that an entity commits itself to purchase or sell an asset. Trade date accounting refers to (a) the recognition of an asset to be received and the liability to pay for it on the trade date, and (b) derecognition of an asset that is sold, recognition of any gain or loss on disposal and the recognition of a receivable from the buyer for payment on the trade date. The settlement date is the date on which an asset is delivered to or by an entity. Settlement date accounting refers to (a) the recognition of an asset on the day it is received by the entity, and (b) the derecognition of an asset and recognition of any gain or loss on disposal on the day that it is delivered by the entity. When settlement date accounting is applied, the Exposure Draft proposes that an entity should account for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset.

Do you agree that the proposed Accounting Standard should provide an option to recognise and derecognise regular way purchase or sale of financial assets using either trade date accounting or settlement date accounting or it should require only trade date accounting with a view to enhance the comparability of financial statements? Give reasons?

Question 3 – Transaction costs directly attributable to the issue of financial liabilities

On the lines of IAS 39, the Exposure Draft of the proposed Accounting Standard proposes that transaction costs directly attributable to the issue of financial liabilities should be deducted from their respective fair values upon initial recognition. The amount so deducted from fair value should be amortised over the expected life of the respective financial liabilities using the effective interest rate method. The treatment proposed in the Exposure Draft of the proposed Accounting Standard is also in line with the principles laid down in Accounting Standard (AS) 16, *Borrowing Costs*, which requires ancillary costs incurred in connection with the arrangement of borrowing to be amortised over the period of concerned borrowings.

Do you agree with the proposed treatment? If not, why not?

Question 4 – Transitional Provisions

The proposed Accounting Standard on *Financial Instruments: Recognition and Measurement* is proposed to be made applicable in respect of accounting periods commencing on or after a particular date. As such, its application would be prospective. However, some transitional issues are still expected to arise on the first application of the proposed Accounting Standard. To address such issues, the Exposure Draft of the proposed Accounting Standard contains certain transitional provisions (refer paragraphs 114-120 of the Exposure Draft).

As per paragraph 114 of the Exposure Draft which deals with designation and measurement of financial assets and financial liabilities, on the date of this Standard becoming mandatory, an entity should change the designation and measurement of all its financial assets and financial liabilities existing on that date as per the requirements of this Standard. Any resulting gain or loss should be adjusted against opening balance of revenue reserves and surplus except gains and/ or losses relating to the financial instruments which as per the requirements of this Standard would be recognised in an appropriate equity account, say, Investment Revaluation Reserve Account. Such gains and/or losses should be

recognised in the said equity account. The transitional provisions proposed in paragraph 114 of the Exposure Draft of the Standard are in line with the transitional provisions contained in certain other standards also, e.g., AS 22, AS 26 and AS 28.

Do you agree with the Transitional Provisions contained in the Standard, particularly paragraph 114 of the Exposure Draft? If not, why not and what Transitional Provisions would you suggest?

Do you feel that apart from the issues addressed in the paragraphs 114-120, any other transitional issues are also expected to arise on the first application of the proposed Accounting Standard? If yes, what are those issues and how these issues should be addressed in the proposed Accounting Standard?

Question 5 – Implications of the application of the final Standard

Have you attempted to apply the proposed requirements contained in the Exposure Draft of proposed AS 30 to certain practical situations with a view to ascertain their implications? If yes, whether any difficulties are expected to arise on the application of the requirements? If yes, what are the difficulties and how these can be overcome?

Question 6 - Other comments

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

Exposure Draft

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

(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 (revised 2004)[1].)*

Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*, issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after ____ (*date to be decided later*) and is mandatory in nature[2] from that date. From the date of this Standard becoming mandatory for the concerned entities, the following stand withdrawn:

(i) Accounting Standard (AS) 4, *Contingencies and Events Occurring After the Balance Sheet Date*, to the extent it deals with contingencies[3].

(ii) Accounting Standard (AS) 11 (revised 2003), *The Effects of Changes in Foreign Exchange Rates*[4], to the extent it deals with the 'forward exchange contracts'.

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

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

Objective

1. The objective of this Standard is to establish principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. Requirements for presenting information about financial instruments are in Accounting Standard (AS) 31, *Financial Instruments: Presentation*[5]. Requirements for disclosing information about financial instruments are in AS 32, *Financial Instruments: Disclosures*[6].

Scope

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

(a) those interests in subsidiaries, associates and joint ventures that are accounted for under AS 21, Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements, AS 23, Accounting for Investments in Associates, or AS 27, Financial Reporting of Interests in Joint Ventures[7]. However, entities should apply this Standard to an interest in a subsidiary, associate or joint venture that according to AS 21, AS 23 or AS 27 is accounted for under this Standard. Entities should also apply this Standard to derivatives on an interest in a subsidiary, associate or joint venture unless the derivative meets the definition of an equity instrument of the entity in AS 31, Financial Instruments: Presentation[8].

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

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

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

[4] With the issuance of this Standard, Limited Revision is also being proposed to AS 11 (revised 2003) to withdraw the requirements concerning 'forward exchange contracts' from the standard.

[5] Accounting Standard (AS) 31 on *Financial Instruments: Presentation* will be issued alongwith this Accounting Standard.

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

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

[8] See footnote 5.

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

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

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

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

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

(d) financial instruments issued by the entity that meet the definition of an equity instrument in AS 31, Financial Instruments: Presentation[9], (including options and warrants). However, the holder of such equity instruments should apply this Standard to those instruments, unless they meet the exception in (a) above.

(e) (i) rights and obligations arising under an insurance contract as defined in the Accounting Standard on Insurance Contracts[10], other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract in paragraph 8.6, or (ii) a financial instrument that is within the scope of Accounting Standard on Insurance Contracts[11] because it contains a discretionary participation feature. However, this Standard applies to a derivative that is embedded in a contract within the scope of Accounting Standard on Insurance Contracts[12] if the derivative is not itself a contract within the scope of that Standard (see paragraphs 9–13 and Appendix A paragraphs A47–A53). Moreover, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may choose to apply either this Standard or Accounting Standard on Insurance Contracts[13] to such financial guarantee contracts (see Appendix A paragraphs A5 and A6). The issuer may make that choice contract by contract, but the choice made for each contract is irrevocable.

(f) contracts for contingent consideration in a business combination[14]. This exemption applies only to the acquirer.

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

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

(i) financial instruments, contracts and obligations under share-based payment transactions[15], except for contracts within the scope of paragraphs 4-6 of this Standard, to which this Standard applies.

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

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

(a) loan commitments[16] that the entity designates as financial liabilities at fair value through profit or loss. An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination should apply this Standard to all its loan commitments in the same class.

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

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

4. This Standard should be applied to those contracts to buy or sell a non-financial item that can be settled net in

[9] ibid.

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

[11] ibid.

[12] ibid.

[13] ibid.

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

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

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

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

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

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

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

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

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

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

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

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

Definitions

7. The terms defined in AS 31, *Financial Instruments: Presentation*[17], are used in this Standard with the meanings specified in paragraph 7 of AS 31. AS 31[18] defines the following terms:

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

   and provides guidance on applying those definitions.

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

Definition of a Derivative

8.1 A derivative is a financial instrument or other contract within the scope of this Standard (see paragraphs 2-6) with all three of the following characteristics:

(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying');

(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and

(c) it is settled at a future date.

Definitions of Four Categories of Financial Instruments

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

(a) It is classified as held for trading. A financial asset or financial liability is classified as held for trading if it is:

(i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term; or

(ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or

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

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

(i) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases (see Appendix A paragraphs A15-A18); or

[17] See footnote 5.

[18] ibid.

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

Accounting Standard (AS) 32, Financial Instruments: Disclosures[19], requires the entity to provide disclosures about financial assets and financial liabilities it has designated as at fair value through profit or loss, including how it has satisfied these conditions. For instruments qualifying in accordance with (ii) above, that disclosure includes a narrative description of how designation as at fair value through profit or loss is consistent with the entity's documented risk management or investment strategy.

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

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

8.3 Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity (see Appendix A paragraphs A36-A45) other than:

(a) those that the entity upon initial recognition designates as at fair value through profit or loss;

(b) those that meet the definition of loans and receivables; and

(c) those that the entity designates as available for sale.

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

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

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

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

8.4 Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than:

(a) those that the entity intends to sell immediately or in the near term, which should be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss;

(b) those that the entity upon initial recognition designates as available for sale; or

(c) those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which should be classified as available for sale.

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

8.5 Available-for-sale financial assets are those non-derivative financial assets that are designated as available for sale or are not classified as (a) loans and receivables, (b) held-to-maturity investments, or (c) financial assets at fair value through profit or loss.

Definition of a financial guarantee contract

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

Definitions Relating to Recognition and Measurement

8.7 The amortised cost of a financial asset or financial liability is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

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

8.9 The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through

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

the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability (see Appendix A paragraphs A23-A27).

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

8.11 Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction[20].

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

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

Definitions Relating to Hedge Accounting

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

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

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

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

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

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

Embedded Derivatives

9. An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract. A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.

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

(a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract (see Appendix A paragraphs A50 and A53);

(b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

(c) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in the statement of profit and loss (i.e., a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).

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

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

(a) the embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract; or

(b) it is clear with little or no analysis when a similar hybrid (combined) instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.

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

[20] Paragraphs 50-52 and A80-A94 of Appendix A contain requirements for determining the fair value of a financial asset or financial liability.

at fair value through profit or loss.

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

Recognition and Derecognition

Initial Recognition

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

Derecognition of a Financial Asset

15. Before evaluating whether, and to what extent, derecognition is appropriate under paragraphs 16-22, an entity determines whether those paragraphs should be applied to a part of a financial asset (or a part of a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety, as follows.

(a) Paragraphs 16-22 are applied to a part of a financial asset (or a part of a group of similar financial assets) if, and only if, the part being considered for derecognition meets one of the following three conditions.

(i) The part comprises only specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash flows, but not the principal cash flows from a debt instrument, paragraphs 16-22 are applied to the interest cash flows.

(ii) The part comprises only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of all cash flows of a debt instrument, paragraphs 16-22 are applied to 90 per cent of those cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the cash flows provided that the transferring entity has a fully proportionate share.

(iii) The part comprises only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of interest cash flows from a financial asset, paragraphs 16-22 are applied to 90 per cent of those interest cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the specifically identified cash flows provided that the transferring entity has a fully proportionate share.

(b) In all other cases, paragraphs 16-22 are applied to the financial asset in its entirety (or to the group of similar financial assets in their entirety). For example, when an entity transfers (i) the rights to the first or the last 90 per cent of cash collections from a financial asset (or a group of financial assets), or (ii) the rights to 90 per cent of the cash flows from a group of receivables, but provides a guarantee to compensate the buyer for any credit losses up to 8 per cent of the principal amount of the receivables, paragraphs 16-22 are applied to the financial asset (or a group of similar financial assets) in its entirety.

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

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

(a) the contractual rights to the cash flows from the financial asset expire; or

(b) it transfers the financial asset as set out in paragraphs 17 and 18 and the transfer qualifies for derecognition in accordance with paragraph 19.

(See paragraph 38-42 for regular way sales of financial assets.)

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

(a) transfers the contractual rights to receive the cash flows of the financial asset; or

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

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

(a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent

amounts from the original asset. Short-term advances by the entity to the eventual recipients with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.

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

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

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

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

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

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

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

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

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

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

22. Whether the entity has retained control (see paragraph 19(c)) of the transferred asset depends on the transferee's ability to sell the asset. If the transferee has the practical ability to sell the asset in its entirety to an unrelated party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer, the entity has not retained control. In all other cases, the entity has retained control.

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

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

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

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

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

difference between:

(a) the carrying amount and

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

should be recognised in the statement of profit and loss.

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

(a) the carrying amount allocated to the part derecognised and

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

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

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

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

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

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

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

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

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

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

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

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

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

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

33. For the purpose of subsequent measurement, recognised

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

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

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

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

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

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

All Transfers

36. If a transferred asset continues to be recognised, the asset and the associated liability should not be offset. Similarly, the entity should not offset any income arising from the transferred asset with any expense incurred on the associated liability (see AS 31, Financial Instruments: Presentation[21], paragraph 72).

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

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

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

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

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

Regular Way Purchase or Sale of a Financial Asset

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

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

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

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

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

[21] See footnote 5.

Derecognition of a Financial Liability

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

44. An exchange between an existing borrower and lender of debt instruments with substantially different terms should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

45. The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, should be recognised in the statement of profit and loss.

46. If an entity repurchases a part of a financial liability, the entity allocates the previous carrying amount of the financial liability between the part that continues to be recognised and the part that is derecognised based on the relative fair values of those parts on the date of the repurchase. The difference between (a) the carrying amount allocated to the part derecognised and (b) the consideration paid, including any non-cash assets transferred or liabilities assumed, for the part derecognised is recognised in the statement of profit and loss.

Measurement

Initial Measurement of Financial Assets and Financial Liabilities

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

(a) A financial asset or financial liability at fair value through profit or loss should be measured at fair value on the date of acquisition or issue.

(b) Short-term receivables and payables with no stated interest rate should be measured at original invoice amount if the effect of discounting is immaterial.

(c) Other financial assets or financial liabilities should be measured at fair value plus/ minus transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

48. When an entity uses settlement date accounting for an asset that is subsequently measured at cost or amortised cost, the asset is recognised initially at its fair value on the trade date (see paragraphs 38–42).

49. Often it will be obvious whether the effect of discounting of short-term receivables and payables would be material or immaterial and there would be no need to make detailed calculations. In other cases, it will be necessary to make detailed calculations.

Subsequent Measurement of Financial Assets

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

(a) financial assets at fair value through profit or loss;

(b) held-to-maturity investments;

(c) loans and receivables; and

(e) available-for-sale financial assets.

These categories apply to measurement and profit or loss recognition under this Standard. The entity may use other descriptors for these categories or other categorisation when presenting information on the face of the financial statements. The entity should disclose in the notes the information required by AS 32 on *Financial Instruments: Disclosures*[22].

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

(a) loans and receivables as defined in paragraph 8.4, which should be measured at amortised cost using the effective interest method. However, short-term receivables with no stated interest rate should not be measured at amortised cost if the effect of discounting is immaterial. Such short-term receivables should be measured at the original invoice amount;

(b) held-to-maturity investments as defined in paragraph 8.3, which should be measured at amortised cost using the effective interest method; and

(c) investments in equity instruments that do not have a quoted market price in an active market and whose fair value can not be reliably measured and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments, which should be measured at cost (see Appendix A paragraphs A100 and A101).

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

Subsequent Measurement of Financial Liabilities

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

(a) financial liabilities at fair value through profit or loss. Such liabilities, including derivatives that are

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

liabilities, should be measured at fair value other than a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured, which should be measured at cost.

(b) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies. Paragraphs 29 and 31 apply to the measurement of such financial liabilities.

(c) short-term payables with no stated interest rate should be measured at the original invoice amount if the effect of discounting is immaterial.

(d) financial guarantee contracts as defined in paragraph 8.6. After initial recognition, an issuer of such a contract should (unless paragraph 52(a) or (b) applies) measure it at the higher of:

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

(ii) the amount initially recognised (see paragraphs 47-49) less, when appropriate, cumulative amortisation recognised, if any.

(e) commitments to provide a loan at a below-market interest rate. After initial recognition, an issuer of such a commitment should (unless paragraph 52(a) applies) measure it at the higher of:

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

(ii) the amount initially recognised (see paragraphs 47-49) less, when appropriate, cumulative amortisation recognised, if any.

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

Fair Value Measurement Considerations

53. In determining the fair value of a financial asset or a financial liability for the purpose of applying this Standard, AS 31, Financial Instruments: Presentation[23] or AS 32 on Financial Instruments: Disclosures[24], an entity should apply paragraphs A88-A102 of Appendix A.

54. The best evidence of fair value is quoted prices in an active market. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique. The chosen valuation technique makes maximum use of market inputs and relies as little as possible on entity-specific inputs. It incorporates all factors that market participants would consider in setting a price and is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (i.e., without modification or repackaging) or based on any available observable market data.

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

Reclassifications

56. An entity should not reclassify a financial instrument into or out of the fair value through profit or loss category while it is held or issued.

57. If, as a result of a change in intention or ability, it is no longer appropriate to classify an investment as held to maturity, it should be reclassified as available for sale and remeasured at fair value, and the difference between its carrying amount and fair value should be accounted for in accordance with paragraph 61(b).

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

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

60. If,

(a) as a result of a change in intention or ability; or

(b) in the rare circumstance that a reliable measure of fair value is no longer available (see paragraphs 51(c) and 52); or

(c) the 'two preceding financial years' referred to in paragraph 8.3 have passed,

it becomes appropriate to carry a financial asset or financial liability at cost or amortised cost rather than at

[23] See footnote 5.

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

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

(a) In the case of a financial asset with a fixed maturity, the gain or loss should be amortised to the statement of profit and loss over the remaining life of the held-to-maturity investment using the effective interest method. Any difference between the new amortised cost and maturity amount should also be amortised over the remaining life of the financial asset using the effective interest method, similar to the amortisation of a premium and a discount. If the financial asset is subsequently impaired, any gain or loss that has been recognised directly in the appropriate equity account is recognised in the statement of profit and loss in accordance with paragraph 76.

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

Gains and Losses

61. A gain or loss arising from a change in the fair value of a financial asset or financial liability that is not part of a hedging relationship (see paragraphs 99-113), should be recognised, as follows.

(a) A gain or loss on a financial asset or financial liability classified as at fair value through profit or loss should be recognised in the statement of profit and loss.

(b) A gain or loss on an available-for-sale financial asset should be recognised directly in an appropriate equity account, say, Investment Revaluation Reserve Account, except for impairment losses (see paragraphs 76-79) and foreign exchange gains and losses (see Appendix A paragraph A103), until the financial asset is derecognised, at which time the cumulative gain or loss previously recognised in the appropriate equity account should be recognised in the statement of profit and loss. However, interest calculated using the effective interest method (see paragraph 8.9 and Appendix A paragraphs A23-A27) is recognised in the statement of profit and loss. Dividends on an available-for-sale equity instrument are recognised in the statement of profit and loss when the entity's right to receive payment is established (see AS 9, Revenue Recognition).

62. For financial assets and financial liabilities carried at amortised cost (see paragraphs 51 and 52), a gain or loss is recognised in the statement of profit and loss when the financial asset or financial liability is derecognised or impaired, and through the amortisation process. However, for financial assets or financial liabilities that are hedged items (see paragraphs 87-94 and Appendix A paragraphs A118-A125) the accounting for the gain or loss should follow paragraphs 99-113.

63. If an entity recognises financial assets using settlement date accounting (see paragraphs 38-42), any change in the fair value of the asset to be received during the period between the trade date and the settlement date is not recognised for assets carried at cost or amortised cost (other than impairment losses). For assets carried at fair value, however, the change in fair value should be recognised in the statement of profit and loss or in the appropriate equity account, as appropriate under paragraph 61.

Impairment and Uncollectibility of Financial Assets

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

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

(a) significant financial difficulty of the issuer or obligor;

(b) a breach of contract, such as a default or delinquency in interest or principal payments;

(c) the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;

(d) it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;

(e) an active market no longer exists for that financial asset because of financial difficulties; or

(f) observable data indicating that there is a measurable decrease in the estimated future cash flows from a

group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:

(i) adverse changes in the payment status of borrowers in the group (e.g., an increased number of delayed payments or an increased number of credit card borrowers who have reached their credit limit and are paying the minimum monthly amount); or

(ii) national or local economic conditions that correlate with defaults on the assets in the group (e.g., an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).

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

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

68. In some cases the observable data required to estimate the amount of an impairment loss on a financial asset may be limited or no longer fully relevant to current circumstances. For example, this may be the case when a borrower is in financial difficulties and there are few available historical data relating to similar borrowers. In such cases, an entity uses its experienced judgement to estimate the amount of any impairment loss. Similarly an entity uses its experienced judgement to adjust observable data for a group of financial assets to reflect current circumstances (see paragraph A109). The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

Financial Assets Carried at Amortised Cost

69. If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e., the effective interest rate computed at initial recognition). The carrying amount of the asset should be reduced either directly or through use of an allowance account[25]. The amount of the loss should be recognised in the statement of profit and loss.

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

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

Short-term Receivables Carried at Original Invoice Amount

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

73. An entity first assesses whether objective evidence of impairment exists individually for short-term receivables that are individually significant, and individually or collectively for short-term receivables that are not individually significant (see paragraph 65). If an entity determines that no objective evidence of impairment exists for an individually assessed short-term receivable, whether

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

significant or not, it includes the receivable in a group of short-term receivables with similar credit risk characteristics and collectively assesses them for impairment. Short-term receivables that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

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

Financial Assets Carried at Cost

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

Available-for-Sale Financial Assets

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

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

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

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

Hedging

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

Hedging Instruments

Qualifying Instruments

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

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

Designation of Hedging Instruments

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

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

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

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

contract can qualify for hedge accounting.

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

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

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

Hedged Items

Qualifying Items

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

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

89. For hedge accounting purposes, only assets, liabilities, firm commitments or highly probable forecast transactions that involve a party external to the entity can be designated as hedged items. It follows that hedge accounting can be applied to transactions between entities or segments in the same group only in the individual or separate financial statements of those entities or segments and not in the consolidated financial statements of the group. As an exception, the foreign currency risk of an intragroup monetary item (e.g., a payable/receivable between two subsidiaries) may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation in accordance with Accounting Standard (AS) 11, *The Effects of Changes in Foreign Exchange Rates*. In accordance with AS 11, foreign exchange rate gains and losses on intragroup monetary item are not fully eliminated on consolidation when the intragroup monetary item is transacted between two group entities that have different functional currencies[26]. In addition, the foreign currency risk of a highly probable forecast intragroup transaction may qualify as a hedged item in consolidated financial statements provided that the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss.

Designation of Financial Items as Hedged Items

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

91. In a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only in such a hedge), the portion hedged may be designated in terms of an amount of a currency (e.g. an amount of rupees, dollars, euro, pounds or rand) rather than as individual assets (or liabilities). Although the portfolio may, for risk management purposes, include assets and liabilities, the amount designated is an amount of assets or an amount of liabilities. Designation of a net amount including assets and liabilities is not permitted. The entity may hedge a portion of the interest rate risk associated with this designated amount. For example, in the case of a hedge of a portfolio containing prepayable assets, the entity may hedge the change in fair value that is attributable to a change in the hedged interest rate on the basis of expected, rather than contractual, repricing dates. When the portion hedged is based on expected repricing dates, the effect that changes in the hedged interest rate have on those expected repricing dates should be included when determining the change in the fair value of the hedged item. Consequently, if a portfolio that contains prepayable items is hedged with a non-prepayable derivative, ineffectiveness arises if the dates on which items in the hedged portfolio are expected

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

to prepay are revised, or actual prepayment dates differ from those expected.

Designation of Non-Financial Items as Hedged Items

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

Designation of groups of items as hedged items

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

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

Hedge Accounting

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

96. Hedging relationships are of three types:

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

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

(c) <u>hedge of a net investment in a non-integral foreign operation</u> as defined in AS 11.

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

98. A hedging relationship qualifies for hedge accounting under paragraphs 99-113 if, and only if, all of the following conditions are met.

(a) At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation should include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.

(b) The hedge is expected to be highly effective (see Appendix A paragraphs A129-A138) in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.

(c) For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.

(d) The effectiveness of the hedge can be reliably measured, i.e., the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured (see paragraphs 51 and 52 and Appendix A paragraphs A100 and A101 for guidance on determining fair value).

(e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

Fair Value Hedges

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

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

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

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

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

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

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

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

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

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

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

(c) the entity revokes the designation.

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

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

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

Cash Flow Hedges

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

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

(b) the portion of the gain or loss on the hedging instrument that is determined to be an ineffective hedge should be recognised in the statement of profit and loss.

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

(a) the appropriate equity account (Hedging Reserve Account) associated with the hedged item is adjusted to the lesser of the following (in absolute amounts):

(i) the cumulative gain or loss on the hedging instrument from inception of the hedge; and

(ii) the cumulative change in fair value (present value) of the expected future cash flows on the hedged item from inception of the hedge;

(b) any remaining gain or loss on the hedging instrument or designated component of it (that is not an effective hedge) is recognised in the statement of profit and loss; and

(c) if an entity's documented risk management strategy for a particular hedging relationship excludes from the assessment of hedge effectiveness a specific component of the gain or loss or related cash flows on the hedging instrument (see paragraphs 83, 84 and 98(a)), that excluded component of gain or loss is recognised in accordance with paragraph 61.

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

109. If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or a non-financial liability, or a forecast transaction for a non-financial asset or non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, then the

entity should adopt (a) or (b) below:

(a) It reclassifies, i.e., recognises, the associated gains and losses that were recognised directly in the appropriate equity account in accordance with paragraph 106 into the statement of profit and loss in the same period or periods during which the asset acquired or liability assumed affects profit or loss (such as in the periods that depreciation expense or cost of sales is recognised). However, if an entity expects that all or a portion of a loss recognised directly in the equity account will not be recovered in one or more future periods, it should reclassify into, i.e., recognise in, the statement of profit and loss the amount that is not expected to be recovered.

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

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

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

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

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

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

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

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

Hedges of a Net Investment

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

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

(b) the portion of the gain or loss on the hedging instrument that is determined to be an ineffective hedge should be recognised in the statement of profit and loss.

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

Transitional Provisions

Designation and Measurement of Financial Assets and Financial Liabilities

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

Derecognition of Financial Assets and Financial Liabilities

115. The derecognition requirements in the Standard should be applied prospectively for transactions occurring on or after the date of this Standard becoming mandatory. An entity may, however, apply the derecognition requirements in the Standard retrospectively from a date of the entity's choosing, provided that the information needed to apply this Standard to financial assets and financial liabilities derecognised as a result of past transactions was obtained at the time of initially accounting for those transactions.

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

Hedge Accounting

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

(a) measure all derivatives at fair value; and

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

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

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

Embedded Derivatives

120. An entity that applies this Standard for the first time should assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of the conditions that existed on the date it first became a party to the contract or on the date on which a reassessment is required by Appendix A paragraph A56, whichever is the later date.

Appendix A

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

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

Scope (paragraphs 2-6)

A1. Some contracts require a payment based on climatic, geological or other physical variables. (Those based on climatic variables are sometimes referred to as 'weather derivatives'.) If those contracts are not within the scope of Accounting Standard on *Insurance Contracts*[27], they are within the scope of this Standard.

A2. This Standard does not change the requirements relating to employee benefit plans that comply with Accounting Standard on *Accounting and Reporting by Retirement Benefit Plans*[28] and recognition of revenue arising from royalty agreements based on the volume of sales or service revenues that are accounted for under AS 9.

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

[28] A separate Accounting Standard on *Accounting and Reporting by Retirement Benefit Plans*, which is being formulated, will specify the requirements relating to accounting and reporting retirement by retirement benefit plans.

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

A4. This Standard applies to the financial assets and financial liabilities of insurers, other than rights and obligations arising under an insurance contract and financial instruments that paragraph 2(e) excludes because they arise under contracts within the scope of Accounting Standard on *Insurance Contracts*[29].

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

(a) Although a financial guarantee contract meets the definition of an insurance contract in Accounting Standard on *Insurance Contracts*[30] if the risk transferred is significant, the issuer applies this Standard. Nevertheless, if the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may chose to apply either this Standard or Accounting Standard on *Insurance Contracts*[31] to such financial guarantee contracts. If this Standard applies, paragraph 47 requires the issuer to recognise a financial guarantee contract initially at fair value. If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's length transaction, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary. Subsequently, unless the financial guarantee contract was designated at inception as at fair value through profit or loss or unless paragraphs 29–37 and A70–A75 apply (when a transfer of a financial asset does not qualify for derecognition or the continuing involvement approach applies), the issuer measures it at the higher of:

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

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

(b) Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a guarantee is one that requires payments in response to changes in a specified credit rating or credit index. Such guarantees are not financial guarantee contracts, as defined in this Standard, and are not insurance contracts, as defined in Accounting Standard on *Insurance Contracts*[32]. Such guarantees are derivatives and the issuer applies this Standard to them.

(c) If a financial guarantee contract was issued in connection with the sale of goods, the issuer applies AS 9 (Revised) [33] in determining when it recognises the revenue from the guarantee and from the sale of goods.

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

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

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

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

A10. A loan commitment is excluded from the scope of this Standard only if it cannot be settled net. If the value of a loan commitment can be settled net in cash or another financial instrument, including when the entity has a past practice of selling the resulting loan assets shortly after origination, it is

[29] See footnote 27.

[30] ibid.

[31] ibid.

[32] ibid.

[33] AS 9 is presently under revision.

difficult to justify its exclusion from the requirement in this Standard to measure at fair value similar instruments that meet the definition of a derivative.

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

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

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

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

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

Definitions (paragraphs 7 and 8)

Designation as at Fair Value through Profit or Loss

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

A14. The decision of an entity to designate a financial asset or financial liability as at fair value through profit or loss is similar to an accounting policy choice (although, unlike an accounting policy choice, it is not required to be applied consistently to all similar transactions). When an entity has such a choice, Accounting Standard (AS) 5, *Accounting Policies, Changes in Accounting Estimates and Errors*[34] requires the chosen policy to result in the financial statements providing reliable and more relevant information about the effects of transactions, other events and conditions on the entity's financial position, financial performance or cash flows. In the case of designation as at fair value through profit or loss, paragraph 8.2 sets out the two circumstances when the requirement for more relevant information will be met. Accordingly, to choose such designation in accordance with paragraph 8.2, the entity needs to demonstrate that it falls within one (or both) of these two circumstances.

Paragraph 8.2(b)(i): Designation eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise

A15. Under this Standard, measurement of a financial asset or financial liability and classification of recognised changes in its value are determined by the item's classification and whether the item is part of a designated hedging relationship. Those requirements can create a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') when, for example, in the absence of designation as at fair value through profit or loss, a financial asset would be classified as available for sale (with most changes in fair value recognised directly in the appropriate equity account) and a liability the entity considers related would be measured at amortised cost (with changes in fair value not recognised). In such circumstances, an entity may conclude that its financial statements would provide more relevant information if both the asset and the liability were classified as at fair value through profit or loss.

A16. The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through profit or loss only if it meets the principle in paragraph 8.2(b)(i).

(a) An entity has liabilities whose cash flows are contractually based on the performance of assets that would otherwise be classified as available for sale. For example, an insurer may have liabilities containing a discretionary participation feature that pay benefits based on realised and/or unrealised investment returns of a specified pool of the insurer's assets. If the measurement of those liabilities reflects current market prices, classifying the assets as at fair value through profit or loss means that changes in the fair value of the financial assets are recognised in the statement of profit and loss in the same period as related changes in the value of the liabilities.

(b) An entity has liabilities under insurance contracts whose measurement incorporates current information (as permitted by Accounting Standard on *Insurance Contracts*[35]), and financial assets it considers related that would otherwise be classified as available for sale or measured at amortised cost.

(c) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other. However, only some of the instruments would be measured at fair value through profit or loss (i.e., derivatives, or instruments classified as held for trading). It may also be the case that the requirements for hedge accounting are not met, say, because the requirements for effectiveness in paragraph 98 are not met.

(d) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other and the entity does not qualify for hedge accounting because none of the instruments is a derivative. Furthermore, in the absence of hedge accounting there is a significant inconsistency in the recognition of gains and losses. For example:

    (i) the entity has financed a portfolio of fixed rate assets that would otherwise be classified as available for sale by issuing fixed rate bonds/ debentures whose changes in fair value tend to offset each other. Reporting both the assets and the bonds/ debentures at fair value through profit or loss corrects the inconsistency that would otherwise arise from measuring the assets at fair value with changes reported in the appropriate equity account and the bonds/ debentures at amortised cost.

[34] AS 5 is presently under revision.

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

(ii) the entity has financed a specified group of loans by issuing traded bonds/ debentures whose changes in fair value tend to offset each other. If, in addition, the entity regularly buys and sells the bonds/ debentures but rarely, if ever, buys and sells the loans, reporting both the loans and the bonds/ debentures at fair value through profit or loss eliminates the inconsistency in the timing of recognition of gains and losses that would otherwise result from measuring them both at amortised cost and recognising a gain or loss each time a bond/ debenture is repurchased.

A17. In cases such as those described in the preceding paragraph, to designate, at initial recognition, the financial assets and financial liabilities not otherwise so measured as at fair value through profit or loss may eliminate or significantly reduce the measurement or recognition inconsistency and produce more relevant information. For practical purposes, the entity need not enter into all of the assets and liabilities giving rise to the measurement or recognition inconsistency at exactly the same time. A reasonable delay is permitted provided that each transaction is designated as at fair value through profit or loss at its initial recognition and, at that time, any remaining transactions are expected to occur.

A18. It would not be acceptable to designate only some of the financial assets and financial liabilities giving rise to the inconsistency as at fair value through profit or loss if to do so would not eliminate or significantly reduce the inconsistency and would therefore not result in more relevant information. However, it would be acceptable to designate only some of a number of similar financial assets or similar financial liabilities if doing so achieves a significant reduction (and possibly a greater reduction than other allowable designations) in the inconsistency. For example, assume an entity has a number of similar financial liabilities that sum to Rs. 100 and a number of similar financial assets that sum to Rs. 50 but are measured on a different basis. The entity may significantly reduce the measurement inconsistency by designating at initial recognition all of the assets but only some of the liabilities (for example, individual liabilities with a combined total of Rs. 45) as at fair value through profit or loss. However, because designation as at fair value through profit or loss can be applied only to the whole of a financial instrument, the entity in this example must designate one or more liabilities in their entirety. It could not designate either a component of a liability (e.g., changes in value attributable to only one risk, such as changes in a benchmark interest rate) or a proportion (i.e., percentage) of a liability.

Paragraph 8.2(b)(ii): A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy

A19. An entity may manage and evaluate the performance of a group of financial assets, financial liabilities or both in such a way that measuring that group at fair value through profit or loss results in more relevant information. The focus in this instance is on the way the entity manages and evaluates performance, rather than on the nature of its financial instruments.

A20. The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through profit or loss only if it meets the principle in paragraph 8.2(b)(ii).

(a) The entity is a venture capital organisation, mutual fund, unit trust or similar entity whose business is investing in financial assets with a view to profiting from their total return in the form of interest or dividends and changes in fair value. AS 23 and AS 27 allow such investments to be excluded from their scope provided they are measured at fair value through profit or loss[36]. An entity may apply the same accounting policy to other investments managed on a total return basis but over which its influence is insufficient for them to be within the scope of AS 23 or AS 27.

(b) The entity has financial assets and financial liabilities that share one or more risks and those risks are managed and evaluated on a fair value basis in accordance with a documented policy of asset and liability management. An example could be an entity that has issued 'structured products' containing multiple embedded derivatives and manages the resulting risks on a fair value basis using a mix of derivative and non-derivative financial instruments. A similar example could be an entity that originates fixed interest rate loans and manages the resulting benchmark interest rate risk using a mix of derivative and non-derivative financial instruments.

(c) The entity is an insurer that holds a portfolio of financial assets, manages that portfolio so as to maximise its total return (i.e., interest or dividends and changes in fair value), and evaluates its performance on that basis. The portfolio may be held to back specific liabilities, equity or both. If the portfolio is held to back specific liabilities, the condition in paragraph 8.2(b)(ii) may be met for the assets regardless of whether the insurer also manages and evaluates the liabilities on a fair value basis. The condition in paragraph 8.2(b)(ii) may be met when the insurer's objective is to maximise total return on the assets over the longer term even if amounts paid to holders of participating contracts depend on other factors such as the amount of gains realised in a shorter period (e.g., a year) or are subject to the insurer's discretion.

A21. As noted above, this condition relies on the way the entity manages and evaluates performance of the group of financial instruments under consideration. Accordingly, (subject to the requirement of designation at initial recognition) an entity that designates financial instruments as at fair value through profit or loss on the basis of this condition should so designate all eligible financial instruments that are managed and evaluated together.

A22. Documentation of the entity's strategy need not be extensive but should be sufficient to demonstrate compliance with paragraph 8.2(b)(ii). Such documentation is not required for each individual item, but may be on a portfolio basis. For example, if the performance management system for a department—as approved by the entity's key management personnel, its board of directors or similar governing body or its chief executive officer—clearly demonstrates that its performance is evaluated on a total return basis, no further documentation is required to demonstrate compliance with paragraph 8.2(b)(ii).

[36] It may be noted that AS 23 and AS 27, at present, do not make this exclusion from their scope. With the issuance of this Standard, Limited Revisions are also being proposed to AS 23 and AS 27 to provide for the same.

Effective Interest Rate

A23. When calculating the effective interest rate, an entity should estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but should not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity should use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

A24. In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. Entities include such incurred credit losses in the estimated cash flows when computing the effective interest rate.

A25. When applying the effective interest method, an entity generally amortises any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the instrument. However, a shorter period is used if this is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate. This will be the case when the variable to which the fees, points paid or received, transaction costs, premiums or discounts relate is repriced to market rates before the expected maturity of the instrument. In such a case, the appropriate amortisation period is the period to the next such repricing date. For example, if a premium or discount on a floating rate instrument reflects interest that has accrued on the instrument since interest was last paid, or changes in market rates since the floating interest rate was reset to market rates, it will be amortised to the next date when the floating interest is reset to market rates. This is because the premium or discount relates to the period to the next interest reset date because, at that date, the variable to which the premium or discount relates (i.e., interest rates) is reset to market rates. If, however, the premium or discount results from a change in the credit spread over the floating rate specified in the instrument, or other variables that are not reset to market rates, it is amortised over the expected life of the instrument.

A26. For floating rate financial assets and floating rate financial liabilities, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. If a floating rate financial asset or floating rate financial liability is recognised initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability.

A27. If an entity revises its estimates of payments or receipts, the entity adjusts the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The adjustment is recognised as income or expense in the statement of profit and loss.

Derivatives

A28. Typical examples of derivatives are futures and forward, swap and option contracts. A derivative usually has a notional amount, which is an amount of currency, a number of shares, a number of units of weight or volume or other units specified in the contract. However, a derivative instrument does not require the holder or writer to invest or receive the notional amount at the inception of the contract. Alternatively, a derivative could require a fixed payment or payment of an amount that can change (but not proportionally with a change in the underlying) as a result of some future event that is unrelated to a notional amount. For example, a contract may require a fixed payment of Rs. 1,000, if six-month MIBOR increases by 100 basis points. Such a contract is a derivative even though a notional amount is not specified.

A29. The definition of a derivative in this Standard includes contracts that are settled gross by delivery of the underlying item (e.g., a forward contract to purchase a fixed rate debt instrument). An entity may have a contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument or by exchanging financial instruments (e.g., a contract to buy or sell a commodity at a fixed price at a future date). Such a contract is within the scope of this Standard unless it was entered into and continues to be held for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (see paragraphs 4-6).

A30. One of the defining characteristics of a derivative is that it has an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. An option contract meets that definition because the premium is less than the investment that would be required to obtain the underlying financial instrument to which the option is linked. A currency swap that requires an initial exchange of different currencies of equal fair values meets the definition because it has a zero initial net investment.

A31. A regular way purchase or sale gives rise to a fixed price commitment between trade date and settlement date that meets the definition of a derivative. However, because of the short duration of the commitment it is not recognised as a derivative financial instrument. Rather, this Standard provides for special accounting for such regular way contracts (see paragraphs 38-42).

A32. The definition of a derivative refers to non-financial variables that are not specific to a party to the contract. These include an index of earthquake losses in a particular region and an index of temperatures in a particular city. Non-financial variables specific to a party to the contract include the occurrence or non-occurrence of a fire that damages or destroys an asset of a party to the contract. A change in the fair value of a non-financial asset is specific to the owner if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific non-financial asset held (a non-financial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car's physical condition, the change in that residual value is specific to the owner of the car.

Transaction Costs

A33. Transaction costs include fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

Financial Assets and Financial Liabilities Held for Trading

A34. Trading generally reflects active and frequent buying and selling, and financial instruments held for trading generally are used with the objective of generating a profit from short-term fluctuations in price or dealer's margin.

A35. Financial liabilities held for trading include:

(a) derivative liabilities that are not accounted for as hedging instruments;

(b) obligations to deliver financial assets borrowed by a short seller (i.e., an entity that sells financial assets it has borrowed and does not yet own);

(c) financial liabilities that are incurred with an intention to repurchase them in the near term (e.g., a quoted debt instrument that the issuer may buy back in the near term depending on changes in its fair value); and

(d) financial liabilities that are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking.

The fact that a liability is used to fund trading activities does not in itself make that liability one that is held for trading.

Held-to-Maturity Investments

A36. An entity does not have a positive intention to hold to maturity an investment in a financial asset with a fixed maturity if:

(a) the entity intends to hold the financial asset for an undefined period;

(b) the entity stands ready to sell the financial asset (other than if a situation arises that is non-recurring and could not have been reasonably anticipated by the entity) in response to changes in market interest rates or risks, liquidity needs, changes in the availability of and the yield on alternative investments, changes in financing sources and terms or changes in foreign currency risk; or

(c) the issuer has a right to settle the financial asset at an amount significantly below its amortised cost.

A37. A debt instrument with a variable interest rate can satisfy the criteria for a held-to-maturity investment. Equity instruments cannot be held-to-maturity investments either because they have an indefinite life (such as equity shares) or because the amounts the holder may receive can vary in a manner that is not predetermined (such as for share options, warrants and similar rights). With respect to the definition of held-to-maturity investments, fixed or determinable payments and fixed maturity mean that a contractual arrangement defines the amounts and dates of payments to the holder, such as interest and principal payments. A significant risk of non-payment does not preclude classification of a financial asset as held to maturity as long as its contractual payments are fixed or determinable and the other criteria for that classification are met. If the terms of a perpetual debt instrument provide for interest payments for an indefinite period, the instrument cannot be classified as held to maturity because there is no maturity date.

A38. The criteria for classification as a held-to-maturity investment are met for a financial asset that is callable by the issuer if the holder intends and is able to hold it until it is called or until maturity and the holder would recover substantially all of its carrying amount. The call option of the issuer, if exercised, simply accelerates the asset's maturity. However, if the financial asset is callable on a basis that would result in the holder not recovering substantially all of its carrying amount, the financial asset cannot be classified as a held-to-maturity investment. The entity considers any premium paid and capitalized transaction costs in determining whether the carrying amount would be substantially recovered.

A39. A financial asset that is puttable (i.e., the holder has the right to require that the issuer repay or redeem the financial asset before maturity) cannot be classified as a held-to-maturity investment because paying for a put feature in a financial asset is inconsistent with expressing an intention to hold the financial asset until maturity.

A40. For most financial assets, fair value is a more appropriate measure than amortised cost. The held-to-maturity classification is an exception, but only if the entity has a positive intention and the ability to hold the investment to maturity. When an entity's actions cast doubt on its intention and ability to hold such investments to maturity, paragraph 8.3 precludes the use of the held-to-maturity classification for a reasonable period of time.

A41. A disaster scenario that is only remotely possible, such as a run on a bank or a similar situation affecting an insurer, is not something that is assessed by an entity in deciding whether it has the positive intention and ability to hold an investment to maturity.

A42. Sales before maturity could satisfy the condition in paragraph 8.3—and therefore not raise a question about the entity's intention to hold other investments to maturity—if they are attributable to any of the following:

(a) a significant deterioration in the issuer's creditworthiness. For example, a sale following a downgrade in a credit rating by an external rating agency would not necessarily raise a question about the entity's intention to hold other investments to maturity if the downgrade provides evidence of a significant deterioration in the issuer's creditworthiness judged by reference to the credit rating at initial recognition. Similarly, if an entity uses internal ratings for assessing exposures, changes in those internal ratings may help to identify issuers for which there has been a significant deterioration in creditworthiness, provided the entity's approach to assigning internal ratings and changes in those ratings give a consistent, reliable and objective measure of the credit quality of the issuers. If there is evidence that a financial asset is impaired (see paragraphs 64 and 65), the deterioration in creditworthiness is often regarded as significant.

(b) a change in tax law that eliminates or significantly reduces the tax-exempt status of interest on the held-to-maturity investment (but not a change in tax law that revises the marginal tax rates applicable to interest income).

(c) a major business combination or major disposition (such as a sale of a segment) that necessitates the sale

or transfer of held-to-maturity investments to maintain the entity's existing interest rate risk position or credit risk policy (although the business combination is an event within the entity's control, the changes to its investment portfolio to maintain an interest rate risk position or credit risk policy may be consequential rather than anticipated).

(d) a change in statutory or regulatory requirements significantly modifying either what constitutes a permissible investment or the maximum level of particular types of investments, thereby causing an entity to dispose of a held-to-maturity investment.

(e) a significant increase in the industry's regulatory capital requirements that causes the entity to downsize by selling held-to-maturity investments.

(f) a significant increase in the risk weights of held-to-maturity investments used for regulatory risk-based capital purposes.

A43. An entity does not have a demonstrated ability to hold to maturity an investment in a financial asset with a fixed maturity if:

(a) it does not have the financial resources available to continue to finance the investment until maturity; or

(b) it is subject to an existing legal or other constraint that could frustrate its intention to hold the financial asset to maturity. (However, an issuer's call option does not necessarily frustrate an entity's intention to hold a financial asset to maturity—see paragraph A38.)

A44. Circumstances other than those described in paragraphs A36-A43 can indicate that an entity does not have a positive intention or the ability to hold an investment to maturity.

A45. An entity assesses its intention and ability to hold its held-to-maturity investments to maturity not only when those financial assets are initially recognised, but also at each subsequent balance sheet date.

Loans and Receivables

A46. Any non-derivative financial asset with fixed or determinable payments (including loan assets, trade receivables, investments in debt instruments and deposits held in banks) could potentially meet the definition of loans and receivables. However, a financial asset that is quoted in an active market (such as a quoted debt instrument, see paragraph A90) does not qualify for classification as a loan or receivable. Financial assets that do not meet the definition of loans and receivables may be classified as held-to-maturity investments if they meet the conditions for that classification (see paragraphs 8.3 and A36-A45). On initial recognition of a financial asset that would otherwise be classified as a loan or receivable, an entity may designate it as a financial asset at fair value through profit or loss, or available for sale.

Embedded Derivatives (paragraphs 9-13)

A47. If a host contract has no stated or predetermined maturity and represents a residual interest in the net assets of an entity, then its economic characteristics and risks are those of an equity instrument, and an embedded derivative would need to possess equity characteristics related to the same entity to be regarded as closely related. If the host contract is not an equity instrument and meets the definition of a financial instrument, then its economic characteristics and risks are those of a debt instrument.

A48. An embedded non-option derivative (such as an embedded forward or swap) is separated from its host contract on the basis of its stated or implied substantive terms, so as to result in it having a fair value of zero at initial recognition. An embedded option-based derivative (such as an embedded put, call, cap, floor or swaption) is separated from its host contract on the basis of the stated terms of the option feature. The initial carrying amount of the host instrument is the residual amount after separating the embedded derivative.

A49. Generally, multiple embedded derivatives in a single instrument are treated as a single compound embedded derivative. However, embedded derivatives that are classified as equity *(see AS 31, Financial Instruments: Presentation*[37]*)* are accounted for separately from those classified as assets or liabilities. In addition, if an instrument has more than one embedded derivative and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other.

A50. The economic characteristics and risks of an embedded derivative are not closely related to the host contract (paragraph 10(a)) in the following examples. In these examples, assuming the conditions in paragraph 10(b) and (c) are met, an entity accounts for the embedded derivative separately from the host contract.

(a) A put option embedded in an instrument that enables the holder to require the issuer to reacquire the instrument for an amount of cash or other assets that varies on the basis of the change in an equity or commodity price or index is not closely related to a host debt instrument.

(b) A call option embedded in an equity instrument that enables the issuer to reacquire that equity instrument at a specified price is not closely related to the host equity instrument from the perspective of the holder (from the issuer's perspective, the call option is an equity instrument provided it meets the conditions for that classification under AS 31, in which case it is excluded from the scope of this Standard).

(c) An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension. If an entity issues a debt instrument and the holder of that debt instrument writes a call option on the debt instrument to a third party, the issuer regards the call option as extending the term to maturity of the debt instrument provided the issuer can be required to participate in or facilitate the remarketing of the debt instrument as a result of the call option being exercised.

(d) Equity-indexed interest or principal payments embedded in a host debt instrument or insurance contract—by which the amount of interest or principal is indexed to

[37] See footnote 5.

the value of equity instruments—are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.

(e) Commodity-indexed interest or principal payments embedded in a host debt instrument or insurance contract—by which the amount of interest or principal is indexed to the price of a commodity (such as gold)—are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.

(f) An equity conversion feature embedded in a convertible debt instrument is not closely related to the host debt instrument from the perspective of the holder of the instrument (from the issuer's perspective, the equity conversion option is an equity instrument and excluded from the scope of this Standard provided it meets the conditions for that classification under AS 31).

(g) A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless the option's exercise price is approximately equal on each exercise date to the amortised cost of the host debt instrument or the carrying amount of the host insurance contract. From the perspective of the issuer of a convertible debt instrument with an embedded call or put option feature, the assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element under AS 31.

(h) Credit derivatives that are embedded in a host debt instrument and allow one party (the 'beneficiary') to transfer the credit risk of a particular reference asset, which it may not own, to another party (the 'guarantor') are not closely related to the host debt instrument. Such credit derivatives allow the guarantor to assume the credit risk associated with the reference asset without directly owning it.

A51. An example of a hybrid instrument is a financial instrument that gives the holder a right to put the financial instrument back to the issuer in exchange for an amount of cash or other financial assets that varies on the basis of the change in an equity or commodity index that may increase or decrease (a 'puttable instrument'). Unless the issuer on initial recognition designates the puttable instrument as a financial liability at fair value through profit or loss, it is required to separate an embedded derivative (i.e., the indexed principal payment) under paragraph 10 because the host contract is a debt instrument under paragraph A47 and the indexed principal payment is not closely related to a host debt instrument under paragraph A50(a). Because the principal payment can increase and decrease, the embedded derivative is a non-option derivative whose value is indexed to the underlying variable.

A52. In the case of a puttable instrument that can be put back at any time for cash equal to a proportionate share of the net asset value of an entity (such as units of an open-ended mutual fund or some unit-linked investment products), the effect of separating an embedded derivative and accounting for each component is to measure the combined instrument at the redemption amount that is payable at the balance sheet date if the holder exercised its right to put the instrument back to the issuer.

A53. The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract in the following examples. In these examples, an entity does not account for the embedded derivative separately from the host contract.

(a) An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt contract or insurance contract is closely related to the host contract unless the combined instrument can be settled in such a way that the holder would not recover substantially all of its recognised investment or the embedded derivative could at least double the holder's initial rate of return on the host contract and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract.

(b) An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the contract is issued, and the cap or floor is not leveraged in relation to the host contract. Similarly, provisions included in a contract to purchase or sell an asset (e.g., a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money at inception and are not leveraged.

(c) An embedded foreign currency derivative that provides a stream of principal or interest payments that are denominated in a foreign currency and is embedded in a host debt instrument (e.g., a dual currency bond) is closely related to the host debt instrument. Such a derivative is not separated from the host instrument because AS 11 requires foreign currency gains and losses on monetary items to be recognised in the statement of profit and loss.

(d) An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument (such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:

(i) the functional currency of any substantial party to that contract;

(ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or

(iii) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (e.g., a relatively stable and liquid cur-

rency that is commonly used in local business transactions or external trade).

(e) An embedded prepayment option in an interest-only or principal-only strip is closely related to the host contract provided the host contract (i) initially resulted from separating the right to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative, and (ii) does not contain any terms not present in the original host debt contract.

(f) An embedded derivative in a host lease contract is closely related to the host contract if the embedded derivative is (i) an inflation-related index such as an index of lease payments to a consumer price index (provided that the lease is not leveraged and the index relates to inflation in the entity's own economic environment), (ii) contingent rentals based on related sales or (iii) contingent rentals based on variable interest rates.

(g) A unit-linking feature embedded in a host financial instrument or host insurance contract is closely related to the host instrument or host contract if the unit-denominated payments are measured at current unit values that reflect the fair values of the assets of the fund. A unit-linking feature is a contractual term that requires payments denominated in units of an internal or external investment fund.

(h) A derivative embedded in an insurance contract is closely related to the host insurance contract if the embedded derivative and host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately (i.e., without considering the host contract).

Instruments containing Embedded Derivatives

A54. When an entity becomes a party to a hybrid (combined) instrument that contains one or more embedded derivatives, paragraph 10 requires the entity to identify any such embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently. These requirements can be more complex, or result in less reliable measures, than measuring the entire instrument at fair value through profit or loss. For that reason this Standard permits the entire instrument to be designated as at fair value through profit or loss.

A55. Such designation may be used whether paragraph 10 requires the embedded derivatives to be separated from the host contract or prohibits such separation. However, paragraph 11 would not justify designating the hybrid (combined) instrument as at fair value through profit or loss in the cases set out in paragraph 11(a) and (b) because doing so would not reduce complexity or increase reliability.

Reassessment of Embedded Derivatives

A56. An entity should assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity first becomes a party to the contract. Subsequent reassessment is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract, in which case reassessment is required. An entity determines whether a modification to cash flows is significant by considering the extent to which the expected future cash flows associated with the embedded derivative, the host contract or both have changed and whether the change is significant relative to the previously expected cash flows on the contract.

Recognition and Derecognition (paragraphs 14-46)

Initial Recognition (paragraph 14)

A57. As a consequence of the principle in paragraph 14, an entity recognises all of its contractual rights and obligations under derivatives in its balance sheet as assets and liabilities, respectively, except for derivatives that prevent a transfer of financial assets from being accounted for as a sale (see paragraph A72). If a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset (see paragraph A73).

A58. The following are examples of applying the principle in paragraph 14:

(a) unconditional receivables and payables are recognised as assets or liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash.

(b) assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognised until at least one of the parties has performed under the agreement. For example, an entity that receives a firm order does not generally recognise an asset (and the entity that places the order does not recognise a liability) at the time of the commitment but, rather, delays recognition until the ordered goods or services have been shipped, delivered or rendered. If a firm commitment to buy or sell non-financial items is within the scope of this Standard under paragraphs 4-6, its net fair value is recognised as an asset or liability on the commitment date (see (c) below). In addition, if a previously unrecognised firm commitment is designated as a hedged item in a fair value hedge, any change in the net fair value attributable to the hedged risk is recognised as an asset or liability after the inception of the hedge (see paragraphs 104 and 105).

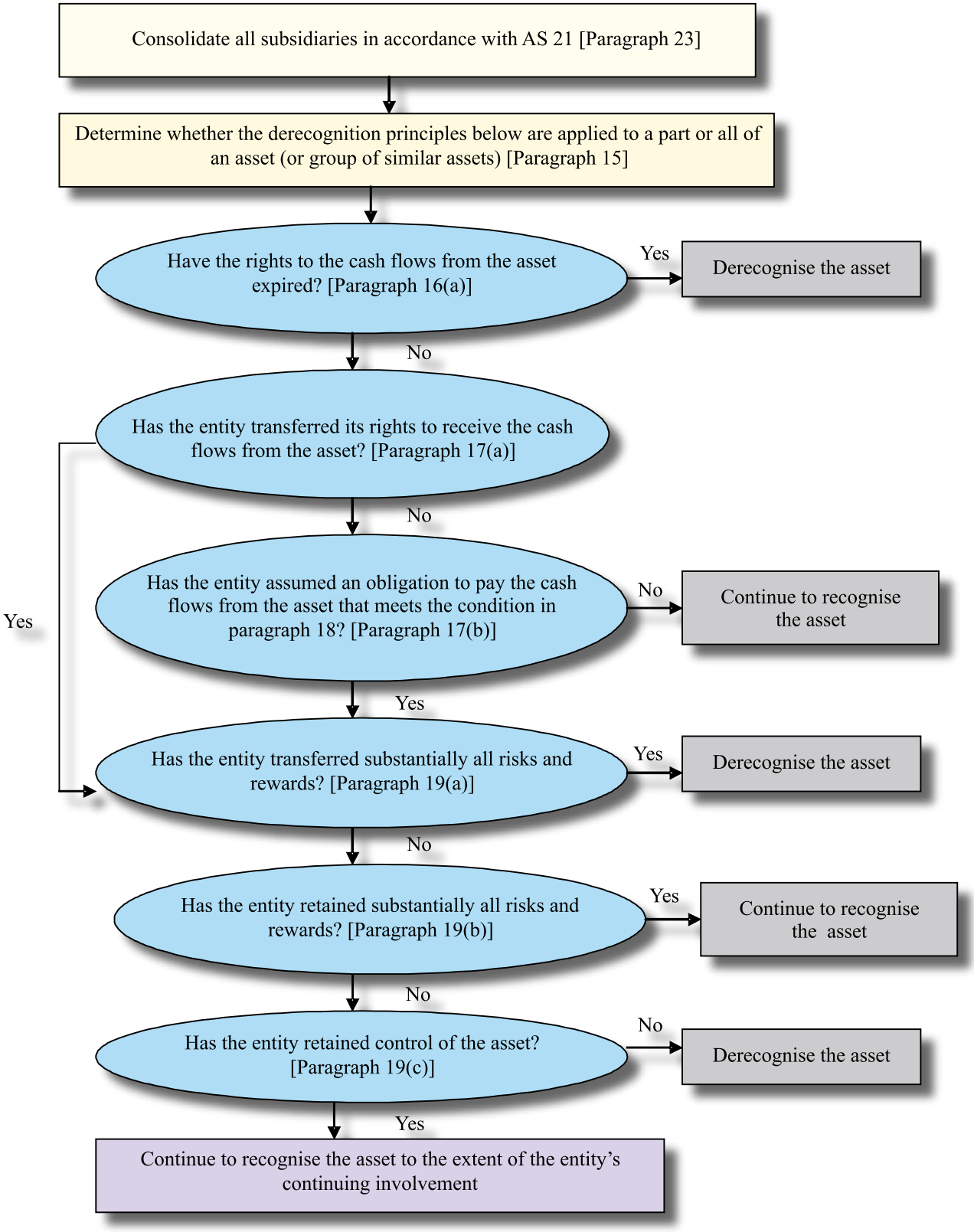
(c) a forward contract that is within the scope of this Standard (see paragraphs 2-6) is recognised as an asset or a liability on the commitment date, rather than on the date on which settlement takes place. When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero. If the net fair value of the right and obligation is not zero, the contract is recognised as an asset or liability.

(d) option contracts that are within the scope of this Standard (see paragraphs 2-6) are recognised as assets or liabilities when the holder or writer becomes a party to the contract.

(e) planned future transactions, no matter how likely, are not assets and liabilities because the entity has not become a party to a contract.

Derecognition of a Financial Asset (paragraphs 15-37)

A59. The following flow chart illustrates the evaluation of whether and to what extent a financial asset is derecognised.



Arrangements under which an entity retains the contractual rights to receive the cash flows of a financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients (paragraph 17(b))

A60. The situation described in paragraph 17(b) (when an entity retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients) occurs, for example, if the entity is a special purpose entity or trust, and issues to investors beneficial interests in the underlying financial assets that it owns and provides servicing of those financial assets. In that case, the financial assets qualify for derecognition if the conditions in paragraphs 18 and 19 are met.

A61. In applying paragraph 18, the entity could be, for example, the originator of the financial asset, or it could be a group that includes a consolidated special purpose entity that has acquired the financial asset and passes on cash flows to unrelated third party investors.

Evaluation of the transfer of risks and rewards of ownership (paragraph 19)

A62. Examples of when an entity has transferred substantially all the risks and rewards of ownership are:

(a) an unconditional sale of a financial asset;

(b) a sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase; and

(c) sale of a financial asset together with a put or call option that is deeply out of the money (i.e., an option that is so far out of the money it is highly unlikely to go into the money before expiry).

A63. Examples of when an entity has retained substantially all the risks and rewards of ownership are:

(a) a sale and repurchase transaction (e.g., REPO transactions) where the repurchase price is a fixed price or the sale price plus a lender's return;

(b) a securities lending agreement;

(c) a sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity;

(d) a sale of a financial asset together with a deep in-the-money put or call option (i.e., an option that is so far in the money that it is highly unlikely to go out of the money before expiry); and

(e) a sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.

A64. If an entity determines that as a result of the transfer, it has transferred substantially all the risks and rewards of ownership of the transferred asset, it does not recognise the transferred asset again in a future period, unless it reacquires the transferred asset in a new transaction.

Evaluation of the transfer of control

A65. An entity has not retained control of a transferred asset if the transferee has the practical ability to sell the transferred asset. An entity has retained control of a transferred asset if the transferee does not have the practical ability to sell the transferred asset. A transferee has the practical ability to sell the transferred asset if it is traded in an active market because the transferee could repurchase the transferred asset in the market if it needs to return the asset to the entity. For example, a transferee may have the practical ability to sell a transferred asset if the transferred asset is subject to an option that allows the entity to repurchase it, but the transferee can readily obtain the transferred asset in the market if the option is exercised. A transferee does not have the practical ability to sell the transferred asset if the entity retains such an option and the transferee cannot readily obtain the transferred asset in the market if the entity exercises its option.

A66. The transferee has the practical ability to sell the transferred asset only if the transferee can sell the transferred asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without imposing additional restrictions on the transfer. The critical question is what the transferee is able to do in practice, not what contractual rights the transferee has concerning what it can do with the transferred asset or what contractual prohibitions exist. In particular:

(a) a contractual right to dispose of the transferred asset has little practical effect if there is no market for the transferred asset; and

(b) an ability to dispose of the transferred asset has little practical effect if it cannot be exercised freely. For that reason:

  (i) the transferee's ability to dispose of the transferred asset must be independent of the actions of others (i.e., it must be a unilateral ability); and

  (ii) the transferee must be able to dispose of the transferred asset without needing to attach restrictive conditions or 'strings' to the transfer (e.g., conditions about how a loan asset is serviced or an option giving the transferee the right to repurchase the asset).

A67. That the transferee is unlikely to sell the transferred asset does not, of itself, mean that the transferor has retained control of the transferred asset. However, if a put option or guarantee constrains the transferee from selling the transferred asset, then the transferor has retained control of the transferred asset. For example, if a put option or guarantee is sufficiently valuable it constrains the transferee from selling the transferred asset because the transferee would, in practice, not sell the transferred asset to a third party without attaching a similar option or other restrictive conditions. Instead, the transferee would hold the transferred asset so as to obtain payments under the guarantee or put option. Under these circumstances the transferor has retained control of the transferred asset.

Transfers that Qualify for Derecognition

A68. An entity may retain the right to a part of the interest payments on transferred assets as compensation for servicing those assets. The part of the interest payments that the entity would give up upon termination or transfer of the servicing contract is allocated to the servicing asset or servicing liability. The part of the interest payments that the entity would not give up is an interest-only strip receivable. For example, if the entity

would not give up any interest upon termination or transfer of the servicing contract, the entire interest spread is an interest-only strip receivable. For the purposes of applying paragraph 27, the fair values of the servicing asset and interest-only strip receivable are used to allocate the carrying amount of the receivable between the part of the asset that is derecognised and the part that continues to be recognised. If there is no servicing fee specified or the fee to be received is not expected to compensate the entity adequately for performing the servicing, a liability for the servicing obligation is recognised at fair value.

A69. In estimating the fair values of the part that continues to be recognised and the part that is derecognised for the purposes of applying paragraph 27, an entity applies the fair value measurement requirements in paragraphs 53-55 and A88-A102 in addition to paragraph 28.

Transfers that Do Not Qualify for Derecognition

A70. The following is an application of the principle outlined in paragraph 29. If a guarantee provided by the entity for default losses on the transferred asset prevents a transferred asset from being derecognised because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the transferred asset continues to be recognised in its entirety and the consideration received is recognised as a liability.

Continuing Involvement in Transferred Assets

A71. The following are examples of how an entity measures a transferred asset and the associated liability under paragraph 30.

All assets

(a) If a guarantee provided by an entity to pay for default losses on a transferred asset prevents the transferred asset from being derecognised to the extent of the continuing involvement, the transferred asset at the date of the transfer is measured at the lower of (i) the carrying amount of the asset and (ii) the maximum amount of the consideration received in the transfer that the entity could be required to repay ('the guarantee amount'). The associated liability is initially measured at the guarantee amount plus the fair value of the guarantee (which is normally the consideration received for the guarantee). Subsequently, the initial fair value of the guarantee is recognised in the statement of profit and loss on a time proportion basis (see AS 9 (revised)[38]) and the carrying value of the asset is reduced by any impairment losses.

Assets measured at amortised cost

(b) If a put option obligation written by an entity or call option right held by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at amortised cost, the associated liability is measured at its cost (i.e., the consideration received) adjusted for the amortisation of any difference between that cost and the amortised cost of the transferred asset at the expiration date of the option. For example, assume that the amortised cost and carrying amount of the asset on the date of the transfer is Rs. 98 and that the consideration received is Rs. 95. The amortised cost of the asset on the option exercise date will be Rs. 100. The initial carrying amount of the associated liability is Rs. 95 and the difference between Rs. 95 and Rs. 100 is recognised in the statement of profit and loss using the effective interest method. If the option is exercised, any difference between the carrying amount of the associated liability and the exercise price is recognised in the statement of profit and loss.

Assets measured at fair value

(c) If a call option right retained by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at fair value, the asset continues to be measured at its fair value. The associated liability is measured at (i) the option exercise price less the time value of the option if the option is in or at the money, or (ii) the fair value of the transferred asset less the time value of the option if the option is out of the money. The adjustment to the measurement of the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the call option right. For example, if the fair value of the underlying asset is Rs. 80, the option exercise price is Rs. 95 and the time value of the option is Rs. 5, the carrying amount of the associated liability is Rs. 75 (Rs. 80 - Rs. 5) and the carrying amount of the transferred asset is Rs. 80 (i.e., its fair value).

(d) If a put option written by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at fair value, the associated liability is measured at the option exercise price plus the time value of the option. The measurement of the asset at fair value is limited to the lower of the fair value and the option exercise price because the entity has no right to increases in the fair value of the transferred asset above the exercise price of the option. This ensures that the net carrying amount of the asset and the associated liability is the fair value of the put option obligation. For example, if the fair value of the underlying asset is Rs. 120, the option exercise price is Rs. 100 and the time value of the option is Rs. 5, the carrying amount of the associated liability is Rs. 105 (Rs. 100 + Rs. 5) and the carrying amount of the asset is Rs. 100 (in this case the option exercise price).

(e) If a collar, in the form of a purchased call and written put, prevents a transferred asset from being derecognised and the entity measures the asset at fair value, it continues to measure the asset at fair value. The associated liability is measured at (i) the sum of the call exercise price and fair value of the put option less the time value of the call option, if the call option is in or at the money, or (ii) the sum of the fair value of the asset and the fair value of the put option less the time value of the call option if the call option is out of the money. The adjustment to the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the options held and written by the entity. For example, assume an entity transfers a financial asset that is measured at fair value while simultaneously purchasing a call with an exercise price of Rs. 120 and writing a put with an exercise price of Rs. 80. Assume also that the fair value of the asset is Rs. 100 at the date of the transfer. The time value of the put and call are Rs. 1 and Rs. 5 respectively. In this case, the entity recognises an asset of Rs. 100 (the fair value of the asset)

[38] AS 9 is presently under revision.

and a liability of Rs. 96 [(Rs. 100 + Rs. 1) – Rs. 5]. This gives a net asset value of Rs. 4, which is the fair value of the options held and written by the entity.

All Transfers

A72. To the extent that a transfer of a financial asset does not qualify for derecognition, the transferor's contractual rights or obligations related to the transfer are not accounted for separately as derivatives if recognising both the derivative and either the transferred asset or the liability arising from the transfer would result in recognising the same rights or obligations twice. For example, a call option retained by the transferor may prevent a transfer of financial assets from being accounted for as a sale. In that case, the call option is not separately recognised as a derivative asset.

A73. To the extent that a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset. The transferee derecognises the cash or other consideration paid and recognises a receivable from the transferor. If the transferor has both a right and an obligation to reacquire control of the entire transferred asset for a fixed amount (such as under a repurchase agreement), the transferee may account for its receivable as a loan or receivable.

Examples

A74. The following examples illustrate the application of the derecognition principles of this Standard.

(a) *Repurchase agreements and securities lending*. If a financial asset is sold under an agreement to repurchase it at a fixed price or at the sale price plus a lender's return or if it is loaned under an agreement to return it to the transferor, it is not derecognised because the transferor retains substantially all the risks and rewards of ownership. If the transferee obtains the right to sell or pledge the asset, the transferor reclassifies the asset on its balance sheet, for example, as a loaned asset or repurchase receivable.

(b) *Repurchase agreements and securities lending—assets that are substantially the same.* If a financial asset is sold under an agreement to repurchase the same or substantially the same asset at a fixed price or at the sale price plus a lender's return or if a financial asset is borrowed or loaned under an agreement to return the same or substantially the same asset to the transferor, it is not derecognised because the transferor retains substantially all the risks and rewards of ownership.

(c) *Repurchase agreements and securities lending—right of substitution.* If a repurchase agreement at a fixed repurchase price or a price equal to the sale price plus a lender's return, or a similar securities lending transaction, provides the transferee with a right to substitute assets that are similar and of equal fair value to the transferred asset at the repurchase date, the asset sold or lent under a repurchase or securities lending transaction is not derecognised because the transferor retains substantially all the risks and rewards of ownership.

(d) *Repurchase right of first refusal at fair value.* If an entity sells a financial asset and retains only a right of first refusal to repurchase the transferred asset at fair value in case the transferee subsequently sells it, the entity derecognises the asset because it has transferred substantially all the risks and rewards of ownership.

(e) *Wash sale transaction.* The repurchase of a financial asset shortly after it has been sold is sometimes referred to as a wash sale. Such a repurchase does not preclude derecognition provided that the original transaction met the derecognition requirements. However, if an agreement to sell a financial asset is entered into concurrently with an agreement to repurchase the same asset at a fixed price or the sale price plus a lender's return, then the asset is not derecognised.

(f) *Put options and call options that are deeply in the money.* If a transferred financial asset can be called back by the transferor and the call option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership. Similarly, if the financial asset can be put back by the transferee and the put option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership.

(g) *Put options and call options that are deeply out of the money.* A financial asset that is transferred subject only to a deep out-of-the-money put option held by the transferee or a deep out-of-the-money call option held by the transferor is derecognised. This is because the transferor has transferred substantially all the risks and rewards of ownership.

(h) *Readily obtainable assets subject to a call option that is neither deeply in the money nor deeply out of the money.* If an entity holds a call option on an asset that is readily obtainable in the market and the option is neither deeply in the money nor deeply out of the money, the asset is derecognised. This is because the entity (i) has neither retained nor transferred substantially all the risks and rewards of ownership, and (ii) has not retained control. However, if the asset is not readily obtainable in the market, derecognition is precluded to the extent of the amount of the asset that is subject to the call option because the entity has retained control of the asset.

(i) *A not readily obtainable asset subject to a put option written by an entity that is neither deeply in the money nor deeply out of the money.* If an entity transfers a financial asset that is not readily obtainable in the market, and writes a put option that is not deeply out of the money, the entity neither retains nor transfers substantially all the risks and rewards of ownership because of the written put option. The entity retains control of the asset if the put option is sufficiently valuable to prevent the transferee from selling the asset, in which case the asset continues to be recognised to the extent of the transferor's continuing involvement (see paragraph A67). The entity transfers control of the asset if the put option is not sufficiently valuable to prevent the transferee from selling the asset, in which case the asset is derecognised.

(j) *Assets subject to a fair value put or call option or a forward repurchase agreement.* A transfer of a financial asset that is

subject only to a put or call option or a forward repurchase agreement that has an exercise or repurchase price equal to the fair value of the financial asset at the time of repurchase results in derecognition because of the transfer of substantially all the risks and rewards of ownership.

(k) *Cash settled call or put options.* An entity evaluates the transfer of a financial asset that is subject to a put or call option or a forward repurchase agreement that will be settled net in cash to determine whether it has retained or transferred substantially all the risks and rewards of ownership. If the entity has not retained substantially all the risks and rewards of ownership of the transferred asset, it determines whether it has retained control of the transferred asset. That the put or the call or the forward repurchase agreement is settled net in cash does not automatically mean that the entity has transferred control (see paragraphs A67 and (g), (h) and (i) above).

(l) *Removal of accounts provision.* A removal of accounts provision is an unconditional repurchase (call) option that gives an entity the right to reclaim assets transferred subject to some restrictions. Provided that such an option results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership, it precludes derecognition only to the extent of the amount subject to repurchase (assuming that the transferee cannot sell the assets). For example, if the carrying amount and proceeds from the transfer of loan assets are Rs. 100,000 and any individual loan could be called back but the aggregate amount of loans that could be repurchased could not exceed Rs. 10,000, Rs. 90,000 of the loans would qualify for derecognition.

(m) *Clean-up calls.* An entity, which may be a transferor, that services transferred assets may hold a clean-up call to purchase remaining transferred assets when the amount of outstanding assets falls to a specified level at which the cost of servicing those assets becomes burdensome in relation to the benefits of servicing. Provided that such a clean-up call results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership and the transferee cannot sell the assets, it precludes derecognition only to the extent of the amount of the assets that is subject to the call option.

(n) *Subordinated retained interests and credit guarantees.* An entity may provide the transferee with credit enhancement by subordinating some or all of its interest retained in the transferred asset. Alternatively, an entity may provide the transferee with credit enhancement in the form of a credit guarantee that could be unlimited or limited to a specified amount. If the entity retains substantially all the risks and rewards of ownership of the transferred asset, the asset continues to be recognised in its entirety. If the entity retains some, but not substantially all, of the risks and rewards of ownership and has retained control, derecognition is precluded to the extent of the amount of cash or other assets that the entity could be required to pay.

(o) *Total return swaps.* An entity may sell a financial asset to a transferee and enter into a total return swap with the transferee, whereby all of the interest payment cash flows from the underlying asset are remitted to the entity in exchange for a fixed payment or variable rate payment and any increases or declines in the fair value of the underlying asset are absorbed by the entity. In such a case, derecognition of all of the asset is prohibited.

(p) *Interest rate swaps.* An entity may transfer to a transferee a fixed rate financial asset and enter into an interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount that is equal to the principal amount of the transferred financial asset. The interest rate swap does not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on payments being made on the transferred asset.

(q) *Amortising interest rate swaps.* An entity may transfer to a transferee a fixed rate financial asset that is paid off over time, and enter into an amortising interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount. If the notional amount of the swap amortises so that it equals the principal amount of the transferred financial asset outstanding at any point in time, the swap would generally result in the entity retaining substantial prepayment risk, in which case the entity either continues to recognise all of the transferred asset or continues to recognise the transferred asset to the extent of its continuing involvement. Conversely, if the amortisation of the notional amount of the swap is not linked to the principal amount outstanding of the transferred asset, such a swap would not result in the entity retaining prepayment risk on the asset. Hence, it would not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on interest payments being made on the transferred asset and the swap does not result in the entity retaining any other significant risks and rewards of ownership on the transferred asset.

A75. This paragraph illustrates the application of the continuing involvement approach when the entity's continuing involvement is in a part of a financial asset.

Assume an entity has a portfolio of prepayable loans whose coupon and effective interest rate is 10 per cent and whose principal amount and amortised cost is Rs. 10,000. It enters into a transaction in which, in return for a payment of Rs. 9,115, the transferee obtains the right to Rs. 9,000 of any collections of principal plus interest thereon at 9.5 per cent. The entity retains rights to Rs. 1,000 of any collections of principal plus interest thereon at 10 per cent, plus the excess spread of 0.5 per cent on the remaining Rs. 9,000 of principal. Collections from prepayments are allocated between the entity and the transferee proportionately in the ratio of 1:9, but any defaults are deducted from the entity's interest of Rs. 1,000 until that interest is exhausted. The fair value of the loans at the date of the transaction is Rs. 10,100 and the estimated fair value of the excess spread of 0.5 per cent is Rs. 40.

The entity determines that it has transferred some significant risks and rewards of ownership (for example, significant prepayment risk) but has also retained some significant risks and rewards of ownership (because of its subordinated retained interest) and has retained control. It therefore applies the continuing involvement approach.

To apply this Standard, the entity analyses the transaction as (a) a retention of a fully proportionate retained interest of Rs. 1,000, plus (b) the subordination of that retained interest to provide credit enhancement to the transferee for credit losses.

The entity calculates that Rs. 9,090 (90 per cent × Rs. 10,100) of the consideration received of Rs. 9,115 represents the consideration for a fully proportionate 90 per cent share. The remainder of the consideration received (Rs. 25) represents consideration received for subordinating its retained interest to provide credit enhancement to the transferee for credit losses. In addition, the excess spread of 0.5 per cent represents consideration received for the credit enhancement. Accordingly, the total consideration received for the credit enhancement is Rs. 65 (Rs. 25 + Rs. 40).

The entity calculates the gain or loss on the sale of the 90 per cent share of cash flows. Assuming that separate fair values of the 90 per cent part transferred and the 10 per cent part retained are not available at the date of the transfer, the entity allocates the carrying amount of the asset in accordance with paragraph 28 as follows:

	Estimated Fair Value	**Percentage**	**Allocated Carrying Amount**
Portion transferred	9,090	90%	9,000
Portion retained	1,010	10%	1,000
Total	10,100		10,000

The entity computes its gain or loss on the sale of the 90 per cent share of the cash flows by deducting the allocated carrying amount of the portion transferred from the consideration received, i.e., Rs. 90 (Rs. 9,090 - Rs. 9,000). The carrying amount of the portion retained by the entity is Rs. 1,000.

In addition, the entity recognises the continuing involvement that results from the subordination of its retained interest for credit losses. Accordingly, it recognises an asset of Rs. 1,000 (the maximum amount of the cash flows it would not receive under the subordination), and an associated liability of Rs. 1,065 (which is the maximum amount of the cash flows it would not receive under the subordination, i.e., Rs. 1,000 plus the fair value of the subordination of Rs. 65).

The entity uses all of the above information to account for the transaction as follows:

	Debit	**Credit**
Original asset	–	9,000
Asset recognised for subordination or the residual interest	1,000	–
Asset for the consideration received in the form of excess spread	40	
Profit or loss (gain on transfer)	–	90
Liability	–	1,065
Cash received	9,115	–
Total	**10,155**	**10,155**

Immediately following the transaction, the carrying amount of the asset is Rs. 2,040 comprising Rs. 1,000, representing the allocated cost of the portion retained, and Rs. 1,040, representing the entity's additional continuing involvement from the subordination of its retained interest for credit losses (which includes the excess spread of Rs. 40).

In subsequent periods, the entity recognises the consideration received for the credit enhancement (Rs. 65) on a time proportion basis, accrues interest on the recognised asset using the effective interest method and recognises any credit impairment on the recognised assets. As an example of the latter, assume that in the following year there is a credit impairment loss on the underlying loans of Rs. 300. The entity reduces its recognised asset by Rs. 600 (Rs. 300 relating to its retained interest and Rs. 300 relating to the additional continuing involvement that arises from the subordination of its retained interest for credit losses), and reduces its recognised liability by Rs. 300. The net result is a charge to the statement of profit and loss for credit impairment of Rs. 300.

Derecognition of a Financial Liability (paragraphs 43-46)

A76. A financial liability (or part of it) is extinguished when the debtor either:

(a) discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or

(b) is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (If the debtor has given a guarantee this condition may still be met.)

A77. If an issuer of a debt instrument repurchases that instrument, the debt is extinguished even if the issuer is a market maker in that instrument or intends to resell it in the near term.

A78. Payment to a third party, including a trust (sometimes called 'in-substance defeasance'), does not, by itself, relieve the debtor of its primary obligation to the creditor, in the absence of legal release.

A79. If a debtor pays a third party to assume an obligation and notifies its creditor that the third party has assumed its debt obligation, the debtor does not derecognise the debt obligation unless the condition in paragraph A76(b) is met. If the debtor pays a third party to assume an obligation and obtains a legal release from its creditor, the debtor has extinguished the debt. However, if the debtor agrees to make payments on the debt to the third party or direct to its original creditor, the debtor recognises a new debt obligation to the third party. For example, suppose Entity A which owes Rs. 1,000,000 to Entity B agrees to pay Rs. 1,000,000 to Entity C at a future date to assume its obligation to Entity B. Entity B legally releases Entity A from any further obligation under the debt. As desired by Entity C, Entity A agrees to make payment to Entity B on behalf of Entity C. In this case, Entity A derecognises its obligation to pay Rs. 1,000,000 to Entity B and recognises a new obligation to pay this amount to Entity C.

A80. Although legal release, whether judicially or by the creditor, results in derecognition of a liability, the entity recognises a new liability if the derecognition criteria in paragraphs 15-37

are not met for the financial assets transferred. If those criteria are not met, the transferred assets are not derecognised, and the entity recognises a new liability relating to the transferred assets.

A81. For the purpose of paragraph 44, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.

A82. In some cases, a creditor releases a debtor from its present obligation to make payments, but the debtor assumes a guarantee obligation to pay if the party assuming primary responsibility defaults. In this circumstance the debtor:

(a) recognises a new financial liability based on the fair value of its obligation for the guarantee; and

(b) recognises a gain or loss based on the difference between (i) any proceeds paid and (ii) the carrying amount of the original financial liability less the fair value of the new financial liability.

Measurement (paragraphs 47-79)

Initial Measurement of Financial Assets and Financial Liabilities (paragraph 47)

A83. The fair value of a financial instrument on initial recognition is normally the transaction price (i.e., the fair value of the consideration given or received, see also paragraph A96). However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated, using a valuation technique (see paragraphs A93-A99). For example, the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset.

A84. If an entity originates a loan that bears an off-market interest rate (e.g., 5 per cent when the market rate for similar loans is 8 per cent), and receives an up-front fee as compensation, the entity recognises the loan at its fair value, i.e., net of the fee it receives. The entity accretes the discount to the statement of profit and loss using the effective interest rate method.

Example Illustrating Paragraph A84

Entity S lends Rs. 1,000,000 to Entity A. The loan carries interest at 5% per annum payable annually and is payable in full after a period of five years, even though the market rate for similar loans is 8%. To compensate entity S for the below market rate of interest, entity A pays an origination fees of Rs. 120,000 to entity S. There are no other directly related payments by either party.

Entity S recognises the loan at its fair value, i.e., net present value of interest Rs. 50,000 to be received each year for next five years and repayment of principal Rs. 1,000,000 to be received at the end of five years. The fair value of loan computed in this manner comes out to be Rs. 880,000 which is the same amount as the loan amount net of fees received. Entity S recognises interest on loan using the effective interest rate method computed as below:

Year	Balance Outstanding	Interest income @ 8% p.a.	Total	Cash received	Balance at end
1	880,000	70,400	950,400	50,000	900,400
2	900,400	72,032	972,432	50,000	922,432
3	922,432	73,795	996,227	50,000	946,227
4	946,227	75,698	1,021,925	50,000	971,925
5	971,925	78,075	1,050,000	1,000,000 + 50,000 = 1,050,000	Nil

Subsequent Measurement of Financial Assets (paragraphs 50 and 51)

A85. If a financial instrument that was previously recognised as a financial asset is measured at fair value and its fair value falls below zero, it is a financial liability measured in accordance with paragraph 52.

A86. The following example illustrates the accounting for transaction costs on the initial and subsequent measurement of an available-for-sale financial asset. An asset is acquired for Rs. 100 plus a purchase commission of Rs. 2. Initially, the asset is recognised at Rs. 102. The next financial reporting date occurs one day later, when the quoted market price of the asset is Rs. 100. If the asset were sold, a commission of Rs. 3 would be paid. On that date, the asset is measured at Rs. 100 (without regard to the possible commission on sale) and a loss of Rs. 2 is recognised in the appropriate equity account. If the available-for-sale financial asset has fixed or determinable payments, the transaction costs are amortised to the statement of profit and loss using the effective interest method. If the available-for-sale financial asset does not have fixed or determinable payments, the transaction costs are recognised in the statement of profit and loss when the asset is derecognised or becomes impaired.

A87. Instruments that are classified as loans and receivables are measured at amortised cost without regard to the entity's intention to hold them to maturity. However, short-term receivables with no stated interest rate are not measured at the amortised cost if the effect of discounting is immaterial. Such short-term receivables are measured at the original invoice amount.

Fair Value Measurement Considerations (paragraphs 53-55)

A88. Underlying the definition of fair value is a presumption that an entity is a going concern without any intention or need to liquidate, to curtail materially the scale of its operations or to undertake a transaction on adverse terms. Fair value is not, therefore, the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale. However, fair value reflects the credit quality of the instrument.

A89. This Standard uses the terms 'bid price' and 'asking price' (sometimes referred to as 'current offer price') in the context of quoted market prices, and the term 'the bid-ask spread' to include only transaction costs. Other adjustments to arrive at fair value (e.g., for counterparty credit risk) are not included in the term 'bid-ask spread'.

Active Market: Quoted Price

A90. A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from a reliable source, such as, an exchange, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. Fair value is defined in terms of a price agreed by a willing buyer and a willing seller in an arm's length transaction. The objective of determining fair value for a financial instrument that is traded in an active market is to arrive at the price at which a transaction would occur at the measurement date in that instrument (i.e., without modifying or repackaging the instrument) in the most advantageous active market to which the entity has immediate access. However, the entity adjusts the price in the more advantageous market to reflect any differences in counterparty credit risk between instruments traded in that market and the one being valued. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used to measure the financial asset or financial liability.

A91. The appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the asking price. When an entity has assets and liabilities with offsetting market risks, it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate. When current bid and asking prices are unavailable, the price of the most recent transaction provides evidence of the current fair value as long as there has not been a significant change in economic circumstances since the time of the transaction. If conditions have changed since the time of the transaction (e.g., a change in the risk-free interest rate following the most recent price quote for a corporate bond), the fair value reflects the change in conditions by reference to current prices or rates for similar financial instruments, as appropriate. Similarly, if the entity can demonstrate that the last transaction price is not fair value (e.g., because it reflected the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale), that price is adjusted. The fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price. If a published price quotation in an active market does not exist for a financial instrument in its entirety, but active markets exist for its component parts, fair value is determined on the basis of the relevant market prices for the component parts.

A92. If a rate (rather than a price) is quoted in an active market, the entity uses that market-quoted rate as an input into a valuation technique to determine fair value. If the market-quoted rate does not include credit risk or other factors that market participants would include in valuing the instrument, the entity adjusts for those factors.

No Active Market: Valuation Technique

A93. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. Valuation techniques include using:

(a) recent arm's length market transactions between knowledgeable, willing parties, if such transactions are available;

(b) if available, reference to the current fair value of another instrument that is substantially the same;

(c) discounted cash flow analysis; and

(d) option pricing models.

If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.

A94. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Fair value is estimated on the basis of the results of a valuation technique that makes maximum use of market inputs, and relies as little as possible on entity-specific inputs. A valuation technique would be expected to arrive at a realistic estimate of the fair value if (a) it reasonably reflects how the market could be expected to price the instrument and (b) the inputs to the valuation technique reasonably represent market expectations and measures of the risk-return factors inherent in the financial instrument.

A95. Therefore, a valuation technique (a) incorporates all factors that market participants would consider in arriving at a price and (b) is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (i.e., without modification or repackaging) or based on any available observable market data. An entity obtains market data consistently in the same market where the instrument was originated or purchased. The best evidence of the fair value of a financial instrument at initial recognition is the transaction price (i.e., the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e., without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets.

A96. The subsequent measurement of the financial asset or financial liability and the subsequent recognition of gains and losses should be consistent with the requirements of this Standard. The application of paragraph A95 may result in no

gain or loss being recognised on the initial recognition of a financial asset or financial liability. In such a case, this Standard requires that a gain or loss should be recognised after the initial recognition only to the extent that it arises from a change in a factor (including time) that market participants would consider in arriving at a price.

A97. The initial acquisition or origination of a financial asset or incurrence of a financial liability is a market transaction that provides a foundation for estimating the fair value of the financial instrument. In particular, if the financial instrument is a debt instrument (such as a loan), its fair value can be determined by reference to the market conditions that existed at its acquisition or origination date and current market conditions or interest rates currently charged by the entity or by others for similar debt instruments (i.e., similar remaining maturity, cash flow pattern, currency, credit risk, collateral and interest basis). Alternatively, provided there is no change in the credit risk of the debtor and applicable credit spreads after the origination of the debt instrument, an estimate of the current market interest rate may be derived by using a benchmark interest rate reflecting a better credit quality than the underlying debt instrument, holding the credit spread constant, and adjusting for the change in the benchmark interest rate from the origination date. If conditions have changed since the most recent market transaction, the corresponding change in the fair value of the financial instrument being valued is determined by reference to current prices or rates for similar financial instruments, adjusted as appropriate, for any differences from the instrument being valued.

A98. The same information may not be available at each measurement date. For example, at the date that an entity makes a loan or acquires a debt instrument that is not actively traded, the entity has a transaction price that is also a market price. However, no new transaction information may be available at the next measurement date and, although the entity can determine the general level of market interest rates, it may not know what level of credit or other risk market participants would consider in pricing the instrument on that date. An entity may not have information from recent transactions to determine the appropriate credit spread over the basic interest rate to use in determining a discount rate for a present value computation. It would be reasonable to assume, in the absence of evidence to the contrary, that no changes have taken place in the spread that existed at the date the loan was made. However, the entity would be expected to make reasonable efforts to determine whether there is evidence that there has been a change in such factors. When evidence of a change exists, the entity would consider the effects of the change in determining the fair value of the financial instrument.

A99. In applying discounted cash flow analysis, an entity uses one or more discount rates equal to the prevailing rates of return for financial instruments having substantially the same terms and characteristics, including the credit quality of the instrument, the remaining term over which the contractual interest rate is fixed, the remaining term to repayment of the principal and the currency in which payments are to be made. Short-term receivables and payables with no stated interest rate are measured at the original invoice amount if the effect of discounting is immaterial.

No Active Market: Equity Instruments

A100. The fair value of investments in equity instruments that do not have a quoted market price in an active market and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 51(c) and 52) is reliably measurable if (a) the variability in the range of reasonable fair value estimates is not significant for that instrument or (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.

A101. There are many situations in which the variability in the range of reasonable fair value estimates of investments in equity instruments that do not have a quoted market price and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 51(c) and 52) is likely not to be significant. Normally it is possible to estimate the fair value of a financial asset that an entity has acquired from an outside party. However, if the range of reasonable fair value estimates is significant and the probabilities of the various estimates cannot be reasonably assessed, an entity is precluded from measuring the instrument at fair value.

Inputs to Valuation Techniques

A102. An appropriate technique for estimating the fair value of a particular financial instrument would incorporate observable market data about the market conditions and other factors that are likely to affect the instrument's fair value. The fair value of a financial instrument will be based on one or more of the following factors:

(a) *The time value of money (i.e., interest at the basic or risk-free rate)*. Basic interest rates can usually be derived from observable government bond prices and are often quoted in financial publications. These rates typically vary with the expected dates of the projected cash flows along a yield curve of interest rates for different time horizons. For practical reasons, an entity may use a well-accepted and readily observable general rate, such as LIBOR or a swap rate, as the benchmark rate. (Because a rate such as LIBOR is not the risk-free interest rate, the credit risk adjustment appropriate to the particular financial instrument is determined on the basis of its credit risk in relation to the credit risk in this benchmark rate.) In some countries, the central government's bonds may carry a significant credit risk and may not provide a stable benchmark basic interest rate for instruments denominated in that currency. Some entities in these countries may have a better credit standing and a lower borrowing rate than the central government. In such a case, basic interest rates may be more appropriately determined by reference to interest rates for the highest rated corporate bonds issued in the currency of that jurisdiction.

(b) *Credit risk*. The effect on fair value of credit risk (i.e., the premium over the basic interest rate for credit risk) may be derived from observable market prices for traded instruments of different credit quality or from observable interest rates charged by lenders for loans of various credit ratings.

(c) *Foreign currency exchange prices.* Active currency exchange markets exist for most major currencies, and prices are quoted daily in financial publications.

(d) *Commodity prices.* There are observable market prices for many commodities.

(e) *Equity prices.* Prices (and indexes of prices) of traded equity instruments are readily observable in some markets. Present value based techniques may be used to estimate the current market price of equity instruments for which there are no observable prices.

(f) *Volatility (i.e., magnitude of future changes in price of the financial instrument or other item).* Measures of the volatility of actively traded items can normally be reasonably estimated on the basis of historical market data or by using volatilities implied in current market prices.

(g) *Prepayment risk and surrender risk.* Expected prepayment patterns for financial assets and expected surrender patterns for financial liabilities can be estimated on the basis of historical data. (The fair value of a financial liability that can be surrendered by the counterparty cannot be less than the present value of the surrender amount—see paragraph 55.)

(h) *Servicing costs for a financial asset or a financial liability.* Costs of servicing can be estimated using comparisons with current fees charged by other market participants. If the costs of servicing a financial asset or financial liability are significant and other market participants would face comparable costs, the issuer would consider them in determining the fair value of that financial asset or financial liability. It is likely that the fair value at inception of a contractual right to future fees equals the origination costs paid for them, unless future fees and related costs are out of line with market comparables.

The above factors are merely indicative in nature and are not intended to be exhaustive. An enterprise also considers the other relevant factors, if any, in determination of fair value of a financial instrument.

Gains and Losses (paragraphs 61-63)

A103. An entity applies AS 11 to financial assets and financial liabilities that are monetary items in accordance with AS 11 and denominated in a foreign currency. Under AS 11, any foreign exchange gains and losses on monetary assets and monetary liabilities are recognised in the statement of profit and loss. An exception is a monetary item that is designated as a hedging instrument in either a cash flow hedge (see paragraphs 106-112) or a hedge of a net investment in a non-integral foreign operation (see paragraph 113). For the purpose of recognising foreign exchange gains and losses under AS 11, a monetary available-for-sale financial asset is treated as if it were carried at amortised cost in the foreign currency. Accordingly, for such a financial asset, exchange differences resulting from changes in amortised cost are recognised in the statement of profit and loss and other changes in carrying amount are recognised in accordance with paragraph 61(b). For available-for-sale financial assets that are not monetary items under AS 11 (for example, equity instruments), the gain or loss including any related foreign exchange component is recognised directly in the appropriate equity account under paragraph 61(b). If there is a hedging relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in the foreign currency component of those financial instruments are recognised in the statement of profit and loss.

Impairment and Uncollectibility of Financial Assets (paragraphs 64-79)

Financial Assets Carried at Amortised Cost (paragraphs 69-71)

A104. Impairment of a financial asset carried at amortised cost is measured using the financial instrument's original effective interest rate because discounting at the current market rate of interest would, in effect, impose fair value measurement on financial assets that are otherwise measured at amortised cost. If the terms of a loan, receivable or held-to-maturity investment are renegotiated or otherwise modified because of financial difficulties of the borrower or issuer, impairment is measured using the original effective interest rate before the modification of terms. Cash flows relating to short-term receivables are not discounted if the effect of discounting is immaterial. If a loan, receivable or held-to-maturity investment has a variable interest rate, the discount rate for measuring any impairment loss under paragraph 69 is the current effective interest rate(s) determined under the contract. As a practical expedient, a creditor may measure impairment of a financial asset carried at amortised cost on the basis of an instrument's fair value using an observable market price. The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

A105. The process for estimating impairment considers all credit exposures, not only those of low credit quality. For example, if an entity uses an internal credit grading system it considers all credit grades, not only those reflecting a severe credit deterioration.

A106. Uncertainties surrounding the amount to be recognised as impairment loss are dealt with by various means according to the circumstances. The process for estimating the amount of an impairment loss may result either in a single amount or in a range of possible amounts. In the latter case, the entity recognises an impairment loss equal to the best estimate within the range taking into account all relevant information available before the financial statements are issued about conditions existing at the balance sheet date. In a range of possible outcomes, the best estimate of loss is determined by using 'expected value' statistical method of valuation which weighs all possible outcomes by their associated probabilities. Under this method, the best estimate of loss will be different depending on whether the probability of a loss of a given amount is, for example, 60 per cent or 90 per cent. Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the mid-point of the range is used as the best estimate.

A107. For the purpose of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics that are indicative of the debtors' ability to pay all amounts due according to the contractual terms (for

example, on the basis of a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status and other relevant factors). The characteristics chosen are relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated. However, loss probabilities and other loss statistics differ at a group level between (a) assets that have been individually evaluated for impairment and found not to be impaired and (b) assets that have not been individually evaluated for impairment, with the result that a different amount of impairment may be required. If an entity does not have a group of assets with similar risk characteristics, it does not make the additional assessment.

A108. Impairment losses recognised on a group basis represent an interim step pending the identification of impairment losses on individual assets in the group of financial assets that are collectively assessed for impairment. As soon as information is available that specifically identifies losses on individually impaired assets in a group, those assets are removed from the group.

A109. Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group. Entities that have no entity-specific loss experience or insufficient experience, use peer group experience for comparable groups of financial assets. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. Estimates of changes in future cash flows reflect and are directionally consistent with changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of incurred losses in the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

A110. As an example of applying paragraph A109, an entity may determine, on the basis of historical experience, that one of the main causes of default on credit card loans is the death of the borrower. The entity may observe that the death rate is unchanged from one year to the next. On this basis, the entity concludes that some of the borrowers in its group of credit card loans may have died in that year, indicating that an impairment loss has occurred on those loans, even if, at the year-end, the entity is not yet aware which specific borrowers have died. It would be appropriate for an impairment loss to be recognised for these 'incurred but not reported' losses. However, it would not be appropriate to recognise an impairment loss for deaths that are expected to occur in a future period, because the necessary loss event (the death of the borrower) has not yet occurred.

A111. When using historical loss rates in estimating future cash flows, it is important that information about historical loss rates is applied to groups that are defined in a manner consistent with the groups for which the historical loss rates were observed. Therefore, the method used should enable each group to be associated with information about past loss experience in groups of assets with similar credit risk characteristics and relevant observable data that reflect current conditions.

A112. Formula-based approaches or statistical methods may be used to determine impairment losses in a group of financial assets (e.g., for smaller balance loans) as long as they are consistent with the requirements in paragraphs 69-71 and A107-A111. Any model used would incorporate the effect of the time value of money, consider the cash flows for all of the remaining life of an asset (not only the next year), consider the age of the loans within the portfolio and not give rise to an impairment loss on initial recognition of a financial asset.

Interest Income After Impairment Recognition

A113. Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is thereafter recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

Hedging (paragraphs 80-113)

Hedging Instruments (paragraphs 81-86)

Qualifying Instruments (paragraphs 81 and 82)

A114. The potential loss on an option that an entity writes could be significantly greater than the potential gain in value of a related hedged item. In other words, a written option is not effective in reducing the profit or loss exposure of a hedged item. Therefore, a written option does not qualify as a hedging instrument unless it is designated as an offset to a purchased option, including one that is embedded in another financial instrument (for example, a written call option used to hedge a callable liability). In contrast, a purchased option has potential gains equal to or greater than losses and therefore has the potential to reduce profit or loss exposure from changes in fair values or cash flows. Accordingly, it can qualify as a hedging instrument.

A115. A held-to-maturity investment carried at amortised cost may be designated as a hedging instrument in a hedge of foreign currency risk.

A116. An investment in an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured or a derivative that is linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 51(c) and 52) cannot be designated as a hedging instrument.

A117. An entity's own equity instruments are not financial assets or financial liabilities of the entity and therefore cannot be designated as hedging instruments.

Hedged Items (paragraphs 87-94)

Qualifying Items (paragraphs 87-89)

A118. A firm commitment to acquire a business in a business combination cannot be a hedged item, except for foreign exchange risk, because the other risks being hedged cannot be specifically identified and measured. These other risks are general business risks.

A119. An investment accounted for using the equity method of accounting or using the proportionate consolidation cannot

be a hedged item in a fair value hedge because the equity method and the proportionate consolidation recognises in the consolidated statement of profit and loss the investor's share of the associate's profit or loss and the venturer's share of the jointly controlled entity's profit or loss, respectively, rather than changes in the investment's fair value. For a similar reason, an investment in a consolidated subsidiary cannot be a hedged item in a fair value hedge because consolidation recognises in the consolidated statement of profit and loss the subsidiary's profit or loss, rather than changes in the investment's fair value. A hedge of a net investment in a non-integral foreign operation is different because it is a hedge of the foreign currency exposure, not a fair value hedge of the change in the value of the investment.

A120. Paragraph 89 states that in consolidated financial statements the foreign currency risk of a highly probable forecast intragroup transaction may qualify as a hedged item in a cash flow hedge, provided the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss. For this purpose an entity can be a parent, subsidiary, associate, joint venture or branch. If the foreign currency risk of a forecast intragroup transaction does not affect consolidated profit or loss, the intragroup transaction cannot qualify as a hedged item. This is usually the case for royalty payments, interest payments or management charges between members of the same group unless there is a related external transaction. However, when the foreign currency risk of a forecast intragroup transaction will affect consolidated profit or loss, the intragroup transaction can qualify as a hedged item. An example is forecast sales or purchases of inventories between members of the same group if there is an onward sale of the inventory to a party external to the group. Similarly, a forecast intragroup sale of plant and equipment from the group entity that manufactured it to a group entity that will use the plant and equipment in its operations may affect consolidated profit or loss. This could occur, for example, because the plant and equipment will be depreciated by the purchasing entity and the amount initially recognised for the plant and equipment may change if the forecast intragroup transaction is denominated in a currency other than the functional currency of the purchasing entity.

A121. If a hedge of a forecast intragroup transaction qualifies for hedge accounting, any gain or loss that is recognised directly in the appropriate equity account in accordance with paragraph 106(a) should be reclassified into, i.e., recognised in, the statement of profit and loss in the same period or periods during which the foreign currency risk of the hedged transaction affects consolidated profit or loss.

Designation of Financial Items as Hedged Items (paragraphs 90 and 91)

A122. If a portion of the cash flows of a financial asset or financial liability is designated as the hedged item, that designated portion must be less than the total cash flows of the asset or liability. For example, in the case of a liability whose effective interest rate is below LIBOR, an entity cannot designate (a) a portion of the liability equal to the principal amount plus interest at LIBOR and (b) a negative residual portion. However, the entity may designate all of the cash flows of the entire financial asset or financial liability as the hedged item and hedge them for only one particular risk (e.g., only for changes that are attributable to changes in LIBOR). For example, in the case of a financial liability whose effective interest rate is 100 basis points below LIBOR, an entity can designate as the hedged item the entire liability (i.e., principal plus interest at LIBOR minus 100 basis points) and hedge the change in the fair value or cash flows of that entire liability that is attributable to changes in LIBOR. The entity may also choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph A124.

A123. In addition, if a fixed rate financial instrument is hedged some time after its origination and interest rates have changed in the meantime, the entity can designate a portion equal to a benchmark rate that is higher than the contractual rate paid on the item. The entity can do so provided that the benchmark rate is less than the effective interest rate calculated on the assumption that the entity had purchased the instrument on the day it first designates the hedged item. For example, assume an entity originates a fixed rate financial asset of Rs. 100 that has an effective interest rate of 6 per cent at a time when LIBOR is 4 per cent. It begins to hedge that asset some time later when LIBOR has increased to 8 per cent and the fair value of the asset has decreased to Rs. 90. The entity calculates that if it had purchased the asset on the date it first designates it as the hedged item for its then fair value of Rs. 90, the effective yield would have been 9.5 per cent. Because LIBOR is less than this effective yield, the entity can designate a LIBOR portion of 8 per cent that consists partly of the contractual interest cash flows and partly of the difference between the current fair value (i.e., Rs. 90) and the amount repayable on maturity (i.e., Rs. 100).

Designation of Non-Financial Items as Hedged Items (paragraph 92)

A124. Changes in the price of an ingredient or component of a non-financial asset or non-financial liability generally do not have a predictable, separately measurable effect on the price of the item that is comparable to the effect of, say, a change in market interest rates on the price of a bond. Thus, a non-financial asset or non-financial liability is a hedged item only in its entirety or for foreign exchange risk. If there is a difference between the terms of the hedging instrument and the hedged item (such as for a hedge of the forecast purchase of Brazilian coffee using a forward contract to purchase Colombian coffee on otherwise similar terms), the hedging relationship nonetheless can qualify as a hedge relationship provided all the conditions in paragraph 98 are met, including that the hedge is expected to be highly effective. For this purpose, the amount of the hedging instrument may be greater or less than that of the hedged item if this improves the effectiveness of the hedging relationship. For example, a regression analysis could be performed to establish a statistical relationship between the hedged item (e.g., a transaction in Brazilian coffee) and the hedging instrument (e.g., a transaction in Colombian coffee). If there is a valid statistical relationship between the two variables (i.e., between the unit prices of Brazilian coffee and Colombian coffee), the slope of the regression line can be used to establish the hedge ratio that will maximise expected effectiveness. For example, if the slope of the regression line is 1.02, a hedge ratio based on 0.98 quantities of hedged items to 1.00 quantities of the hedging instrument maximises expected effectiveness. However, the hedging relationship may result in ineffectiveness that is recognised in

the statement of profit and loss during the term of the hedging relationship.

Designation of Groups of Items as Hedged Items (paragraphs 93 and 94)

A125. A hedge of an overall net position (e.g., the net of all fixed rate assets and fixed rate liabilities with similar maturities), rather than of a specific hedged item, does not qualify for hedge accounting. However, almost the same effect on profit or loss of hedge accounting for this type of hedging relationship can be achieved by designating as the hedged item part of the underlying items. For example, if a bank has Rs. 100 of assets and Rs. 90 of liabilities with risks and terms of a similar nature and hedges the net Rs. 10 exposure, it can designate as the hedged item Rs. 10 of those assets. This designation can be used if such assets and liabilities are fixed rate instruments, in which case it is a fair value hedge, or if they are variable rate instruments, in which case it is a cash flow hedge. Similarly, if an entity has a firm commitment to make a purchase in a foreign currency of Rs. 100 and a firm commitment to make a sale in the foreign currency of Rs. 90, it can hedge the net amount of Rs. 10 by acquiring a derivative and designating it as a hedging instrument associated with Rs. 10 of the firm purchase commitment of Rs. 100.

Hedge Accounting (paragraphs 95-113)

A126. An example of a fair value hedge is a hedge of exposure to changes in the fair value of a fixed rate debt instrument as a result of changes in interest rates. Such a hedge could be entered into by the issuer or by the holder.

A127. An example of a cash flow hedge is the use of a swap to change floating rate debt to fixed rate debt (i.e., a hedge of a future transaction where the future cash flows being hedged are the future interest payments).

A128. A hedge of a firm commitment (e.g., a hedge of the change in fuel price relating to an unrecognised contractual commitment by an electric utility to purchase fuel at a fixed price) is a hedge of an exposure to a change in fair value. Accordingly, such a hedge is a fair value hedge. However, under paragraph 97 a hedge of the foreign currency risk of a firm commitment could alternatively be accounted for as a cash flow hedge.

Assessing Hedge Effectiveness

A129. A hedge is regarded as highly effective only if both of the following conditions are met:

(a) At the inception of the hedge and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. Such an expectation can be demonstrated in various ways, including a comparison of past changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk with past changes in the fair value or cash flows of the hedging instrument, or by demonstrating a high statistical correlation between the fair value or cash flows of the hedged item and those of the hedging instrument. The entity may choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph A124.

(b) The actual results of the hedge are within a range of 80-125 per cent. For example, if actual results are such that the loss on the hedging instrument is Rs. 120 and the gain on the cash instrument is Rs. 100, offset can be measured by 120 / 100, which is 120 per cent, or by 100 / 120, which is 83 per cent. In this example, assuming the hedge meets the condition in (a), the entity would conclude that the hedge has been highly effective.

A130. Effectiveness is assessed, at a minimum, at the time an entity prepares its annual or interim financial statements.

A131. This Standard does not specify a single method for assessing hedge effectiveness. The method an entity adopts for assessing hedge effectiveness depends on its risk management strategy. For example, if the entity's risk management strategy is to adjust the amount of the hedging instrument periodically to reflect changes in the hedged position, the entity needs to demonstrate that the hedge is expected to be highly effective only for the period until the amount of the hedging instrument is next adjusted. In some cases, an entity adopts different methods for different types of hedges. An entity's documentation of its hedging strategy includes its procedures for assessing effectiveness. Those procedures state whether the assessment includes all of the gain or loss on a hedging instrument or whether the instrument's time value is excluded.

A132. If an entity hedges less than 100 per cent of the exposure on an item, such as 85 per cent, it should designate the hedged item as being 85 per cent of the exposure and should measure ineffectiveness based on the change in that designated 85 per cent exposure. However, when hedging the designated 85 per cent exposure, the entity may use a hedge ratio of other than one to one if that improves the expected effectiveness of the hedge, as explained in paragraph A124.

A133. If the principal terms of the hedging instrument and of the hedged asset, liability, firm commitment or highly probable forecast transaction are the same, the changes in fair value and cash flows attributable to the risk being hedged may be likely to offset each other fully, both when the hedge is entered into and afterwards. For example, an interest rate swap is likely to be an effective hedge if the notional and principal amounts, term, repricing dates, dates of interest and principal receipts and payments, and basis for measuring interest rates are the same for the hedging instrument and the hedged item. In addition, a hedge of a highly probable forecast purchase of a commodity with a forward contract is likely to be highly effective if:

(a) the forward contract is for the purchase of the same quantity of the same commodity at the same time and location as the hedged forecast purchase;

(b) the fair value of the forward contract at inception is zero; and

(c) either the change in the discount or premium on the forward contract is excluded from the assessment of effectiveness and is recognised in the statement of profit and loss or the change in expected cash flows on the highly probable forecast transaction is based on the forward price for the commodity.

A134. Sometimes the hedging instrument offsets only part of the hedged risk. For example, a hedge would not be fully effective if the hedging instrument and hedged item are denominated in different currencies that do not move in tandem. Also, a hedge of

interest rate risk using a derivative would not be fully effective if part of the change in the fair value of the derivative is attributable to the counterparty's credit risk.

A135. To qualify for hedge accounting, the hedge must relate to a specific identified and designated risk, and not merely to the entity's general business risks, and must ultimately affect the entity's profit or loss. A hedge of the risk of obsolescence of a physical asset or the risk of expropriation of property by a government is not eligible for hedge accounting; effectiveness cannot be measured because those risks are not measurable reliably.

A136. In the case of interest rate risk, hedge effectiveness may be assessed by preparing a maturity schedule for financial assets and financial liabilities that shows the net interest rate exposure for each time period, provided that the net exposure is associated with a specific asset or liability (or a specific group of assets or liabilities or a specific portion of them) giving rise to the net exposure, and hedge effectiveness is assessed against that asset or liability.

A137. In assessing the effectiveness of a hedge, an entity generally considers the time value of money. The fixed interest rate on a hedged item need not exactly match the fixed interest rate on a swap designated as a fair value hedge. Nor does the variable interest rate on an interest-bearing asset or liability need to be the same as the variable interest rate on a swap designated as a cash flow hedge. A swap's fair value derives from its net settlements. The fixed and variable rates on a swap can be changed without affecting the net settlement if both are changed by the same amount.

A138. If an entity does not meet hedge effectiveness criteria, the entity discontinues hedge accounting from the last date on which compliance with hedge effectiveness was demonstrated. However, if the entity identifies the event or change in circumstances that caused the hedging relationship to fail the effectiveness criteria, and demonstrates that the hedge was effective before the event or change in circumstances occurred, the entity discontinues hedge accounting from the date of the event or change in circumstances.

Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk

A139. For a fair value hedge of interest rate risk associated with a portfolio of financial assets or financial liabilities, an entity would meet the requirements of this Standard if it complies with the procedures set out in (a)-(i) and paragraphs A140-A157 below.

(a) As part of its risk management process the entity identifies a portfolio of items whose interest rate risk it wishes to hedge. The portfolio may comprise only assets, only liabilities or both assets and liabilities. The entity may identify two or more portfolios (e.g., the entity may group its available-for-sale assets into a separate portfolio), in which case it applies the guidance below to each portfolio separately.

(b) The entity analyses the portfolio into repricing time periods based on expected, rather than contractual, repricing dates. The analysis into repricing time periods may be performed in various ways including scheduling cash flows into the periods in which they are expected to occur, or scheduling notional principal amounts into all periods until repricing is expected to occur.

(c) On the basis of this analysis, the entity decides the amount it wishes to hedge. The entity designates as the hedged item an amount of assets or liabilities (but not a net amount) from the identified portfolio equal to the amount it wishes to designate as being hedged. This amount also determines the percentage measure that is used for testing effectiveness in accordance with paragraph A151(b).

(d) The entity designates the interest rate risk it is hedging. This risk could be a portion of the interest rate risk in each of the items in the hedged position, such as a benchmark interest rate (e.g., LIBOR).

(e) The entity designates one or more hedging instruments for each repricing time period.

(f) Using the designations made in (c)-(e) above, the entity assesses at inception and in subsequent periods, whether the hedge is expected to be highly effective during the period for which the hedge is designated.

(g) Periodically, the entity measures the change in the fair value of the hedged item (as designated in (c)) that is attributable to the hedged risk (as designated in (d)), on the basis of the expected repricing dates determined in (b). Provided that the hedge is determined actually to have been highly effective when assessed using the entity's documented method of assessing effectiveness, the entity recognises the change in fair value of the hedged item as a gain or loss in the statement of profit and loss and in one of two line items in the balance sheet as described in paragraph 100. The change in fair value need not be allocated to individual assets or liabilities.

(h) The entity measures the change in fair value of the hedging instrument(s) (as designated in (e)) and recognises it as a gain or loss in the statement of profit and loss. The fair value of the hedging instrument(s) is recognised as an asset or liability in the balance sheet.

(i) Any ineffectiveness[39] will be recognised in the statement of profit and loss as the difference between the change in fair value referred to in (g) and that referred to in (h).

A140. This approach is described in more detail below. The approach is applied only to a fair value hedge of the interest rate risk associated with a portfolio of financial assets or financial liabilities.

A141. The portfolio identified in paragraph A139(a) could contain assets and liabilities. Alternatively, it could be a portfolio containing only assets, or only liabilities. The portfolio is used to determine the amount of the assets or liabilities the entity wishes to hedge. However, the portfolio is not itself designated as the hedged item.

A142. In applying paragraph A139(b), the entity determines the expected repricing date of an item as the earlier of the dates when that item is expected to mature or to reprice to market rates. The expected repricing dates are estimated at the inception of the hedge and throughout the term of the hedge, based on historical experience and other available information, including information and expectations regarding prepayment rates, interest rates and the interaction between them. Entities that have no entity-specific experience or insufficient experience use peer group experience

[39] The same materiality considerations apply in this context as apply throughout Accounting Standards.

for comparable financial instruments. These estimates are reviewed periodically and updated in the light of experience. In the case of a fixed rate item that is prepayable, the expected repricing date is the date on which the item is expected to prepay unless it reprices to market rates on an earlier date. For a group of similar items, the analysis into time periods based on expected repricing dates may take the form of allocating a percentage of the group, rather than individual items, to each time period. An entity may apply other methodologies for such allocation purposes. For example, it may use a prepayment rate multiplier for allocating amortising loans to time periods based on expected repricing dates. However, the methodology for such an allocation should be in accordance with the entity's risk management procedures and objectives.

A143. As an example of the designation set out in paragraph A139(c), if in a particular repricing time period an entity estimates that it has fixed rate assets of Rs. 100 and fixed rate liabilities of Rs. 80 and decides to hedge all of the net position of Rs. 20, it designates as the hedged item assets in the amount of Rs. 20 (a portion of the assets)[40]. The designation is expressed as an 'amount of a currency' (e.g., an amount of dollars, euro, pounds or rand) rather than as individual assets. It follows that all of the assets (or liabilities) from which the hedged amount is drawn—i.e., all of the Rs. 100 of assets in the above example—must be:

(a) items whose fair value changes in response to changes in the interest rate being hedged; and

(b) items that could have qualified for fair value hedge accounting if they had been designated as hedged individually. In particular, because the Standard[41] specifies that the fair value of a financial liability with a demand feature (such as demand deposits and some types of time deposits) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid, such an item cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the holder can demand payment. In the above example, the hedged position is an amount of assets. Hence, such liabilities are not a part of the designated hedged item, but are used by the entity to determine the amount of the asset that is designated as being hedged. If the position the entity wished to hedge was an amount of liabilities, the amount representing the designated hedged item must be drawn from fixed rate liabilities other than liabilities that the entity can be required to repay in an earlier time period, and the percentage measure used for assessing hedge effectiveness in accordance with paragraph A151(b) would be calculated as a percentage of these other liabilities. For example, assume that an entity estimates that in a particular repricing time period it has fixed rate liabilities of Rs. 100, comprising Rs. 40 of demand deposits and Rs. 60 of liabilities with no demand feature, and Rs. 70 of fixed rate assets. If the entity decides to hedge all of the net position of Rs. 30, it designates as the hedged item liabilities of Rs. 30 or 50 per cent[42] of the liabilities with no demand feature.

A144. The entity also complies with the other designation and documentation requirements set out in paragraph 98(a). For a portfolio hedge of interest rate risk, this designation and documentation specifies the entity's policy for all of the variables that are used to identify the amount that is hedged and how effectiveness is measured, including the following:

(a) which assets and liabilities are to be included in the portfolio hedge and the basis to be used for removing them from the portfolio.

(b) how the entity estimates repricing dates, including what interest rate assumptions underlie estimates of prepayment rates and the basis for changing those estimates. The same method is used for both the initial estimates made at the time an asset or liability is included in the hedged portfolio and for any later revisions to those estimates.

(c) the number and duration of repricing time periods.

(d) how often the entity will test effectiveness and which of the two methods in paragraph A151 it will use.

(e) the methodology used by the entity to determine the amount of assets or liabilities that are designated as the hedged item and, accordingly, the percentage measure used when the entity tests effectiveness using the method described in paragraph A151(b).

(f) when the entity tests effectiveness using the method described in paragraph A151(b), whether the entity will test effectiveness for each repricing time period individually, for all time periods in aggregate, or by using some combination of the two.

The policies specified in designating and documenting the hedging relationship should be in accordance with the entity's risk management procedures and objectives. Changes in policies should not be made arbitrarily. They should be justified on the basis of changes in market conditions and other factors and be founded on and consistent with the entity's risk management procedures and objectives.

A145. The hedging instrument referred to in paragraph A139(e) may be a single derivative or a portfolio of derivatives all of which contain exposure to the hedged interest rate risk designated in paragraph A139(d) (e.g., a portfolio of interest rate swaps all of which contain exposure to LIBOR). Such a

[40] The Standard permits an entity to designate any amount of the available qualifying assets or liabilities, i.e., in this example any amount of assets between Rs. 0 and Rs. 100.

[41] See Paragraph 52.

[42] Rs. 30 / (Rs. 100 – Rs. 40) = 50 per cent

portfolio of derivatives may contain offsetting risk positions. However, it may not include written options or net written options, because the Standard[43] does not permit such options to be designated as hedging instruments (except when a written option is designated as an offset to a purchased option). If the hedging instrument hedges the amount designated in paragraph A139(c) for more than one repricing time period, it is allocated to all of the time periods that it hedges. However, the whole of the hedging instrument must be allocated to those repricing time periods because the Standard[44] does not permit a hedging relationship to be designated for only a portion of the time period during which a hedging instrument remains outstanding.

A146. When the entity measures the change in the fair value of a prepayable item in accordance with paragraph A139(g), a change in interest rates affects the fair value of the prepayable item in two ways: it affects the fair value of the contractual cash flows and the fair value of the prepayment option that is contained in a prepayable item. Paragraph 90 of the Standard permits an entity to designate a portion of a financial asset or financial liability, sharing a common risk exposure, as the hedged item, provided effectiveness can be measured. For prepayable items, paragraph 91 permits this to be achieved by designating the hedged item in terms of the change in the fair value that is attributable to changes in the designated interest rate on the basis of expected, rather than contractual, repricing dates. However, the effect that changes in the hedged interest rate have on those expected repricing dates should be included when determining the change in the fair value of the hedged item. Consequently, if the expected repricing dates are revised (e.g., to reflect a change in expected prepayments), or if actual repricing dates differ from those expected, ineffectiveness will arise as described in paragraph A151. Conversely, changes in expected repricing dates that (a) clearly arise from factors other than changes in the hedged interest rate, (b) are uncorrelated with changes in the hedged interest rate and (c) can be reliably separated from changes that are attributable to the hedged interest rate (e.g., changes in prepayment rates clearly arising from a change in demographic factors or tax regulations rather than changes in interest rate) are excluded when determining the change in the fair value of the hedged item, because they are not attributable to the hedged risk. If there is uncertainty about the factor that gave rise to the change in expected repricing dates or the entity is not able to separate reliably the changes that arise from the hedged interest rate from those that arise from other factors, the change is assumed to arise from changes in the hedged interest rate.

A147. The Standard does not specify the techniques used to determine the amount referred to in paragraph A139(g), namely the change in the fair value of the hedged item that is attributable to the hedged risk. If statistical or other estimation techniques are used for such measurement, management must expect the result to approximate closely that which would have been obtained from measurement of all the individual assets or liabilities that constitute the hedged item. It is not appropriate to assume that changes in the fair value of the hedged item equal changes in the value of the hedging instrument.

A148. Paragraph 100 requires that if the hedged item for a particular repricing time period is an asset, the change in its value is presented in a separate line item within assets. Conversely, if the hedged item for a particular repricing time period is a liability, the change in its value is presented in a separate line item within liabilities. These are the separate line items referred to in paragraph A139(g). Specific allocation to individual assets (or liabilities) is not required.

A149. Paragraph A139(i) notes that ineffectiveness arises to the extent that the change in the fair value of the hedged item that is attributable to the hedged risk differs from the change in the fair value of the hedging derivative. Such a difference may arise for a number of reasons, including:

(a) actual repricing dates being different from those expected, or expected repricing dates being revised;

(b) items in the hedged portfolio becoming impaired or being derecognised;

(c) the payment dates of the hedging instrument and the hedged item being different; and

(d) other causes (e.g., when a few of the hedged items bear interest at a rate below the benchmark rate for which they are designated as being hedged, and the resulting ineffectiveness is not so great that the portfolio as a whole fails to qualify for hedge accounting).

Such ineffectiveness[45] should be identified and recognised in the statement of profit and loss.

A150. Generally, the effectiveness of the hedge will be improved:

(a) if the entity schedules items with different prepayment characteristics in a way that takes account of the differences in prepayment behaviour.

(b) when the number of items in the portfolio is larger. When only a few items are contained in the portfolio, relatively high ineffectiveness is likely if one of the items prepays earlier or later than expected. Conversely, when the portfolio contains many items, the prepayment behaviour can be predicted more accurately.

(c) when the repricing time periods used are narrower (e.g., 1-month as opposed to 3-month repricing time periods). Narrower repricing time periods reduces the effect of any mismatch between the repricing and payment dates (within the repricing time period) of the hedged item and those of the hedging instrument.

(d) the greater the frequency with which the amount of the hedging instrument is adjusted to reflect changes in the hedged item (e.g., because of changes in prepayment expectations).

[43] See paragraphs 83 and A106

[44] See paragraph 81

[45] The same materiality considerations apply in this context as apply throughout Accounting Standards.

A151. An entity tests effectiveness periodically. If estimates of repricing dates change between one date on which an entity assesses effectiveness and the next, it should calculate the amount of effectiveness either:

(a) as the difference between the change in the fair value of the hedging instrument (see paragraph A139(h)) and the change in the value of the entire hedged item that is attributable to changes in the hedged interest rate (including the effect that changes in the hedged interest rate have on the fair value of any embedded prepayment option); or

(b) using the following approximation. The entity:

(i) calculates the percentage of the assets (or liabilities) in each repricing time period that was hedged, on the basis of the estimated repricing dates at the last date it tested effectiveness.

(ii) applies this percentage to its revised estimate of the amount in that repricing time period to calculate the amount of the hedged item based on its revised estimate.

(iii) calculates the change in the fair value of its revised estimate of the hedged item that is attributable to the hedged risk and presents it as set out in paragraph A139(g).

(iv) recognises ineffectiveness equal to the difference between the amount determined in (iii) and the change in the fair value of the hedging instrument (see paragraph A139(h)).

A152. When measuring effectiveness, the entity distinguishes revisions to the estimated repricing dates of existing assets (or liabilities) from the origination of new assets (or liabilities), with only the former giving rise to ineffectiveness. All revisions to estimated repricing dates (other than those excluded in accordance with paragraph A146), including any reallocation of existing items between time periods, are included when revising the estimated amount in a time period in accordance with paragraph A151(b)(ii) and hence when measuring effectiveness. Once ineffectiveness has been recognised as set out above, the entity establishes a new estimate of the total assets (or liabilities) in each repricing time period, including new assets (or liabilities) that have been originated since it last tested effectiveness, and designates a new amount as the hedged item and a new percentage as the hedged percentage. The procedures set out in paragraph A151(b) are then repeated at the next date it tests effectiveness.

A153. Items that were originally scheduled into a repricing time period may be derecognised because of earlier than expected prepayment or write offs caused by impairment or sale. When this occurs, the amount of change in fair value included in the separate line item referred to in paragraph A139(g) that relates to the derecognised item is removed from the balance sheet, and included in the gain or loss that arises on derecognition of the item. For this purpose, it is necessary to know the repricing time period(s) into which the derecognised item was scheduled, because this determines the repricing time period(s) from which to remove it and hence the amount to remove from the separate line item referred to in paragraph A139(g). When an item is derecognised, if it can be determined in which time period it was included, it is removed from that time period. If not, it is removed from the earliest time period if the derecognition resulted from higher than expected prepayments, or allocated to all time periods containing the derecognised item on a systematic and rational basis if the item was sold or became impaired.

A154. In addition, any amount relating to a particular time period that has not been derecognised when the time period expires is recognised in the statement of profit and loss at that time (see paragraph 100). For example, assume an entity schedules items into three repricing time periods. At the previous redesignation, the change in fair value reported in the single line item on the balance sheet was an asset of Rs. 25. That amount represents amounts attributable to periods 1, 2 and 3 of Rs. 7, Rs. 8 and Rs. 10, respectively. At the next redesignation, the assets attributable to period 1 have been either realised or rescheduled into other periods. Therefore, Rs. 7 is derecognised from the balance sheet and recognised in the statement of profit and loss. Rs. 8 and Rs. 10 are now attributable to periods 1 and 2, respectively. These remaining periods are then adjusted, as necessary, for changes in fair value as described in paragraph A139(g).

A155. As an illustration of the requirements of the previous two paragraphs, assume that an entity scheduled assets by allocating a percentage of the portfolio into each repricing time period. Assume also that it scheduled Rs. 100 into each of the first two time periods. When the first repricing time period expires, Rs. 110 of assets are derecognised because of expected and unexpected repayments. In this case, all of the amount contained in the separate line item referred to in paragraph A139(g) that relates to the first time period is removed from the balance sheet, plus 10 per cent of the amount that relates to the second time period.

A156. If the hedged amount for a repricing time period is reduced without the related assets (or liabilities) being derecognised, the amount included in the separate line item referred to in paragraph A139(g) that relates to the reduction should be amortised in accordance with paragraph 103.

A157. An entity may wish to apply the approach set out in paragraphs A139-A156 to a portfolio hedge that had previously been accounted for as a cash flow hedge in accordance with this Standard. Such an entity would revoke the previous designation of a cash flow hedge in accordance with paragraph 112(d), and apply the requirements set out in that paragraph. It would also redesignate the hedge as a fair value hedge and apply the approach set out in paragraphs A139-A156 prospectively to subsequent accounting periods.

Appendix B

Illustrative Example

This example accompanies, but is not part of, AS 30. The purpose of this example is to illustrate application of hedge accounting principles of AS 30 to hedge the interest rate risk of a portfolio comprising assets and liabilities.

Facts

IE1. On 1 January 20x7, Entity A identifies a portfolio comprising assets and liabilities whose interest rate risk it wishes to hedge. The liabilities include demandable deposit liabilities that the depositor may withdraw at any time without notice. For risk management purposes, the entity views all of the items in the portfolio as fixed rate items.

IE2. For risk management purposes, Entity A analyses the assets and liabilities in the portfolio into repricing time periods based on expected repricing dates. The entity uses monthly time periods and schedules items for the next five years (i.e., it has 60 separate monthly time periods)[46]. The assets in the portfolio are prepayable assets that Entity A allocates into time periods based on the expected prepayment dates, by allocating a percentage of all of the assets, rather than individual items, into each time period. The portfolio also includes demandable liabilities that the entity expects, on a portfolio basis, to repay between one month and five years and, for risk management purposes, are scheduled into time periods on this basis. On the basis of this analysis, Entity A decides what amount it wishes to hedge in each time period.

IE3. This example deals only with the repricing time period expiring in three months' time, i.e., the time period maturing on 31 March 20x7 (a similar procedure would be applied for each of the other 59 time periods). Entity A has scheduled assets of Rs. 100 million and liabilities of Rs. 80 million into this time period. All of the liabilities are repayable on demand.

IE4. Entity A decides, for risk management purposes, to hedge the net position of Rs. 20 million and accordingly enters into an interest rate swap[47] on 1 January 20x7 to pay a fixed rate and receive LIBOR, with a notional principal amount of Rs. 20 million and a fixed life of three months.

IE5. This Example makes the following simplifying assumptions:

(a) the coupon on the fixed leg of the swap is equal to the fixed coupon on the asset;

(b) the coupon on the fixed leg of the swap becomes payable on the same dates as the interest payments on the asset; and

(c) the interest on the variable leg of the swap is the overnight LIBOR rate. As a result, the entire fair value change of the swap arises from the fixed leg only, because the variable leg is not exposed to changes in fair value due to changes in interest rates.

In cases when these simplifying assumptions do not hold, greater ineffectiveness will arise. (The ineffectiveness arising from (a) could be eliminated by designating as the hedged item a portion of the cash flows on the asset that are equivalent to the fixed leg of the swap.)

IE6. It is also assumed that Entity A tests effectiveness on a monthly basis.

IE7. The fair value of an equivalent non-prepayable asset of Rs. 20 million, ignoring changes in value that are not attributable to interest rate movements, at various times during the period of the hedge is as follows:

	1 Jan 20x7	31 Jan 20x7	1 Feb 20x7	28 Feb 20x7	31 Mar 20x7
Fair value (asset) (Rs.)	20,000,000	20,047,408	20,047,408	20,023,795	Nil

IE8. The fair value of the swap at various times during the period of the hedge is as follows.

	1 Jan 20x7	31 Jan 20x7	1 Feb 20x7	28 Feb 20x7	31 Mar 20x7
Fair value (asset) (Rs.)	Nil	(47,408)	(47,408)	(23,795)	Nil

Accounting Treatment

IE9. On 1 January 20x7, Entity A designates as the hedged item an amount of Rs. 20 million of assets in the three-month time period. It designates as the hedged risk the change in the value of the hedged item (i.e., the Rs. 20 million of assets) that is attributable to changes in LIBOR. It also complies with the other designation requirements set out in paragraphs 98(d) and Appendix A paragraph A144 of the Standard.

IE10. Entity A designates as the hedging instrument the interest rate swap described in paragraph IE4.

End of month 1 (31 January 20x7)

IE11. On 31 January 20x7 (at the end of month 1) when Entity A tests effectiveness, LIBOR has decreased. Based on historical prepayment experience, Entity A estimates that, as a consequence, prepayments will occur faster than previously estimated. As a result it re-estimates the amount of assets scheduled into this time period (excluding new assets originated during the month) as Rs. 96 million.

[46] In this Example principal cash flows have been scheduled into time periods but the related interest cash flows have been included when calculating the change in the fair value of the hedged item. Other methods of scheduling assets and liabilities are also possible. Also, in this Example, monthly repricing time periods have been used. An entity may choose narrower or wider time periods.

[47] The Example uses a swap as the hedging instrument. An entity may use forward rate agreements or other derivatives as hedging instruments.

IE12. The fair value of the designated interest rate swap with a notional principal of Rs. 20 million is (Rs. 47,408)[48] (the swap is a liability).

IE13. Entity A computes the change in the fair value of the hedged item, taking into account the change in estimated prepayments, as follows.

(a) First, it calculates the percentage of the initial estimate of the assets in the time period that was hedged. This is 20 per cent (Rs. 20 million / Rs. 100 million).

(b) Second, it applies this percentage (20 per cent) to its revised estimate of the amount in that time period (Rs. 96 million) to calculate the amount that is the hedged item based on its revised estimate. This is Rs. 19.2 million.

(c) Third, it calculates the change in the fair value of this revised estimate of the hedged item (Rs. 19.2 million) that is attributable to changes in LIBOR. This is Rs. 45,511 (Rs. 47,408[49] x (Rs. 19.2 million / Rs. 20 million)).

IE14. Entity A makes the following accounting entries relating to this time period:

Dr	Cash	Rs. 172,097	
	Cr Statement of profit and loss (interest income)[50]		Rs. 172,097
To recognise the interest received on the hedged amount (Rs. 19.2 million).			

Dr	Statement of profit and loss (interest expense)	Rs. 179,268	
	Cr Statement of profit and loss (interest income)		Rs. 179,268
	Cr Cash		Nil
To recognise the interest received and paid on the swap designated as the hedging instrument.			

Dr	Statement of profit and loss (loss)	Rs. 47,408	
	Cr Derivative liability		Rs. 47,408
To recognise the change in the fair value of the swap.			

Dr	Separate balance sheet line item	Rs. 45,511	
	Cr Statement of profit and loss (gain)		Rs. 45,511
To recognise the change in the fair value of the hedged amount.			

IE15. The net result on profit or loss (excluding interest income and interest expense) is to recognise a loss of (Rs. 1,897). This represents ineffectiveness in the hedging relationship that arises from the change in estimated prepayment dates.

Beginning of month 2

IE16. On 1 February 20x7 Entity A sells a proportion of the assets in the various time periods. Entity A calculates that it has sold $8\frac{1}{3}$ per cent of the entire portfolio of assets. Because the assets were allocated into time periods by allocating a percentage of the assets (rather than individual assets) into each time period, Entity A determines that it cannot ascertain into which specific time periods the sold assets were scheduled. Hence it uses a systematic and rational basis of allocation. Based on the fact that it sold a representative selection of the assets in the portfolio, Entity A allocates the sale proportionately over all time periods.

IE17. On this basis, Entity A computes that it has sold $8\frac{1}{3}$ per cent of the assets allocated to the three-month time period, i.e., Rs. 8 million ($8\frac{1}{3}$ per cent of Rs. 96 million). The proceeds received are Rs. 8,018,400, equal to the fair value of the assets[51]. On derecognition of the assets, Entity A also removes from the separate balance sheet line item an amount that represents the change in the fair value of the hedged assets that it has now sold. This is $8\frac{1}{3}$ per cent of the total line item balance of Rs. 45,511, i.e., Rs. 3,793.

IE18. Entity A makes the following accounting entries to recognise the sale of the asset and the removal of part of the balance in the separate balance sheet line item.

Dr	Cash	Rs. 8,018,400	
	Cr Asset		Rs. 8,000,000
	Cr Separate balance sheet line		Rs. 3,793
	Cr Statement of profit and loss (gain)		Rs. 14,607
To recognise the sale of the asset at fair value and to recognise a gain on sale.			

Because the change in the amount of the assets is not attributable to a change in the hedged interest rate no ineffectiveness arises.

IE19. Entity A now has Rs. 88 million of assets and Rs. 80 million of liabilities in this time period. Hence the net amount Entity A wants to hedge is now Rs. 8 million and, accordingly, it designates Rs. 8 million as the hedged amount.

IE20. Entity A decides to adjust the hedging instrument by designating only a proportion of the original swap as the hedging instrument. Accordingly, it designates as the hedging instrument Rs. 8 million or 40 per cent of the notional amount of the original swap with a remaining life of two months and a fair value of Rs. 18,963.[52] It also complies with the other designation requirements in paragraphs 98(a) and A144 of the Standard. The Rs. 12 million of the notional amount of the swap that is no longer designated as the hedging instrument is either classified as held for trading with changes in fair value recognised in the statement of profit and loss, or is designated as the hedging instrument in a different hedge.[53]

IE21. As at 1 February 20x7 and after accounting for the sale of assets, the separate balance sheet line item is Rs. 41,718

[48] See paragraph IE8.

[49] i.e., Rs. 20,047,408 – Rs. 20,000,000. See paragraph IE7.

[50] This Example does not show how amounts of interest income and interest expense are calculated.

[51] The amount realised on sale of the asset is the fair value of a prepayable asset, which is less than the fair value of the equivalent non-prepayable asset shown in paragraph IE7.

[52] Rs. 47,408 x 40 per cent

[53] The entity could instead enter into an offsetting swap with a notional principal of Rs. 12 million to adjust its position and designate as the hedging instrument all Rs. 20 million of the existing swap and all Rs. 12 million of the new offsetting swap.

(Rs. 45,511 – Rs. 3,793), which represents the cumulative change in fair value of Rs. 17.6[54] million of assets. However, as at 1 February 20x7, Entity A is hedging only Rs. 8 million of assets that have a cumulative change in fair value of Rs. 18,963.[55] The remaining separate balance sheet line item of Rs. 22,755[56] relates to an amount of assets that Entity A still holds but is no longer hedging. Accordingly Entity A amortises this amount over the remaining life of the time period, i.e., it amortises Rs. 22,755 over two months.

IE22. Entity A determines that it is not practicable to use a method of amortisation based on a recalculated effective yield and hence uses a straight-line method.

End of month 2 (28 February 20x7)

IE23. On 28 February 20x7 when Entity A next tests effectiveness, LIBOR is unchanged. Entity A does not revise its prepayment expectations. The fair value of the designated interest rate swap with a notional principal of Rs. 8 million is (Rs. 9,518)[57] (the swap is a liability). Also, Entity A calculates the fair value of the Rs. 8 million of the hedged assets as at 28 February 20x7 as Rs. 8,009,518[58].

IE24. Entity A makes the following accounting entries relating to the hedge in this time period:

Dr	Cash	Rs. 71,707	
	Cr Statement of profit and loss (interest income)		Rs. 71,707
To recognise the interest received on the hedged amount (Rs. 8 million).			

Dr	Statement of profit and loss (interest expense)	Rs. 71,707	
	Cr Statement of profit and loss (interest income)		Rs. 62,115
	Cr Cash		Rs. 9,592
To recognise the interest received and paid on the portion of the swap designated as the hedging instrument (Rs. 8 million).			

Dr	Derivative liability	Rs. 9,445	
	Cr Statement of profit and loss (gain)		Rs. 9,445
To recognise the change in the fair value of the portion of the swap designated as the hedging instrument (Rs. 8 million) (Rs. 9,518 – Rs. 18,963).			

Dr	Statement of profit and loss (loss)	Rs. 9,445	
	Cr Separate balance sheet line item		Rs. 9,445
To recognise the change in the fair value of the hedged amount (Rs. 8,009,518 – Rs. 8,018,963).			

IE25. The net effect on profit or loss (excluding interest income and interest expense) is nil reflecting that the hedge is fully effective.

IE26. Entity A makes the following accounting entry to amortise the line item balance for this time period:

Dr	Statement of profit and loss (loss)	Rs. 11,378	
	Cr Separate balance sheet line item		Rs. 11,378[59]
To recognise the amortisation charge for the period.			

End of month 3

IE27. During the third month there is no further change in the amount of assets or liabilities in the three-month time period. On 31 March 20x7 the assets and the swap mature and all balances are recognised in the statement of profit and loss.

IE28. Entity A makes the following accounting entries relating to this time period:

Dr	Cash	Rs. 8,071,707	
	Cr Asset (balance sheet)		Rs. 8,000,000
	Cr Statement of profit and loss (interest income)		Rs. 71,707
To recognise the interest and cash received on maturity of the hedged amount (Rs. 8 million).			

Dr	Statement of profit and loss (interest expense)	Rs. 71,707	
	Cr Statement of profit and loss (interest income)		Rs. 62,115
	Cr Cash		Rs. 9,592
To recognise the interest received and paid on the portion of the swap designated as the hedging instrument (Rs. 8 million).			

Dr	Derivative liability	Rs. 9,518	
	Cr Statement of profit and loss (gain)		Rs. 9,518
To recognise the expiry of the portion of the swap designated as the hedging instrument (Rs. 8 million).			

Dr	Statement of profit and loss (loss)	Rs. 9,518	
	Cr Separate balance sheet line item		Rs. 9,518
To remove the remaining line item balance on expiry of the time period.			

IE29. The net effect on profit or loss (excluding interest income and interest expense) is nil reflecting that the hedge is fully effective.

[54] Rs. 19.2 million – ($8\frac{1}{3}$% x Rs. 19.2 million);
[55] Rs. 41,718 x (Rs. 8 million / Rs. 17.6 million);
[56] Rs. 41,718 – Rs. 18,963;
[57] Rs. 23,795 [see paragraph IE8] x (Rs. 8 million / Rs. 20 million);
[58] Rs. 20,023,795 [see paragraph IE7] x (Rs. 8 million / Rs. 20 million);
[59] Rs. 22,755 / 2

IE30. Entity A makes the following accounting entry to amortise the line item balance for this time period:

Dr	Statement of profit and loss (loss)	Rs. 11,377	
	Cr Separate balance sheet line item		Rs. 11,377[60]
To recognise the amortisation charge for the period.			

Summary

IE31. The tables below summarise:

(a) changes in the separate balance sheet line item;
(b) the fair value of the derivative;
(c) the profit or loss effect of the hedge for the entire three-month period of the hedge; and
(d) interest income and interest expense relating to the amount designated as hedged.

Description	**1 Jan 20x7**	**31 Jan 20x7**	**1 Feb 20x7**	**28 Feb 20x7**	**31 Mar 20x7**
	Rs.	**Rs.**	**Rs.**	**Rs.**	**Rs.**
Amount of asset hedged	**20,000,000**	**19,200,000**	**8,000,000**	**8,000,000**	**8,000,000**
(a) Changes in the separate balance sheet line item					
Brought forward:					
Balance to be amortised	Nil	Nil	Nil	22,755	11,377
Remaining balance	Nil	Nil	45,511	18,963	9,518
Less: Adjustment on sale of asset	Nil	Nil	(3,793)	Nil	Nil
Adjustment for change in fair value of the hedged asset	Nil	45,511	Nil	(9,445)	(9,518)
Amortisation	Nil	Nil	Nil	(11,378)	(11,377)
Carried forward:					
Balance to be amortised	**Nil**	**Nil**	**22,755**	**11,377**	**Nil**
Remaining balance	**Nil**	**45,511**	**18,963**	**9,518**	**Nil**
(b) The fair value of the derivative					
	1 Jan 20x7	31 Jan 20x7	1 Feb 20x7	28 Feb 20x7	31 Mar 20x7
Rs. 20,000,000	Nil	47,408	-	-	-
Rs. 12,000,000	Nil	-	28,445	No longer designated as the hedging instrument	
Rs. 8,000,000	Nil	-	18,963	9,518	Nil
Total	**Nil**	**47,408**	**47,408**	**9,518**	**Nil**
(c) Profit or loss effect of the hedge					
	1 Jan 20x7	**31 Jan 20x7**	**1 Feb 20x7**	**28 Feb 20x7**	**31 Mar 20x7**
Change in line item: asset	Nil	45,511	N/A	(9,445)	(9,518)
Change in derivative fair value	Nil	(47,408)	N/A	9,445	9,518
Net effect	**Nil**	**(1,897)**	**N/A**	**Nil**	**Nil**
Amortisation	**Nil**	**Nil**	**N/A**	**(11,378)**	**(11,377)**
In addition, there is a gain on sale of assets of Rs. 14,607 at 1 February 20x7.					
(d) Interest income and interest expense relating to the amount designated as hedged					
Profit or loss recognised for the amount hedged	**1 Jan 20x7**	**31 Jan 20x7**	**1 Feb 20x7**	**28 Feb 20x7**	**31 Mar 20x7**
Interest income					
- on the asset	Nil	172,097	N/A	71,707	71,707
- on the swap	Nil	179,268	N/A	62,115	62,115
Interest expense					
- on the swap	Nil	(179,268)	N/A	(71,707)	(71,707)

Appendices C & D to this Exposure Draft of Proposed Accounting Standard (AS) 30, *Financial Instruments; Recognition and Measurement* will be published in February 2007 Issue of the Journal.

[60] Rs. 22,755 / 2

Exposure Draft

Proposed Limited Revision to Accounting Standard (AS) 2 (revised 1999)

Valuation of Inventories

(Last date for comments: March 31, 2007)

The following is the text of the Exposure Draft of proposed limited revision to AS 2, Valuation of Inventories, issued by the Accounting Standards Board of the Institute of Chartered Accountants of India, for comment. Comments on the proposed limited revisions may be sent to the Secretary, Accounting Standards Board, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002, so as to reach him not later than March 31, 2007. Comments can also be sent by e-mail at tdte@icai.org or at edcommentsasb@icai.org.

In view of the proposed Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* AS 2 (revised 1999) is proposed to be modified as under (proposed modifications are shown in red colour underline/strike-through):

After the existing paragraph 12, new paragraph 12A is proposed to be added as below:

12A. An enterprise may purchase inventories on deferred settlement terms. When the arrangement effectively contains a financing element, that element, for example a difference between the purchase price for normal credit terms and the amount paid, is recognised as interest expense over the period of the financing.

The limited revision comes into effect in respect of accounting periods commencing on or after _____ *(date to be decided later)*.

Exposure Draft

Proposed Limited Revision to Accounting Standard (AS) 11 (revised 2003)

The Effects of Changes in Foreign Exchange Rates

(Last date for comments: March 31, 2007)

The following is the text of the Exposure Draft of proposed limited revision to AS 11 (revised 2003), The Effects of Changes in Foreign Exchange Rates, issued by the Accounting Standards Board of the Institute of Chartered Accountants of India, for comment. Comments on the proposed limited revisions may be sent to the Secretary, Accounting Standards Board, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002, so as to reach him not later than March 31, 2007. Comments can also be sent by e-mail at tdte@icai.org or at edcommentsasb@icai.org.

In view of the proposed Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement, AS 11 (revised 2003) is proposed to be modified as under (proposed modifications are shown in red colour underline/strike-through):

1. Scope Paragraphs of the Standard are proposed to be amended as follows:

Scope

1. ***This Statement should be applied:***

   (a) ***in accounting for transactions*** and balances ***in foreign currencies,*** except for those derivative transactions and balances that are within the scope of AS 30, Financial Instruments: Recognition and Measurement; **and**

   (b) ***in translating the financial statements of foreign operations.***

~~2. This Statement also deals with accounting for foreign currency transactions in the nature of forward exchange contracts.~~[‡]

2. AS 30 applies to many foreign currency derivatives and, accordingly, these are excluded from the scope of this Statement. However, those foreign currency derivatives that are not within the scope of AS 30 (e.g., some foreign currency derivatives that are embedded in other contracts) are within the scope of this Statement.

2A. This Statement does not apply to hedge accounting for foreign currency items, including the hedging of a net investment in a non-integral foreign operation. AS 30 applies to hedge accounting.

3. This Statement does not specify the currency in which an enterprise presents its financial statements. However, an enterprise normally uses the currency of the country in which it is domiciled. If it uses a different currency, this Statement

~~[‡]It may be noted that on the basis of a decision of the Council at its meeting held on June 24-26, 2004, an Announcement titled 'Applicability of Accounting Standard (AS) 11 (revised 2003), The Effects of Changes in Foreign Exchange Rates, in respect of exchange differences arising on a forward exchange contract entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction' has been issued. The Announcement clarifies that AS 11 (revised 2003) does not deal with the accounting of exchange difference arising on a forward exchange contract entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction. It has also been separately clarified that AS 11 (revised 2003) continues to be applicable to exchange differences on all other forward exchange contracts. [For full text of the Announcement reference may be made to the section titled 'Announcements of the Council regarding status of various documents issued by the Institute of Chartered Accountants of India' appearing at the beginning of this Compendium.]~~

requires disclosure of the reason for using that currency. This Statement also requires disclosure of the reason for any change in the reporting currency.

4. This Statement does not deal with the restatement of an enterprise's financial statements from its reporting currency into another currency for the convenience of users accustomed to that currency or for similar purposes.

5. This Statement does not deal with the presentation in a cash flow statement of cash flows arising from transactions in a foreign currency and the translation of cash flows of a foreign operation (see AS 3, *Cash Flow Statements*).

6. This Statement does not deal with exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs (see paragraph 4(e) of AS 16, *Borrowing Costs*).

2. From the definition paragraph, the definitions of the terms 'Forward exchange contract' and 'Forward rate' are proposed to be deleted.

3. Paragraph 8 is proposed to be amended as follows:

8. A foreign currency transaction is a transaction which is denominated in or requires settlement in a foreign currency, including transactions arising when an enterprise either:

(a) buys or sells goods or services whose price is denominated in a foreign currency;

(b) borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency; or

~~(c) becomes a party to an unperformed forward exchange contract; or~~

(~~d~~c) otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

4. A new paragraph no. 12A is proposed to be added under the existing heading 'Recognition of Exchange Differences'. This would become the first paragraph under this heading and would appear as follows:

12A. As noted in paragraph 2A, AS 30 applies to hedge accounting for foreign currency items. The application of hedge accounting requires an enterprise to account for some exchange differences differently from the treatment of exchange differences required by this Statement. For example, AS 30 requires that exchange differences on monetary items that qualify as hedging instruments in a cash flow hedge are reported initially in an appropriate equity account, e.g., Hedging Reserve Account, to the extent that the hedge is effective.

5. The heading 'Forward Exchange Contracts' and paragraphs 36 to 39, given under the heading, are proposed to be deleted.

6. Paragraph 40, given under the heading 'Disclosures', is proposed to be amended as follows:

40. An enterprise should disclose:

(a) the amount of exchange differences included in the net profit or loss for the period except for those arising on financial instruments measured at fair value through profit or loss in accordance with AS 30; and

(b) net exchange differences accumulated in foreign currency translation reserve as a separate component of shareholders' funds, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

7. The name of AS 21, appearing in paragraphs 29 and 30 of the Standard, is proposed to be changed to reflect the proposed new name of AS 21, viz., the following:

AS 21, Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements

8. The name of AS 23, appearing in paragraph 30 of the Standard, is proposed to be changed to reflect the proposed new name of AS 23, viz., the following:

AS 23, Accounting for Investments in Associates

9. Alongwith the proposed Limited Revision to AS 11 (revised 2003), Comparison with IAS 21, *The Effects of Changes in Foreign Exchange Rates*, (revised 1993) contained in Appendix to AS 11 (revised 2003) is proposed to be replaced by the following Comparison with IAS 21, *The Effects of Changes in Foreign Exchange Rates* (revised 2003):

Appendix

Note: This Appendix is not a part of the Accounting Standard. The purpose of this appendix is only to bring out the major differences between Accounting Standard 11 (revised 2003) and corresponding International Accounting Standard (IAS) 21 (revised 2003).

Comparison with IAS 21, The Effects of Changes in Foreign Exchange Rates (revised 2003)

AS 11 (revised 2003) is based on the integral and non-integral foreign operations approach, i.e., the approach which was followed in the earlier IAS 21 (revised 1993). The International Accounting Standards Board (IASB) has, in 2003, revised IAS 21 to adopt the functional currency approach. It has been observed that in all except one of the situations there is effectively no difference between the financial statements prepared under IAS 21 and AS 11. The only difference is that IAS 21 also lays down the method where the reporting enterprise's functional currency, i.e., the currency of the primary economic environment in which the enterprise operates, is different as compared to its presentation currency, i.e., the currency in which financial statements are presented, whereas AS 11 only requires certain disclosures in such a case. However, it may be mentioned that in the context of most of the Indian enterprises, the functional currency and the presentation currency will be the same, *i.e.*, the rupees, except there may be some Indian enterprises which are an integral foreign operation of a foreign enterprise. Therefore, only in very limited cases the application of the principles of IAS 21 will make a difference as compared to AS 11.

AS 11 (revised 2003) has recently become effective, i.e., from 1-4-2004. The Indian corporates have recently started applying this Standard. It is, therefore, felt that it is not appropriate to totally revise AS 11 (revised 2003) at this stage to adopt the IAS 21 which became effective from 1-1-2005.

The limited revision comes into effect in respect of accounting periods commencing on or after _____ *(date to be decided later)*.

Exposure Draft

Proposed Limited Revision to Accounting Standard (AS) 21 (issued 2001)

(Last date for comments: March 31, 2007)

The following is the text of the Exposure Draft of proposed limited revision to AS 21, Consolidated Financial Statements, issued by the Accounting Standards Board of the Institute of Chartered Accountants of India, for comment. Comments on the proposed limited revisions may be sent to the Secretary, Accounting Standards Board, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002, so as to reach him not later than March 31, 2007. Comments can also be sent by e-mail at tdte@icai.org or at edcommentsasb@icai.org.

In view of the proposed Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* AS 21 (issued 2001) is proposed to be modified as under (proposed modifications are shown in red colour underline/ strike-through):

1. The name of the Standard is proposed to be modified as below:

Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements

2. The 'Applicability' paragraph of the Standard is proposed to be amended as follows:

Accounting Standard (AS) 21 (issued 2001), *Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements*, issued by the Council of the Institute of Chartered Accountants of India, ~~comes~~ came into effect in respect of accounting periods commencing on or after 1-4-2001. This limited revision to the Standard comes into effect in respect of accounting periods commencing on or after _____ *(date to be decided later)*. In respect of separate financial statements of an enterprise, this Standard is mandatory in nature[1] from that date. In respect of consolidated financial statements, this Accounting Standard is mandatory[1] where the enterprise prepares and presents consolidated financial statements. In other words, the accounting standard does not mandate an enterprise to present consolidated financial statements but, if the enterprise presents consolidated financial statements, for a period commencing on or after the date on which this Standard first came into effect, i.e., 1-4-2001, for complying with the requirements of any statute or otherwise, it should prepare and present consolidated financial statements in accordance with this Standard. ~~An enterprise that presents consolidated financial statements should prepare and present these statements in accordance with this Standard.[2]~~

The following is the text of the Accounting Standard.

3. The 'Objective' paragraph of the Standard is proposed to be amended as follows:

The objective of this Statement is to lay down principles and procedures for preparation and presentation of consolidated financial statements and for accounting for investments in subsidiaries in separate financial statements. Consolidated financial statements are presented by a parent (also known as holding enterprise) to provide financial information about the economic activities of its group. These statements are intended to present financial information about a parent and its subsidiary(ies) as a single economic entity to show the economic resources controlled by the group, the obligations of the group and results the group achieves with its resources.

4. The 'Scope' paragraphs of the Standard are proposed to be amended as follows:

Scope

1. ***This Statement should be applied in the preparation and presentation of consolidated financial statements for a group of enterprises under the control of a parent.***
2. ***This Statement should also be applied in accounting for investments in subsidiaries in the separate financial statements of a parent.***
3. In the preparation of consolidated financial statements, other Accounting Standards also apply in the same manner as they apply to the separate financial statements.
4. This Statement does not deal with:
   (a) methods of accounting for amalgamations and their effects on consolidation, including goodwill arising on amalgamation (see AS 14, Accounting for Amalgamations);
   (b) accounting for investments in associates (~~at present governed by~~ see AS ~~13~~23, Accounting for Investments in Associates[3]); and
   (c) accounting for ~~investments~~ interests in joint ventures (~~at present governed by~~ see AS ~~13~~27, ~~Accounting for~~

[1] 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.

~~[2] It is clarified that AS 21 is mandatory if an enterprise presents consolidated financial statements. In other words, the accounting standard does not mandate an enterprise to present consolidated financial statements but, if the enterprise presents consolidated financial statements for complying with the requirements of any statute or otherwise, it should prepare and present consolidated financial statements in accordance with AS 21 (see 'The Chartered Accountant', July 2001, page 95).~~

~~[3] Accounting Standard (AS) 23, 'Accounting for Investments in Associates in Consolidated Financial Statements', which came into effect in respect of accounting periods commencing on or after 1-4-2002, specifies the requirements relating to accounting for investments in associates in Consolidated Financial Statements.~~

~~Investments~~ *Financial Reporting of Interests in Joint Ventures*[4]).

5. Paragraph 11 is proposed to be amended as follows:

11. A subsidiary should be excluded from consolidation when:

(a) control is intended to be temporary because the subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future[5]; or

(b) it operates under severe long-term restrictions which significantly impair its ability to transfer funds to the parent.

In consolidated financial statements, investments in such subsidiaries should be accounted for in accordance with Accounting Standard (AS) ~~13~~30, ~~Accounting for Investments~~Financial Instruments: Recognition and Measurement. The reasons for not consolidating a subsidiary should be disclosed in the consolidated financial statements.

6. After paragraph 11, new paragraph 11A is proposed to be added. New paragraph 11A is proposed to be as follows:

11A. A subsidiary is not excluded from consolidation simply because the parent is a venture capital organisation or a similar entity.

7. Paragraphs 23 and 24 are proposed to be amended as follows:

23. An investment in an enterprise should be accounted for in accordance with Accounting Standard (AS) ~~13~~30, ~~Accounting for Investments~~Financial Instruments: Recognition and Measurement, from the date that the enterprise ceases to be a subsidiary, ~~and~~ provided that it does not become an associate as defined in AS 23 or a jointly controlled entity as described in AS 27[6].

24. The carrying amount of the investment at the date that ~~it~~ the enterprise ceases to be a subsidiary is regarded as the cost on initial measurement of a financial asset in accordance with AS 30 ~~thereafter~~.

8. Paragraph 28, appearing under the heading 'Accounting for Investments in Subsidiaries in a Parent's Separate Financial Statements' is proposed to be amended. New paragraphs 28A and 28B are proposed to be added. Amended paragraph 28 and new paragraphs 28A and 28B are proposed to be as follows:

Accounting for Investments in Subsidiaries in a Parent's Separate Financial Statements

28. In a parent's separate financial statements, investments in subsidiaries, except investments in subsidiaries covered under paragraph 11 of this Statement, should be accounted for ~~in accordance with Accounting Standard (AS) 13, Accounting for Investments~~ at cost. Investments in subsidiaries covered under paragraph 11 of this Statement should be accounted for in accordance with Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement.

28A. A parent makes an investment in a subsidiary for strategic reasons and with the intention of establishing or maintaining a long-term operating relationship with the enterprise in which the investment is made. In case of such an investment, the enterprise does not intend to gain from changes in the fair value of investment. Accordingly, paragraph 28 requires an investment in such a subsidiary to be valued at cost. However, in the situations covered in paragraph 11 of this Statement, viz., when control is intended to be temporary or when the subsidiary operates under severe long-term restrictions, the economic benefits of establishing or maintaining a long-term operating relationship with the enterprise in which the investment is made do not in effect exist. Keeping this in view, paragraph 11 of this Statement requires such an investment to be excluded from consolidation. Accordingly, such an investment is not accounted for at cost in separate financial statements; rather the principles of accounting for investments that are prescribed in AS 30 are applied to such investments in separate financial statements.

28B. To determine whether an investment in a subsidiary accounted for at cost in accordance with paragraph 28 is impaired, an enterprise applies AS 28, *Impairment of Assets*. AS 28 which explains how an enterprise reviews the carrying amount of its assets, how it determines the recoverable amount of an asset, and when it recognises, or reverses the recognition of, an impairment loss is also applicable to impairment of an investment in a subsidiary.

~~[4]Accounting Standard (AS) 27, 'Financial Reporting of Interests in Joint Ventures', which came into effect in respect of accounting periods commencing on or after 1-4- 2002, specifies the requirements relating to accounting for investments in joint ventures.~~

[5]See also Accounting Standards Interpretations (ASIs) 8 and 25.

~~[6]Accounting Standard (AS) 23, 'Accounting for Investments in Associates in Consolidated Financial Statements', which came into effect in respect of accounting periods commencing on or after 1.4.2002, defines the term 'associate' and specifies the requirements relating to accounting for investments in associates in Consolidated Financial Statements.~~

Exposure Draft

Proposed Limited Revision to Accounting Standard (AS) 23 (issued 2001)

(Last date for comments: March 31, 2007)

The following is the text of the Exposure Draft of proposed limited revision to AS 23, Accounting for Investments in Associates in Consolidated Financial Statements, issued by the Accounting Standards Board of the Institute of Chartered Accountants of India, for comment. Comments on the proposed limited revisions may be sent to the Secretary, Accounting Standards Board, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002, so as to reach him not later than March 31, 2007. Comments can also be sent by e-mail at tdte@icai.org or at edcommentsasb@icai.org.

In view of the proposed Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* AS 23 (issued 2001) is proposed to be modified as under (proposed modifications are shown in red colour underline/strike-through):

1. The name of the Standard is proposed to be modified as below:

Accounting for Investments in Associates ~~in Consolidated Financial Statements~~

2. The 'Applicability' paragraph of the Standard is proposed to be amended as follows:

Accounting Standard (AS) 23 (issued 2001), *Accounting for Investments in Associates* ~~*in Consolidated Financial Statements*~~, issued by the Council of the Institute of Chartered Accountants of India, ~~comes~~ came into effect in respect of accounting periods commencing on or after 1-4-2002. This limited revision to the Standard comes into effect in respect of accounting periods commencing on or after _____ *(date to be decided later)*. In respect of separate financial statements of an enterprise, this Standard is mandatory in nature[1] from that date. In respect of consolidated financial statements, this Standard is mandatory[1] where the enterprise prepares and presents consolidated financial statements. In other words, if ~~An~~ an enterprise prepares and ~~that~~ presents consolidated financial statements, for a period commencing on or after the date on which this Standard first came into effect, i.e., 1-4-2002, it should account for investments in associates in the consolidated financial statements in accordance with this Standard.[2]

The following is the text of the Accounting Standard.

3. The 'Objective' paragraph of the Standard is proposed to be amended as follows:

The objective of this Statement is to set out principles and procedures for recognising the effects of the investments~~, in the consolidated financial statements,~~ in associates on the financial position and operating results ~~of a group~~ in the consolidated financial statements of a group and for accounting for investments in associates in the separate financial statements of an investor.

4. The 'Scope' paragraphs of the Standard are proposed to be amended as follows:

1. This Statement should be applied in accounting for investments in associates in the preparation and presentation of separate as well as consolidated financial statements by an investor. However, it does not apply to investments in associates held by:

(a) venture capital organisations, or

(b) mutual funds, unit trusts and similar entities including investment-linked insurance funds

that upon initial recognition are designated as at fair value through profit or loss or are classified as held for trading and accounted for in accordance with AS 30, Financial Instruments: Recognition and Measurement. Such investments should be measured at fair value in accordance with AS 30, with changes in fair value recognised in the statement of profit and loss in the period of the change.

2. The requirements relating to accounting for investments in associates in consolidated financial statements, contained in this Statement, are applicable only where consolidated financial statements are prepared and presented by the investor. ~~This Statement does not deal with accounting for investments in associates in the preparation and presentation of separate financial statements by an investor.[3]~~

5. Paragraph 7 is proposed to be amended as follows:

7. An investment in an associate should be accounted for in consolidated financial statements under the equity method except when:

(a) the investment is acquired and held exclusively with a view to its subsequent disposal in the near future[4]; or

(b) the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor.

Investments in such associates should be accounted for in accordance with Accounting Standard (AS) ~~13~~30, ~~Accounting for Investments~~ Financial Instruments: Recognition and Measurement. The reasons for not applying the equity method in accounting for investments in an associate should be disclosed in the consolidated financial statements.

6. Paragraph 9 is proposed to be amended as follows:

9. An investor should discontinue the use of the equity method from the date that:

[1]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.

~~[2]It is clarified that AS 23 is mandatory if an enterprise presents consolidated financial statements. In other words, if an enterprise presents consolidated financial statements, it should account for investments in associates in the consolidated financial statements in accordance with AS 23 from the date of its coming into effect, i.e., 1-4-2002 (see 'The Chartered Accountant', July 2001, page 95).~~

~~[3]Accounting Standard (AS) 13, 'Accounting for Investments', is applicable for accounting for investments in associates in the separate financial statements of an investor.~~

[4]See also Accounting Standards Interpretation (ASI) 8.

(a) it ceases to have significant influence in an associate but retains, either in whole or in part, its investment; or

(b) the use of the equity method is no longer appropriate because the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor.

From the date of discontinuing the use of the equity method, investments in such associates should be accounted for in accordance with Accounting Standard (AS) ~~13~~30, ~~Accounting for Investments~~ Financial Instruments: Recognition and Measurement. For this purpose, the carrying amount of the investment at that date should be regarded as its cost ~~thereafter~~ on initial measurement as a financial asset in accordance with AS 30.

7. The existing paragraph 20 is proposed to be deleted. After the existing paragraph 19, new paragraphs 20, 20A, 20B and 20C under the heading 'Impairment Loss' and new paragraphs 20D, 20E and 20F under the heading 'Separate Financial Statements of an Investor' are proposed to be added. New paragraphs are proposed to be as follows:

~~***20. The carrying amount of investment in an associate should be reduced to recognise a decline, other than temporary, in the value of the investment, such reduction being determined and made for each investment individually.***~~

Impairment losses

20. After applying the equity method, including recognising the associate's losses in accordance with paragraph 18, the investor applies the requirements of AS 30 to determine whether it is necessary to recognise any additional impairment loss with respect to the investor's net investment in the associate.

20A. The investor also applies the requirements of AS 30 to determine whether any additional impairment loss is recognised with respect to the investor's interest in the associate that does not constitute part of the net investment and the amount of that impairment loss.

20B. Because goodwill included in the carrying amount of an investment in an associate is not separately recognised, it is not tested for impairment separately by applying the requirements for testing of impairment of goodwill in AS 28, *Impairment of Assets*. Instead, the entire carrying amount of the investment is tested under AS 28 for impairment, by comparing its recoverable amount (higher of net selling price and value in use) with its carrying amount, whenever application of the requirements in AS 30 indicates that the investment may be impaired. In determining the value in use of the investment, an enterprise estimates:

(a) its share of the present value of the estimated future cash flows expected to be generated by the associate, including the cash flows from the operations of the associate and the proceeds on the ultimate disposal of the investment; or

(b) the present value of the estimated future cash flows expected to arise from dividends to be received from the investment and from its ultimate disposal.

Under appropriate assumptions, both methods give the same result.

20C. The recoverable amount of an investment in an associate is assessed for each associate, unless the associate does not generate cash inflows from continuing use that are largely independent of those from other assets of the enterprise.

Separate Financial Statements of an Investor

20D. In an investor's separate financial statements, investments in associates, except investments in associates covered under paragraph 7 of this Statement, should be accounted for at cost. Investments in associates covered under paragraph 7 of this Statement should be accounted for in accordance with Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement.

20E. An investor makes an investment in an associate for strategic reasons and with the intention of establishing or maintaining a long-term operating relationship with the enterprise in which the investment is made. In case of such an investment, the enterprise does not intend to gain from changes in the fair value of investment. Accordingly, paragraph 20D requires an investment in such an associate to be valued at cost. However, in the situations covered in paragraph 7 of this Statement, viz., when the investment is acquired and held exclusively with a view to its subsequent disposal in the near future or when the associate operates under severe long-term restrictions, the economic benefits of establishing or maintaining a long-term operating relationship with the enterprise in which the investment is made do not in effect exist. Keeping this in view, paragraph 7 of this Statement requires such an investment to be excluded from application of the equity method. Accordingly, such an investment is not accounted for at cost in separate financial statements; rather the principles of accounting for investments that are prescribed in AS 30 are applied to such investments in separate financial statements.

20F. To determine whether an investment in an associate accounted for at cost in accordance with paragraph 20D is impaired, an enterprise applies AS 28, *Impairment of Assets*. AS 28 which explains how an enterprise reviews the carrying amount of its assets, how it determines the recoverable amount of an asset, and when it recognises, or reverses the recognition of, an impairment loss is also applicable to impairment of an investment in an associate.

8. Paragraph 21 is proposed to be amended as follows:

21. In accordance with Accounting Standard (AS)~~4~~ 29, *Provisions, Contingent Liabilities and Contingent Assets* ~~Contingencies and Events Occurring After the Balance Sheet Date~~[5], the investor discloses in the separate as well as the consolidated financial statements:

(a) its share of the ~~contingencies and capital commitments~~ contingent liabilities of an associate incurred jointly with other investors ~~for which it is also contingently liable~~; and

(b) those ~~contingencies~~ contingent liabilities that arise because the investor is severally liable for all or part of the liabilities of the associate.

9. The name of AS 21, appearing in paragraph 10 of the Standard, is proposed to be changed to reflect the proposed new name of AS 21, viz., the following:

AS 21, Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements

~~[5]Pursuant to AS 29, Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory in respect of accounting periods commencing on or after 1.4.2004, all paragraphs of AS 4 that deal with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by other Indian Accounting Standards.~~

Exposure Draft

Proposed Limited Revision to Accounting Standard (AS) 26 (issued 2002)

Intangible Assets

(Last date for comments: March 31, 2007)

The following is the text of the Exposure Draft of proposed limited revision to AS 26, Intangible Assets, issued by the Accounting Standards Board of the Institute of Chartered Accountants of India, for comment. Comments on the proposed limited revisions may be sent to the Secretary, Accounting Standards Board, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002, so as to reach him not later than March 31, 2007. Comments can also be sent by e-mail at tdte@icai.org or at edcommentsasb@icai.org.

In view of the proposed Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*, AS 26 (issued 2002) is proposed to be modified as under (proposed modifications are shown in red colour underline/ strike-through):

After the existing paragraph 25, new paragraph 25A is proposed to be added as below:

25A. If payment for an intangible asset is deferred beyond normal credit terms, its cost is the cash price equivalent. The difference between this amount and the total payments is recognised as interest expense over the period of credit unless it is capitalised in accordance with AS 16, *Borrowing Costs*.

The limited revision comes into effect in respect of accounting periods commencing on or after _____ *(date to be decided later).*

Exposure Draft

Proposed Limited Revision to Accounting Standard (AS) 27 (issued 2002)

Financial Reporting of Interests in Joint Ventures

(Last date for comments: March 31, 2007)

The following is the text of the Exposure Draft of proposed limited revision to AS 27, Financial Reporting of Interests in Joint Ventures, issued by the Accounting Standards Board of the Institute of Chartered Accountants of India, for comment. Comments on the proposed limited revisions may be sent to the Secretary, Accounting Standards Board, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002, so as to reach him not later than March 31, 2007. Comments can also be sent by e-mail at tdte@icai.org or at edcommentsasb@icai.org.

In view of the proposed Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*, AS 27 (issued 2002) is proposed to be modified as under (proposed modifications are shown in red colour underline/ strike-through):

1. The 'Scope' paragraphs of the Standard are proposed to be amended as follows:

Scope

1. ***This Statement should be applied in accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors, regardless of the structures or forms under which the joint venture activities take place. However, it does not apply to venturer's interests in jointly controlled entities held by:***

   (a) venture capital organisations, or

   (b) mutual funds, unit trusts and similar entities including investment-linked insurance funds

   that upon initial recognition are designated as at fair value through profit or loss or are classified as held for trading and accounted for in accordance with AS 30, Financial Instruments: Recognition and Measurement. Such investments should be measured at fair value in accordance with AS 30, with changes in fair value recognised in the statement of profit and loss in the period of the change.

2. The requirements relating to accounting for joint ventures in consolidated financial statements, contained in this Statement, are applicable only where consolidated financial statements are prepared and presented by the venturer.

2. Paragraph 27, appearing under the heading 'Separate Financial Statements of a Venturer' is proposed to be amended. New paragraphs 28A and 28B are proposed to be added. Amended paragraph 27 and new paragraphs 28A and 28B are proposed to be as follows:

Separate Financial Statements of a Venturer

27. In a venturer's separate financial statements, interests

in a jointly controlled entity entities, except interests covered under paragraph 29 of this Statement, should be accounted for at cost. Interests in jointly controlled entities covered under paragraph 29 of this Statement should be accounted for as an investment in accordance with Accounting Standard (AS) 1330, Accounting for Investments Financial Instruments: Recognition and Measurement.

28. Each venturer usually contributes cash or other resources to the jointly controlled entity. These contributions are included in the accounting records of the venturer and are recognised in its separate financial statements as an investment in the jointly controlled entity.

28A. A venturer makes an investment in a jointly controlled entity for strategic reasons and with the intention of establishing or maintaining a long-term operating relationship with the enterprise in which the investment is made. In case of such an investment, the enterprise does not intend to gain from changes in the fair value of investment. Accordingly, paragraph 27 requires an interest in such a jointly controlled entity to be valued at cost. However, in the situations covered in paragraph 29 of this Statement, viz., when an interest in a jointly controlled entity is acquired and held exclusively with a view to its subsequent disposal in the near future or when the jointly controlled entity operates under severe long-term restrictions, the economic benefits of establishing or maintaining a long-term operating relationship with the jointly controlled entity in which the investment is made do not in effect exist. Keeping this in view, paragraph 29 of this Statement requires an interest in such a jointly controlled entity to be excluded from proportionate consolidation. Accordingly, such an interest is also not accounted for at cost in separate financial statements; rather the principles of accounting for investments that are prescribed in AS 30 are applied to such interest in separate financial statements.

28B. To determine whether an interest in a jointly controlled entity accounted for at cost in accordance with paragraph 27 is impaired, an enterprise applies AS 28, *Impairment of Assets*. AS 28 which explains how an enterprise reviews the carrying amount of its assets, how it determines the recoverable amount of an asset, and when it recognises, or reverses the recognition of, an impairment loss is also applicable to impairment of an interest in a jointly controlled entity.

3. Paragraph 29 is proposed to be amended as follows:

29. In its consolidated financial statements, a venturer should report its interest in a jointly controlled entity using proportionate consolidation except

(a) an interest in a jointly controlled entity which is acquired and held exclusively with a view to its subsequent disposal in the near future[1]; and

(b) an interest in a jointly controlled entity which operates under severe long-term restrictions that significantly impair its ability to transfer funds to the venturer.

Interest in such a jointly controlled entity should be accounted for as an investment in accordance with Accounting Standard (AS) 1330, Accounting for Investments Financial Instruments: Recognition and Measurement.

4. Paragraph 40 is proposed to be amended as follows:

40. From the date of discontinuing the use of the proportionate consolidation, interest in a jointly controlled entity should be accounted for:

(a) in accordance with Accounting Standard (AS) 21, Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements, if the venturer acquires unilateral control over the entity and becomes parent within the meaning of that Standard; and

(b) in all other cases, as an investment in accordance with Accounting Standard (AS) 1330, Accounting for Investments Financial Instruments: Recognition and Measurement, or in accordance with Accounting Standard (AS) 23, Accounting for Investments in Associates in Consolidated Financial Statements, as appropriate. For this purpose, cost of the investment should be determined as under:

(i) the venturer's share in the net assets of the jointly controlled entity as at the date of discontinuance of proportionate consolidation should be ascertained, and

(ii) the amount of net assets so ascertained should be adjusted with the carrying amount of the relevant goodwill/capital reserve (see paragraph 37) as at the date of discontinuance of proportionate consolidation.

5. Paragraphs 46 and 47 are proposed to be amended as follows:

46. An investor in a joint venture, which does not have joint control, should report its interest in a joint venture in its consolidated financial statements in accordance with Accounting Standard (AS) 1330, Accounting for Investments Financial Instruments: Recognition and Measurement, Accounting Standard (AS) 21, Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements or Accounting Standard (AS) 23, Accounting for Investments in Associates in Consolidated Financial Statements, as appropriate.

47. In the separate financial statements of an investor, the interests in joint ventures should be accounted for in accordance with Accounting Standard (AS) 1330, Accounting for Investments Financial Instruments: Recognition and Measurement.

6. The name of AS 21, appearing in paragraphs 6 and 31 of the Standard, is proposed to be changed to reflect the proposed new name of AS 21, viz., the following:

AS 21, Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements

7. The name of AS 23, appearing in paragraph 5 of the Standard, is proposed to be changed to reflect the proposed new name of AS 23, viz., the following:

AS 23, Accounting for Investments in Associates

The limited revision comes into effect in respect of accounting periods commencing on or after _____ *(date to be decided later)*.

[1] See also Accounting Standards Interpretation (ASI) 8.

Exposure Draft

Proposed Limited Revision to Accounting Standard (AS) 28 (issued 2002)

Impairment of Assets

(Last date for comments: March 31, 2007)

The following is the text of the Exposure Draft of proposed limited revision to AS 28, Impairment of Assets, issued by the Accounting Standards Board of the Institute of Chartered Accountants of India, for comment. Comments on the proposed limited revisions may be sent to the Secretary, Accounting Standards Board, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002, so as to reach him not later than March 31, 2007. Comments can also be sent by e-mail at tdte@icai.org or at edcommentsasb@icai.org.

Accounting Standard (AS) 13, *Accounting for Investments*, which deals with accounting for investments including an investment in a subsidiary, associate or joint venture, also contains specific requirements for recognising impairment on such investments. On **the proposed Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,*** becoming mandatory, AS 13 would stand withdrawn except to the extent it relates to accounting for investment properties. Thus, accounting for an investment in a subsidiary, associate and joint venture would no longer be covered by AS 13. It is proposed that the same would be dealt with in AS 21, AS 23 and AS 27. Accordingly, with the issuance of the proposed AS 30, Limited Revisions are also being proposed to AS 21, AS 23 and AS 27. Insofar as impairment of an investment in a subsidiary, associate or joint venture in separate financial statements is concerned, it is proposed that on the lines of IAS 36, Impairment of Assets, the same would be covered under AS 28, Impairment of Assets. With a view to require the same, AS 28 (issued 2002) is proposed to be modified as under (proposed modifications are shown in red colour underline/strike-through):

Under the heading 'Scope', new paragraph 2A is proposed to be added as below:

2A. This Statement applies to financial assets classified as investments in:

(a) subsidiaries, as defined in AS 21, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements;*

(b) associates, as defined in AS 23, *Accounting for Investments in Associates*; and

(c) joint ventures, as defined in AS 27, *Financial Reporting of Interests in Joint Ventures.*

For impairment of other financial assets, refer to AS 30, *Financial Instruments: Recognition and Measurement*.

The limited revision comes into effect in respect of accounting periods commencing on or after _____ *(date to be decided later).*

Exposure Draft

Proposed Limited Revision to Accounting Standard (AS) 29 (issued 2003)

Provisions, Contingent Liabilities and Contingent Assets

(Last date for comments: March 31, 2007)

The following is the text of the Exposure Draft of proposed limited revision to AS 29, Provisions, Contingent Liabilities and Contingent Assets, issued by the Accounting Standards Board of the Institute of Chartered Accountants of India, for comment. Comments on the proposed limited revisions may be sent to the Secretary, Accounting Standards Board, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002, so as to reach him not later than March 31, 2007. Comments can also be sent by e-mail at tdte@icai.org or at edcommentsasb@icai.org.

In view of the proposed Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* AS 29 (issued 2003) is proposed to be modified as under (proposed modifications are shown in red colour underline/strike-through):

Paragraphs 1 and 2, given under the heading 'Scope', are proposed to be amended as below:

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

(a) ~~those resulting from financial instruments[1] that are carried at fair value~~ [Deleted];

(b) those resulting from executory contracts, except where the contract is onerous[2];

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

(d) those covered by another Accounting Standard.

2. This Statement does not apply ~~applies~~ to financial instruments (including guarantees) that are within the scope of Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement* ~~not carried at fair value~~.

The limited revision comes into effect in respect of accounting periods commencing on or after _____ *(date to be decided later).*

~~[1]For the purpose of this Statement, the term 'financial instruments' shall have the same meaning as in Accounting Standard (AS) 20, Earnings Per Share.~~

[2]The meaning of the term 'onerous contracts' and the application of the recognition and measurement principles of this Statement to such contracts are given in the Accounting Standards Interpretation (ASI) 30 on 'Applicability of AS 29 to Onerous Contracts'.

Re-Exposure Draft

Proposed Accounting Standard (AS) 31

Financial Instruments: Presentation

(Last Date for comments: March 31, 2007)

The Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India had issued an Exposure Draft of the proposed Accounting Standard on 'Financial Instruments: Presentation' in September 2005 for public comments. The Board had thereafter finalised the draft Accounting Standard on the subject, after considering the comments received on its Exposure Draft. However, considering the closed linkage of the draft Standard with the proposed Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement, which is being formulated, the issuance of the final Standard on 'Financial Instruments: Presentation' was kept in abeyance. Now, with the issuance of the Exposure Draft of proposed AS 30, Financial Instruments: Recognition and Measurement, the Board has decided to re-expose the draft of the proposed Accounting Standard 'Financial Instruments: Presentation', primarily so as to obtain the views on the changes made in the Exposure Draft of the said Standard and to ensure its consistency with the proposed AS 30.

The Re-Exposure Draft is in the track-changes mode vis-à-vis the Exposure Draft issued in September 2005. Additions in red colour underline whereas omissions are shown in red colour strike-through form.

Although the intention of the Accounting Standards Board is to obtain comments on the changes made in the Re-Exposure Draft vis-à-vis the Exposure Draft of the proposed Accounting Standard issued in September 2005, the comments can also be sent on any other aspect of the Re-Exposure Draft of the proposed Accounting Standard on Financial Instruments: Presentation, published hereinafter. 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 on the Re-Exposure Draft should be submitted in writing to the Secretary, Accounting 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 ***March 31, 2007****. Comments can also be sent by e-mail at tdte@icai.org or at edcommentsasb@icai.org.*

(This Re-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 Re-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) 31, *Financial Instruments: Presentation*, issued by the Council of the Institute of Chartered Accountants of India, would come into effect in respect of accounting periods commencing on or after ____ *(date to be decided later)*. This Standard would be mandatory in nature[2] from that date.

Where, in respect of an entity there is a statutory requirement for presenting any financial instrument in a particular manner as liability or equity and/ or for presenting interest, dividend, and loss relating to a financial instrument in a particular manner as income/ expense or as distribution or profits, the entity should present that instrument and/ or interest, dividend, and loss relating to the instrument in accordance with the requirements of the statute governing the entity. Untill the relevant statute is amended, the entity presenting that instrument and/ or interest, dividend, and loss relating to the instrument in accordance with the requirements thereof will be considered to be complying with this Accounting Standard, in view of paragraph 4.1 of the *Preface to the Statements of Accounting Standards* which recognises that where a requirement of an Accounting Standard is different from the applicable law, the law prevails[3].

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

Objective

1. The objective of this ~~Statement~~ Standard is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial 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.

[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] To illustrate, as per paragraph 34(a) of the Standard, a preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, is a financial liability. However, at present, Schedule VI to the Companies Act, 1956, *inter alia*, requires that all preference shares should be disclosed as a part of the 'Share Capital'. Until Schedule VI is amended, a company classifying the preference shares as share capital will be considered to be complying with this Accounting Standard even in a case where as per this Standard the preference shares are to be shown as a liability. In the latter case, as a corollary to this, dividend on such preference shares treated as a distribution to holders thereof and not as an expense will also be considered as a compliance with this Accounting Standard. Similarly, in case a of co-operative entity those requirements of paragraphs 39 to 46 and Appendix B to the Standard would not apply which are contrary to the law governing such an entity.

2. The principles in this ~~Statement~~ Standard complement the principles for recognising and measuring financial assets and financial liabilities in Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*[4], and for disclosing information about them in Accounting Standard (AS) 32, *Financial Instruments: Disclosures*[5].

Scope

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

(a) those interests in subsidiaries, associates and joint ventures that are accounted for in consolidated financial statements in accordance with AS 21, Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements, AS 23, Accounting for Investments in Associates, or AS 27, Financial Reporting of Interests in Joint Ventures. However, in some cases, AS 21, AS 23 or AS 27 requires an entity to account for an interest in a subsidiary, associate or joint venture in consolidated financial statements using Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement[6]; in those cases, entities should apply the disclosure requirements in AS 21, AS 23 or AS 27 in addition to those in this Standard. Entities should also apply this Standard to an investment in a subsidiary, associate and joint venture in their separate financial statements. Entities should also apply this Standard to all derivatives linked to interests in subsidiaries, associates or joint ventures.

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

(~~b~~c) contracts for contingent consideration in ~~an amalgamation~~ a business combination[7] ~~(see paragraph 41 of AS 14, Accounting for Amalgamations)~~. This exemption applies only to the acquirer.

(d) insurance contracts as defined in the Accounting Standard on Insurance Contracts[8]. However, this Standard applies to derivatives that are embedded in insurance contracts if Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement[9] requires the entity to account for them separately. Moreover, an issuer should apply this Standard to financial guarantee contracts if the issuer applies AS 30 in recognising and measuring the contracts, but should apply the Accounting Standard on Insurance Contracts if the issuer elects, in accordance with the Accounting Standard on Insurance Contracts, to apply that Standard in recognising and measuring them.

(e) financial instruments that are within the scope of the Accounting Standard on Insurance Contracts[10] because they contain a discretionary participation feature. The issuer of these instruments is exempt from applying to these features paragraphs 31-60 of this Standard regarding the distinction between financial liabilities and equity instruments. However, these instruments are subject to all other requirements of this Standard. Furthermore, this Standard applies to derivatives that are embedded in these instruments (see Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement[11]).

~~(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~~f) financial instruments, contracts and obligations under share-based payment transactions[12] except for contracts within the scope of paragraphs ~~6-8~~ 4-6 of this ~~Statement~~Standard, to which this ~~Statement~~Standard 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)[13].~~

[4] ~~A separate~~ Accounting Standard~~s~~ (AS) 30, ~~on~~ *Financial Instruments: Recognition and Measurement*, is being ~~formulated~~separately exposed for comments. It is proposed that this Standard and AS 30 would become applicable from the same date.

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

[6] It may be noted that AS 21, AS 23 and AS 27, at present, make reference to Accounting Standard (AS) 13, *Accounting for Investments*, with regard to the accounting for an investment in a subsidiary, associate and joint venture, respectively. On Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*, becoming mandatory, which is presently under preparation, AS 13 would stand withdrawn except to the extent it relates to accounting for investment properties. In other words, accounting for investments in a subsidiary, associate and joint venture would no longer be covered by AS 13. Keeping this in view, with the issuance of the proposed AS 30, Limited Revisions are being proposed to be made to AS 21, AS 23 and AS 27 to replace the references to AS 13 with those to AS 30. Pursuant to these proposed Limited Revisions, the titles of AS 21 and AS 23 are also proposed to be modified.

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

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

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

[9] See footnote 4.

[10] See footnote 8.

[11] See footnote 4.

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

~~[13] See footnote 3.~~

~~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, 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.[14]***~~

~~6~~4. This ~~Statement~~Standard should be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the ~~enterprise~~entity's expected purchase, sale or usage requirements.

~~7~~5. There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:

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

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

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

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

A contract to which (b) or (c) applies is not entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the ~~enterprise~~entity's expected purchase, sale or usage requirements, and, accordingly, is within the scope of this ~~Statement~~Standard. Other contracts to which paragraph ~~6~~4 applies are evaluated to determine whether they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the ~~enterprise~~entity's expected purchase, sale or usage requirement, and accordingly, whether they are within the scope of this ~~Statement~~Standard.

~~8~~6. A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, in accordance with paragraph ~~7~~5(a) or (d) is within the scope of this ~~Statement~~Standard. Such a contract cannot be entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the ~~enterprise~~entity's expected purchase, sale or usage requirements.

Definitions

~~9~~7. The following terms are used in this ~~Statement~~Standard with the meanings specified:

~~7.1~~ A financial instrument is any contract that gives rise to a financial asset of one ~~enterprise~~entity and a financial liability or equity instrument of another ~~enterprise~~entity.

~~7.2~~ A financial asset is any asset that is:

(a) cash;

(b) an equity instrument of another ~~enterprise~~entity;

(c) a contractual right:

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

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

~~7.3~~ A financial liability is any liability that is:

(a) a contractual obligation:

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

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

(b) a contract[15] that will or may be settled in the ~~enterprise~~entity's own equity instruments and is a non-derivative for which the ~~enterprise~~entity is or

~~[14] 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*.~~

[15] The recognition and measurement of such contracts ~~are expected to~~ would be dealt with in the proposed Accounting Standard (AS) 30, ~~on~~ *Financial Instruments: Recognition and Measurement*, which is ~~under preparation~~being separately exposed for comments.

may be obliged to deliver a variable number of the enterpriseentity's own equity instruments.

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

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

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.

8. The following terms are defined in paragraph 8 of Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*[16] and are used in this Standard with the meaning specified in AS 30.

- amortised cost of a financial asset or financial liability
- available-for-sale financial assets
- derecognition
- derivative
- effective interest method
- financial asset or financial liability at fair value through profit or loss
- financial guarantee contract
- firm commitment
- forecast transaction
- hedge effectiveness
- hedged item
- hedging instrument
- held-to-maturity investments
- loans and receivables
- regular way purchase or sale
- transaction costs.

~~10~~9. In this ~~Statement~~Standard, 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.

10. In this Standard, 'entity' includes individuals, partnerships, incorporated bodies, trusts and government agencies.

Financial Assets and Financial Liabilities

11. Currency (cash) is a financial asset because it represents the medium of exchange and is therefore the basis on which all transactions are measured and recognised in financial statements. A deposit of cash with a bank or similar financial institution is a financial asset because it represents the contractual right of the depositor to obtain cash from the institution or to draw a cheque or similar instrument against the balance in favour of a creditor in payment of a financial liability.

12. Common examples of financial assets representing a contractual right to receive cash in the future and corresponding financial liabilities representing a contractual obligation to deliver cash in the future are:

    (a) trade accounts receivable and payable;

    (b) bills receivable and payable;

    (c) loans receivable and payable;

    (d) bonds receivable and payable; and

    (e) deposits and advances.

In each case, one party's contractual right to receive (or obligation to pay) cash is matched by the other party's corresponding obligation to pay (or right to receive).

13. Another type of financial instrument is one for which the economic benefit to be received or given up is a financial asset other than cash. For example, a promissory note payable in government bonds gives the holder the contractual right to receive and the issuer the contractual obligation to deliver government bonds, not cash. The bonds are financial assets because they represent obligations of the issuing government to pay cash. The promissory note is, therefore, a financial asset of the promissory note holder and a financial liability of the promissory note issuer.

14. 'Perpetual' debt instruments normally provide the holder with the contractual right to receive payments on account of interest at fixed dates extending into the indefinite future, either with no right to receive a return of principal or a right to a return of principal under terms that make it very unlikely or very far in the future. For example, an ~~enterprise~~entity may issue a financial instrument requiring it to make annual payments in perpetuity equal to a stated interest rate of 8 per cent applied to a stated par or principal amount of Rs. 1,000. Assuming 8 per cent to be the market rate of interest

[16] See footnote 4.

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. Some of the contingents rights and obligations may be insurance contracts within the scope of the Accounting Standard on *Insurance Contracts*[17].

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~~property, plant and equipment), leased assets and intangible assets (such as patents and trademarks) are not financial assets. Control of such physical and intangible assets creates an opportunity to generate an inflow of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset.

19. Assets (such as prepaid expenses) for which the future economic benefit is the receipt of goods or services, rather than the right to receive cash or another financial asset, are not financial assets. Similarly, items such as deferred ~~income~~ revenue and most warranty obligations are not financial liabilities because the outflow of economic benefits associated with them is the delivery of goods and services rather than a contractual obligation to pay cash or another financial asset.

20. Liabilities or assets that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial liabilities or financial assets. Accounting for income taxes is dealt with in AS 22, *Accounting for Taxes on Income*.

Equity Instruments

21. Examples of equity instruments include 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~~entity in exchange for a fixed amount of cash or another financial asset. An obligation of an ~~enterprise~~entity 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~~entity. However, if such a contract contains an obligation for the entity to pay cash or another financial asset, it also gives rise to a liability for the present value of the redemption amount. 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~~entity 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~~Standard.

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[18] 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

[17] See footnote 8.

[18] 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).

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~~entities and interest-bearing instruments. An option may require the writer to issue a debt instrument, rather than transfer a financial asset, but the instrument underlying the option would constitute a financial asset of the holder if the option were exercised. The option-holder's right to exchange the financial asset under potentially favourable conditions and the writer's obligation to exchange the financial asset under potentially unfavourable conditions are distinct from the underlying financial asset to be exchanged upon exercise of the option. The nature of the holder's right and of the writer's obligation are not affected by the likelihood that the option will be exercised.

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[19] , 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 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~~Standard as if they were financial instruments (see paragraph ~~6~~4).

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

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

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. When an issuer applies the definitions in paragraph 7 to determine whether a financial instrument is an equity instrument rather than a financial liability, the ~~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~~entity; or

        (ii) to exchange financial assets or financial liabilities with another ~~enterprise~~entity under conditions that are potentially unfavourable to the issuer.

    (b) If the instrument will or may be settled in the issuer's own equity instruments, it is 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~~entity's balance sheet. Substance and legal form are commonly consistent, but not always. Some financial instruments take the legal form of equity but are liabilities in substance and others may combine features associated with equity instruments and features associated with financial liabilities. For example:

    (a) a preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, is a financial liability[20].

    (b) a financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability. This is so even when the amount of cash or other financial assets is determined on the basis of an index or other item that has the potential to increase or decrease, or when the legal form of the puttable instrument gives the holder a right to a residual interest in the assets of an issuer. The existence of an option for the holder to put the instrument back to the issuer for cash or another financial asset means that the puttable instrument meets the definition of a financial liability. For example, open-ended mutual funds, unit trusts and some co-operative entities may provide their unitholders or members with a right to redeem their interests in the issuer at any time for cash equal to their proportionate share of the asset value of the issuer. However, classification as a financial liability does not preclude the use of descriptors such as 'net asset value attributable to unitholders' and 'change in net asset value attributable to unitholders' on the face of the financial statements of an ~~enterprise~~entity that has no equity capital (such as some mutual funds and unit trusts, see Illustrative Example 1 of Appendix A) or the use of additional disclosure to show that total members' interests comprise items such as reserves that meet the definition of equity and puttable instruments that do not (see Illustrative Example 2 of Appendix A).

35. If an ~~enterprise~~entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability. For example:

    (a) a restriction on the ability of an ~~enterprise~~entity to satisfy a contractual obligation, such as lack of access to foreign currency or the need to obtain approval for

~~[20] 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.~~

payment from a regulatory authority, does not negate the ~~enterprise~~entity's contractual obligation or the holder's contractual right under the instrument.

(b) a contractual obligation that is conditional on a counterparty exercising its right to redeem is a financial liability because the ~~enterprise~~entity 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~~entity fails to make distributions or to redeem the instrument. If the ~~enterprise~~entity can avoid a transfer of cash or another financial asset only by settling the non-financial obligation, the financial instrument is a financial liability.

(b) a financial instrument is a financial liability if it provides that on settlement the ~~enterprise~~entity will deliver either:

(i) cash or another financial asset; or

(ii) its own shares whose value is determined to exceed substantially the value of the cash or other financial asset.

Although the ~~enterprise~~entity does not have an explicit contractual obligation to deliver cash or another financial asset, the value of the share settlement alternative is such that the ~~enterprise~~entity will settle in cash. In any event, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option (see paragraph ~~39~~47).

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.

39. The contractual right of the holder of a financial instrument (including members' shares in co-operative entities) to request redemption does not, in itself, require that financial instrument to be classified as a financial liability. Rather, the entity must consider all of the terms and conditions of the financial instrument in determining its classification as a financial liability or equity. Those terms and conditions include relevant laws, regulations and the governing rules or bye-laws of the entity in effect at the date of classification, but not expected future amendments to those laws, regulations or bye-laws.

40. Members' shares in co-operative entities that would be classified as equity if the members did not have a right to request redemption are equity if either of the conditions described in paragraphs 41 and 42 is present. Demand deposits, including current accounts, deposit accounts and similar contracts that arise when members act as customers are financial liabilities of the entity.

41. Members' shares are equity if the entity has an unconditional right to refuse redemption of the members' shares.

42. Law, regulation or the governing rules or bye-laws of the entity can impose various types of prohibitions on the redemption of members' shares, e.g., unconditional prohibitions or prohibitions based on liquidity criteria. If redemption is unconditionally prohibited by law, regulation or the governing rules or bye-laws of the entity, members' shares are equity. However, provisions in law, regulation or the governing rules or bye-laws of the entity that prohibit redemption only if conditions— such as liquidity constraints—are met (or are not met) do not result in members' shares being equity.

43. An unconditional prohibition may be absolute, in that all redemptions are prohibited. An unconditional prohibition may be partial, in that it prohibits redemption of members' shares if redemption would cause the number of members' shares or amount of paid-up capital from members' shares to fall below a specified level. Members' shares in excess of the prohibition against redemption are liabilities, unless

the entity has the unconditional right to refuse redemption as described in paragraph 41. In some cases, the number of shares or the amount of paid-up capital subject to a redemption prohibition may change from time to time. Such a change in the redemption prohibition leads to a transfer between financial liabilities and equity. In such a case, the entity should disclose separately the amount, timing and reason for the transfer.

44. Equity is the residual interest in the assets after deducting all liabilities. Therefore, at initial recognition, the entity should measure the equity component in the member's shares at the residual amount after deducting from the total amount of the shares as a whole the value separately determined for its financial liabilities for redemption. The entity measures its financial liability for redemption at fair value. In the case of members' shares with a redemption feature, the fair value of the financial liability for redemption is measured at no less than the maximum amount payable under the redemption provisions of its governing bye-laws or applicable law discounted from the first date that the amount could be required to be paid (see illustration 3 of Appendix B).

45. As required by paragraph 64, distributions to holders of equity instruments (net of any income tax benefits) are recognised directly in the revenue reserves and surplus. Interest, dividends and other returns relating to financial instruments classified as financial liabilities are expenses, regardless of whether those amounts paid are legally characterised as dividends, interest or otherwise.

46. Appendix B, which is an integral part of the Standard, illustrates the application of paragraphs 39 to 45.

Settlement in the ~~Enterprise~~Entity's Own Equity Instruments (paragraph 32(b))

~~39~~47. A contract is not an equity instrument solely because it will result in the delivery of the ~~enterprise~~entity's own equity instruments. An ~~enterprise~~entity 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~~entity'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~~entity's own equity instruments (e.g. an interest rate, a commodity price or a financial instrument price). Two examples are (a) a contract to deliver as many of the ~~enterprise~~entity's own equity instruments as are equal in value to Rs.100, and (b) a contract to deliver as many of the ~~enterprise~~entity's own equity instruments as are equal in value to the value of 100 grams of gold. Such a contract is a financial liability of the ~~enterprise~~entity even though the ~~enterprise~~entity must or can settle it by delivering its own equity instruments. It is not an equity instrument because the ~~enterprise~~entity uses a variable number of its own equity instruments as a means to settle the contract. Accordingly, the contract does not evidence a residual interest in the ~~enterprise~~entity's assets after deducting all of its liabilities.

Contingent Settlement Provisions

~~40~~48. A financial instrument may require the ~~enterprise~~entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, or the issuer's future revenues, net income or debt-to-equity ratio). The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer unless:

(a) the part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not genuine; or

(b) the issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer.

~~41~~49. Paragraph ~~40~~ 48 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~~entity's own shares only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur is an equity instrument. Similarly, settlement in a fixed number of an ~~enterprise~~entity's own shares may be contractually precluded in circumstances that are outside the control of the ~~enterprise~~entity, but if these circumstances have no genuine possibility of occurring, classification as an equity instrument is appropriate.

Treatment in Consolidated Financial Statements

~~42~~50. In consolidated financial statements, an ~~enterprise~~entity presents minority interests - i.e. the interests of other parties in the equity and income of its subsidiaries in accordance with AS 1 (revised 2006)[21] , *Presentation of Financial Statements*, and AS 21, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements*[22]. When classifying a financial instrument (or a component of it) in consolidated financial statements, an ~~enterprise~~entity considers all terms and conditions agreed between members of the group and the holders of the instrument in determining whether the group as a whole has an obligation to deliver cash or another financial asset in respect of the instrument or to settle it in a manner that results in liability classification. When a subsidiary in a group issues a financial instrument and a parent or other group ~~enterprise~~entity agrees additional terms directly with the holders of the instrument (e.g. a guarantee), the group may not have discretion over distributions or redemption. Although the subsidiary may appropriately classify the instrument without regard to these additional terms in its

[21] AS 1 is presently under revision.

[22] It may be noted that a limited revision has been proposed to AS 21 with the issuance of the proposed Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*. Pursuant to the proposed limited revision, the title of AS 21 is also proposed to be modified.

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 of Appendix A)

~~43~~51. 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~~52. Paragraph ~~43~~ 51 applies only to issuers of non-derivative compound financial instruments. Paragraph ~~43~~ 51 does not deal with compound financial instruments from the perspective of holders. Accounting Standard (AS) 30, ~~on~~ *Financial Instruments: Recognition and Measurement*[23], deals with the separation of embedded derivatives from the perspective of holders of compound financial instruments that contain debt and equity features.

~~45~~53. An ~~enterprise~~entity recognises separately the components of a financial instrument that (a) creates a financial liability of the ~~enterprise~~entity and (b) grants an option to the holder of the instrument to convert it into an equity instrument of the ~~enterprise~~entity. For example, a debenture or similar instrument convertible by the holder into a fixed number of equity shares of the ~~enterprise~~entity is a compound financial instrument. From the perspective of the ~~enterprise~~entity, such an instrument comprises two components: a financial liability (a contractual arrangement to deliver cash or another financial asset) and an equity instrument (a call option granting the holder the right, for a specified period of time, to convert it into a fixed number of equity shares of the ~~enterprise~~entity). The economic effect of issuing such an instrument is substantially the same as issuing simultaneously a debt instrument with an early settlement provision and warrants to purchase equity shares, or issuing a debt instrument with detachable share purchase warrants. Accordingly, in all cases, the ~~enterprise~~entity presents the liability and equity components separately on its balance sheet.

~~46~~54. 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~~entity's contractual obligation to make future payments remains outstanding until it is extinguished through conversion, maturity of the instrument or some other transaction.

~~47~~55. Accounting Standard (AS) 30, ~~on~~ *Financial Instruments: Recognition and Measurement*[24], 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~~entity after deducting all of its liabilities. Therefore, when the initial carrying amount of a compound financial instrument is allocated to its equity and liability components, the equity component is assigned the residual amount after deducting from the 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~~56. A common form of compound financial instrument is a debt instrument with an embedded conversion option, such as a debenture convertible into equity shares of the issuer, and without any other embedded derivative features. Paragraph ~~43~~ 51 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~~57. On conversion of a convertible instrument at maturity, the ~~enterprise~~entity derecognises the liability component and recognises it as equity. The original equity component remains as equity (although it may be transferred from one line item within equity to another). There is no gain or loss on conversion at maturity.

~~50~~58. When an ~~enterprise~~entity extinguishes a convertible instrument before maturity through an early redemption or repurchase in which the original conversion privileges are unchanged, the ~~enterprise~~entity allocates the consideration paid and any transaction costs for the repurchase or redemption to the liability and equity components of the instrument at the date of the transaction. The method used in allocating the consideration paid and transaction costs to the separate components is consistent with

[23] See footnote 4.

[24] See footnote 4.

that used in the original allocation to the separate components of the proceeds received by the ~~enterprise~~entity when the convertible instrument was issued, in accordance with paragraphs ~~43~~51-~~48~~56.

~~51~~59. Once the allocation of the consideration is made, any resulting gain or loss is treated in accordance with accounting principles applicable to the related component, as follows:

(a) the amount of gain or loss relating to the liability component is recognised in the statement of profit and loss; and

(b) the amount of consideration relating to the equity component is adjusted in equity against the original equity component and the balance, if any, against the reserves and surplus.

~~52~~60. An ~~enterprise~~entity may amend the terms of a convertible instrument to induce early conversion, for example by offering a more favourable conversion ratio or paying other additional consideration in the event of conversion before a specified date. The difference, at the date the terms are amended, between the fair value of the consideration the holder receives on conversion of the instrument under the revised terms and the fair value of the consideration the holder would have received under the original terms is recognised as a loss in the statement of profit and loss.

Buy-back of Shares

~~53~~61. If an ~~enterprise~~entity 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~~entity's own shares. Difference between the consideration paid and the nominal value of shares should be recognised directly in reserves and surplus.

~~54~~62. An ~~enterprise~~entity provides disclosure in accordance with AS 18, *Related Party Disclosures*, if the ~~enterprise~~entity buy-backs its own shares from related parties.

~~55~~63. Paragraph ~~53~~61 requires an ~~enterprise~~entity that reacquires its own shares to deduct their nominal value from share capital. However, when an ~~enterprise~~entity 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~~entity's balance sheet.

Interest, Dividends, Losses and Gains

~~56~~64. Interest, dividends, 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~~entity directly in the revenue reserves and surplus~~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 revenue reserves and surplus~~the statement of profit and loss after determination of net profit after tax for the current year.~~

~~57~~65. The classification of a financial instrument as a financial liability or an equity instrument determines whether interest, dividends, losses and gains relating to that instrument are recognised as expense or income in the statement of profit and loss or are recognised directly in the revenue reserves and surplus~~after the determination of the net profit after tax for the current year.~~ Thus, dividend payments on shares wholly recognised as liabilities are recognised as expenses in the same way as interest on a bond/debenture. Similarly, gains and losses associated with redemptions or refinancings of financial liabilities are recognised in the statement of profit and loss. Changes in the fair value of an equity instrument are not recognised in the financial statements.

~~58~~66. An ~~enterprise~~entity 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 revenue reserves and surplus ~~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~~67. 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~~68. The amount of transaction costs recognised in the revenue reserves and surplus ~~statement of profit and loss after determination of net profit after tax for the current year~~ is disclosed separately under AS 1 (revised 2006)[25] .

~~61~~69. The following example illustrates the application of paragraph ~~56~~64 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~~entity 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 directly in the ~~statement of profit and loss after determination of net profit after tax for the current year~~revenue reserves and surplus. A similar treatment would apply if the redemption was not mandatory but at the option of the holder, or if the share was mandatorily convertible into a variable number of ~~ordinary~~ equity shares calculated to equal a fixed amount or an amount based on changes in an underlying variable (e.g., commodity). However, if any unpaid dividends are added to the redemption amount, the entire instrument is a liability. In such a case, any dividends are classified as interest expense.

~~62~~70. Dividends classified as an expense are presented in the statement of profit and loss as a separate item. In addition to the requirements of this Standard, disclosure of interest and dividends is subject to the requirements of AS 1 (revised 2006)[26] and Accounting Standard (AS) 32, *Financial Instruments: Disclosures*[27].

71. Gains and losses related to changes in the carrying amount of a financial liability are recognised as income or expense

[25] See footnote 21.

[26] See footnote 21.

[27] See footnote 5.

in the statement of profit and loss even when they relate to an instrument that includes a right to the residual interest in the assets of the entity in exchange for cash or another financial asset (see paragraph 33(b)). Under AS 1 (revised 2006)[28], the entity presents any gain or loss arising from remeasurement of such an instrument separately on the face of the statement of profit and loss when it is relevant in explaining the entity's performance.

Offsetting a Financial Asset and a Financial Liability

~~63~~72. 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~~entity:

(a) currently has a legally enforceable right to set off the recognised amounts; and

(b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

In accounting for a transfer of a financial asset that does not qualify for derecognition, the ~~enterprise~~entity should not offset the transferred asset and the associated liability (see Accounting Standard (AS) 30, ~~on~~ Financial Instruments: Recognition and Measurement[29]).

~~64~~73. This ~~Statement~~Standard requires the presentation of financial assets and financial liabilities on a net basis when doing so reflects an ~~enterprise~~entity's expected future cash flows from settling two or more separate financial instruments. When an ~~enterprise~~entity has the right to receive or pay a single net amount and intends to do so, it has, in effect, only a single financial asset or financial liability. In other circumstances, financial assets and financial liabilities are presented separately from each other consistently with their characteristics as resources or obligations of the ~~enterprise~~entity.

~~65~~74. 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~~75. 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~~76. 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~~entity's exposure to credit and liquidity risk. However, the existence of the right, by itself, is not a sufficient basis for offsetting. In the absence of an intention to exercise the right or to settle simultaneously, the amount and timing of an ~~enterprise~~entity's future cash flows are not affected. When an ~~enterprise~~entity intends to exercise the right or to settle simultaneously, presentation of the asset and liability on a net basis reflects more appropriately the amounts and timing of the expected future cash flows, as well as the risks to which those cash flows are exposed. An intention by one or both parties to settle on a net basis without the legal right to do so is not sufficient to justify offsetting because the rights and obligations associated with the individual financial asset and financial liability remain unaltered.

~~68~~77. An ~~enterprise~~entity's intentions with respect to settlement of particular assets and liabilities may be influenced by its normal business practices, the requirements of the financial markets and other circumstances that may limit the ability to settle net or to settle simultaneously. When an ~~enterprise~~entity has a right of set-off, but does not intend to settle net or to realise the asset and settle the liability simultaneously, the effect of the right on the ~~enterprise~~entity's credit risk exposure is disclosed in accordance with Accounting Standard (AS) 32, ~~on~~ *Financial Instruments: Disclosures*[30].

~~69~~78. 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~~entity may settle two instruments by receiving and paying separate amounts, becoming exposed to credit risk for the full amount of the asset or liquidity risk for the full amount of the liability. Such risk exposures may be significant even though relatively brief. Accordingly, realisation of a financial asset and settlement of a financial liability are treated as simultaneous only when the transactions occur at the same moment.

~~70~~79. The conditions set out in paragraph ~~63~~72 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~~80. An ~~enterprise~~entity that undertakes a number of financial instrument transactions with a single counterparty may enter into a 'master netting arrangement' with that counterparty. Such an agreement provides for a single net settlement of all financial instruments covered by the agreement in the event of

[28] See footnote 21.

[29] See footnote 4.

[30] See footnote 5.

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~~72 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~~entity's exposure to credit risk is disclosed in accordance with Accounting Standard (AS) 32, ~~on~~ *Financial Instruments: Disclosures*[31].

~~72~~81. The ~~Statement~~Standard does not provide special treatment for so-called 'synthetic instruments', which are groups of separate financial instruments acquired and held to emulate the characteristics of another instrument. For example, a floating rate long-term debt combined with an interest rate swap that involves receiving floating payments and making fixed payments synthesises a fixed rate long-term debt. Each of the individual financial instruments that together constitute a 'synthetic instrument' represents a contractual right or obligation with its own terms and conditions and each may be transferred or settled separately. Each financial instrument is exposed to risks that may differ from the risks to which other financial instruments are exposed. Accordingly, when one financial instrument in a 'synthetic instrument' is an asset and another is a liability, they are not offset and presented on an ~~enterprise~~entity's balance sheet on a net basis unless they meet the criteria for offsetting in paragraph ~~63~~72.

Appendix A

Illustrative Examples

These examples accompany, but are not part of the Re-Exposure Draft of the proposed Accounting Standard (AS) 31, ~~on~~ *Financial Instruments: Presentation*.

~~Enterprises~~ Entities such as Mutual Funds and Co-operatives whose Share Capital is not Equity as ~~Defined~~ defined in the Re-Exposure Draft of the proposed AS 31~~Accounting Standard on Financial Instruments: Presentation~~

Example 1: ~~Enterprises~~ Entities with no equity

~~IE1~~A1. The following example illustrates a statement of profit and loss and balance sheet format that may be used by ~~enterprises~~ entities such as mutual funds that do not have equity as defined in the Re-Exposure Draft of the proposed AS 31 ~~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			80,051~~1~~

Example 2: ~~Enterprises~~ Entities with some equity

~~IE2~~A2. The following example illustrates a statement of profit and loss and balance sheet format that may be used by ~~enterprises~~ entities whose share capital is not equity as defined in the Re-Exposure Draft of the proposed AS 31~~Accounting Standard on Financial Instruments: Presentation~~, because the ~~enterprise~~entity has an obligation to repay the share capital on demand. Other formats are possible.

Statement of profit and loss for the year ended 31 March 20x6				
		20x5-20x6		**2 0 x 4 - 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

[31] See footnote 5.

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[32]					
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~~A3. Paragraph ~~43~~–51 describes how the components of a compound financial instrument are separated by the ~~enterprise~~entity on initial recognition. The following example illustrates how such a separation is made.

~~IE4~~A4. An ~~enterprise~~entity issues 2,000 convertible debentures at the start of year 1. The debentures have a three-year term, and are issued at par with a face value of 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~~A5. The liability component is measured first, and the difference between the proceeds of the debenture issue and the fair value of the liability is assigned to the equity component. The present value of the liability component is calculated using a discount rate of 9 per cent, the market interest rate for similar debentures having no conversion rights, as shown below.

	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~~A6. The following example illustrates the application of paragraph ~~47~~ 55 to the separation of the liability and equity components of a compound financial instrument with multiple embedded derivative features.

~~IE7~~A7. 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~~entity 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~~ 46 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~~A8. The following example illustrates how an ~~enterprise~~entity accounts for a repurchase of a convertible instrument. For simplicity, at inception, the face amount of the instrument is assumed to be equal to the aggregate carrying amount of its liability and equity components in the financial statements, i.e. no original issue premium or discount exists. Also, for simplicity, tax considerations have been omitted from the example.

~~IE9~~A9. On 1 January 1999, ~~Enterprise~~Entity 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~~Entity A at a conversion price of Rs.25 per share. Interest is payable half-yearly in cash. At the date of issue, ~~Enterprise~~Entity A could have issued non-convertible debt with a ten-year term bearing a coupon interest rate of 11 per cent.

~~IE10~~A10. In the financial statements of ~~Enterprise~~Entity A the carrying amount of the debenture was allocated on issue as follows:

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

	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~~A11. On 1 January 2004, the convertible debenture has a fair value of Rs. 1,700.

~~IE12~~A12. ~~Enterprise~~Entity 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~~Entity A could have issued non-convertible debt with a five-year term bearing a coupon interest rate of 8 per cent.

~~IE13~~A13. The repurchase price is allocated as follows:

	Carrying Value	Fair Value	Difference
Liability component:	Rs.	Rs.	Rs.
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 [33]	(559)
Total	1,022	1,700	(678)

~~IE14~~A14. ~~Enterprise~~Entity 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~~A15. The following example illustrates how an ~~enterprise~~entity accounts for the additional consideration paid when the terms of a convertible instrument are amended to induce early conversion.

~~IE16~~A16. On 1 January 2005, ~~Enterprise~~Entity 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~~Entity A reduces the conversion price to Rs.20 if the debenture is converted before 1 March 2006 (i.e. within 60 days).

~~IE17~~A17. Assume the market price of ~~Enterprise~~Entity 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~~Entity 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~~A18. The incremental consideration of Rs. 400 is recognised as a loss in the statement of profit and loss.

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

Appendix B

Examples of Application of Paragraphs 39-45

This appendix is an integral part of AS 31.

B1. This appendix sets out seven examples of the application of paragraphs 39-45. The examples do not constitute an exhaustive list; other fact patterns are possible. Each example assumes that there are no conditions other than those set out in the facts of the example that would require the financial instrument to be classified as a financial liability.

Unconditional Right to Refuse Redemption (Paragraph 41)

Example 1

Facts

B2. The governing bye-laws of the entity state that redemptions are made at the sole discretion of the entity. The bye-laws do not provide further elaboration or limitation on that discretion. In its history, the entity has never refused to redeem members' shares, although the governing board of the entity has the right to do so.

Classification

B3. The entity has the unconditional right to refuse redemption and the members' shares are equity. The Standard establishes principles for classification that are based on the terms of the financial instrument and notes that a history of, or intention to make, discretionary payments does not trigger liability classification. Paragraph 38 of the Standard states:

"When preference shares are non-redeemable, the appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument. When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments. The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:

(a) a history of making distributions;

(b) an intention to make distributions in the future;

(c) a possible negative impact on the price of equity shares of the issuer if distributions are not made (because of restrictions on paying dividends on the equity shares if dividends are not paid on the preference shares);

(d) the amount of the issuer's reserves;

(e) an issuer's expectation of a profit or loss for a period; or

(f) an ability or inability of the issuer to influence the amount of its profit or loss for the period."

Example 2

Facts

B4. The governing bye-laws of the entity state that redemptions are made at the sole discretion of the entity. However, the bye-laws further state that approval of a redemption request is automatic unless the entity is unable to make payments without violating regulations regarding liquidity or reserves.

Classification

B5. The entity does not have the unconditional right to refuse redemption and the members' shares are a financial liability. The restrictions described above are based on the entity's ability to settle its liability. They restrict redemptions only if the liquidity or reserve requirements are not met and then only until such time as they are met. Hence, they do not, under the principles established in the Standard, result in the classification of the financial instrument as equity. Paragraph 37 of the Standard states:

"Preference shares may be issued with various rights. In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability. For example, a preference share that provides for redemption on a specific date or at the option of the holder is a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share. *The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves, does not negate the obligation.* [Emphasis added]"

Prohibitions Against Redemption (Paragraphs 42 and 43)

Example 3

Facts

B6. A co-operative entity has issued shares to its members at different dates and for different amounts in the past as follows:

(a) 1 January 20X1: 100,000 shares at Rs. 10 each (Rs. 1,000,000);

(b) 1 January 20X2: 100,000 shares at Rs. 20 each (a further Rs. 2,000,000, so that the total for shares issued is Rs. 3,000,000).

Shares are redeemable on demand at the amount for which they were issued.

B7. The governing bye-laws of the entity state that cumulative redemptions cannot exceed 20 per cent of the highest number of its members' shares ever outstanding. At 31 December 20X2, the entity has 200,000 of outstanding shares, which is the highest number of members' shares ever outstanding and no shares have been redeemed in the past. On 1 January 20X3, the entity amends its governing bye-laws and increases the permitted level of cumulative redemptions to 25 per cent of the highest number of its members' shares ever outstanding.

Classification

Before the governing bye-laws are amended

B8. Members' shares in excess of the prohibition against redemption are financial liabilities. The co-operative entity measures this financial liability at fair value at initial recognition. Because these shares are redeemable on demand, the co-operative entity determines the fair value of such financial liabilities as required by paragraph 55 of AS 30, which states: 'The fair value of a financial liability with a demand feature (*e.g.*, a demand deposit) is not less than the amount payable on demand…'. Accordingly, the co-operative entity classifies as financial liabilities the maximum amount payable on demand under the redemption provisions.

B9. On 1 January 20X1, the maximum amount payable under the redemption provisions is 20,000 shares at Rs. 10 each and, accordingly, the entity classifies Rs. 200,000 as financial liability and Rs. 800,000 as equity. However, on 1 January 20X2, because of the new issue of shares at Rs. 20, the maximum amount payable under the redemption provisions increases to 40,000 shares at Rs. 20 each. The issue of additional shares at Rs. 20 creates a new liability that is measured on initial recognition at fair value. The liability after these shares have been issued is 20 per cent of the total shares in issue (200,000), measured at Rs. 20, or Rs. 800,000. This requires recognition of an additional liability of Rs. 600,000. In this example no gain or loss is recognised. Accordingly, the entity now classifies Rs. 800,000 as financial liabilities and Rs. 2,200,000 as equity. This example assumes these amounts are not changed between 1 January 20X1 and 31 December 20X2.

After the governing bye-laws are amended

B10. Following the change in its governing bye-laws, the co-operative entity can now be required to redeem a maximum of 25 per cent of its outstanding shares or a maximum of 50,000 shares at Rs. 20 each. Accordingly, on 1 January 20X3, the co-operative entity classifies as financial liabilities an amount of Rs. 1,000,000 being the maximum amount payable on demand under the redemption provisions, as determined in accordance with paragraph 55 of AS 30. It, therefore, transfers on 1 January 20X3 from equity to financial liabilities an amount of Rs. 200,000, leaving Rs. 2,000,000 classified as equity. In this example, the entity does not recognise a gain or loss on the transfer.

Example 4

Facts

B11. Law governing the operations of co-operatives, or the terms of the governing bye-laws of the entity, prohibit an entity from redeeming members' shares if, by redeeming them, it would reduce paid-in capital from members' shares below 75 per cent of the highest amount of paid-in capital from members' shares. The highest amount for a particular co-operative is Rs. 1,000,000. At the balance sheet date, the balance of paid-in capital is Rs. 900,000.

Classification

B12. In this case, Rs. 750,000 would be classified as equity and Rs. 150,000 would be classified as financial liabilities. In addition to the paragraphs already cited, paragraph 34(b) of the Standard states in part:

"…a financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability. This is so even when the amount of cash or other financial assets is determined on the basis of an index or other item that has the potential to increase or decrease, or when the legal form of the puttable instrument gives the holder a right to a residual interest in the assets of an issuer. The existence of an option for the holder to put the instrument back to the issuer for cash or another financial asset means that the puttable instrument meets the definition of a financial liability. …"

B13. The redemption prohibition described in this example is different from the restrictions described in paragraphs 35 and 37 of the Standard. Those restrictions are limitations on the ability of the entity to pay the amount due on a financial liability, *i.e.*, they prevent payment of the liability only if specified conditions are met. In contrast, this example describes an unconditional prohibition on redemptions beyond a specified amount, regardless of the entity's ability to redeem members' shares (*e.g.*, given its cash resources, profits or distributable reserves). In effect, the prohibition against redemption prevents the entity from incurring any financial liability to redeem more than a specified amount of paid-up capital. Therefore, the portion of shares subject to the redemption prohibition is not a financial liability. While each member's shares may be redeemable individually, a portion of the total shares outstanding is not redeemable in any circumstances other than liquidation of the entity.

Example 5

Facts

B14. The facts of this example are as stated in example 4. In addition, at the balance sheet date, liquidity requirements imposed in the jurisdiction prevent the entity from redeeming any members' shares unless its holdings of cash and short-term investments are greater than a specified amount. The effect of these liquidity requirements at the balance sheet date is that the entity cannot pay more than Rs. 50,000 to redeem the members' shares.

Classification

B15. As in example 4, the entity classifies Rs. 750,000 as equity and Rs. 150,000 as a financial liability. This is because the amount classified as a liability is based on the entity's unconditional right to refuse redemption and not on conditional restrictions that prevent redemption only if liquidity or other conditions are not met and then only until such time as they are met. The provisions of paragraphs 35 and 37 of the Standard apply in this case.

Example 6

Facts

B16. The governing bye-laws of the entity prohibit it from redeeming members' shares, except to the extent of proceeds received from the issue of additional members' shares to new or existing members during the preceding three years. Proceeds from issuing members' shares must be applied to redeem shares for which members have requested redemption. During the three preceding years, the proceeds from issuing members' shares have been Rs. 12,000 and no member's shares have been redeemed.

Classification

B17. The entity classifies Rs. 12,000 of the members' shares as financial liabilities. Consistently with the conclusions described in example 4, members' shares subject to an unconditional prohibition against redemption are not financial liabilities. Such an unconditional prohibition applies to an amount equal to the proceeds of shares issued before the preceding three years, and accordingly, this amount is classified as equity. However, an amount equal to the proceeds from any shares issued in the preceding three years is not subject to an unconditional prohibition on redemption. Accordingly, proceeds from the issue of members' shares in the preceding three years give rise to financial liabilities until they are no longer available for redemption of members' shares. As a result the entity has a financial liability equal to the proceeds of shares issued during the three preceding years, net of any redemptions during that period.

Example 7

Facts

B18. The bye-laws governing the operations of a co-operative entity state that atleast 50 per cent of the entity's total 'outstanding liabilities' (a term defined in the byelaws to include members' share accounts) has to be in the form of members' paid-up capital. The effect of the bye-laws is that if all of a co-operative's outstanding liabilities are in the form of members' shares, it is able to redeem them all. On 31 December 20X1, the entity has total outstanding liabilities of Rs. 200,000, of which Rs. 125,000 represent members' share accounts. The terms of the members' share accounts permit the holder to redeem them on demand and there are no limitations on redemption in the governing byelaws of the entity.

Classification

B19. In this example, members' shares are classified as financial liabilities. The redemption prohibition is similar to the restrictions described in paragraphs 35 and 37 of the Standard. The restriction is a conditional limitation on the ability of the entity to pay the amount due on a financial liability, *i.e.*, they prevent payment of the liability only if specified conditions are met. More specifically, the entity could be required to redeem the entire amount of members' shares (Rs. 125,000) if it repaid all of its other liabilities (Rs. 75,000). Consequently, the prohibition against redemption does not prevent the entity from incurring a financial liability to redeem more than a specified number of members' shares or amount of paid-in capital. It allows the entity only to defer redemption until a condition is met, i.e., the repayment of other liabilities. Members' shares in this example are not subject to an unconditional prohibition against redemption and are therefore classified as financial liabilities.

Appendix ~~B~~C

Comparison with IAS 32, Financial Instruments: Presentation

Note: This Appendix is not a part of the Re-Exposure Draft of the proposed Accounting Standard (AS) 31, Financial Instruments: Presentation. The purpose of this appendix is only to bring out the major differences between the Re-Exposure Draft of proposed AS 31 and corresponding International Accounting Standard (IAS) 32 (as amended upto August 2005).

Comparison with IAS 32, Financial Instruments: Presentation

The Re-Exposure Draft of the proposed Accounting Standard is based on International Accounting Standard (IAS) 32, Financial Instruments: Presentation and incorporates IFRIC Interpretation 2, Members' Shares in Co-operative Entities and Similar Instruments (Re. IAS 32, Financial Instruments: Presentation), issued by the International Financial Reporting Interpretation Committee (IFRIC) of the International Accounting Standards Board (IASB). The Re-Exposure Draft differs from IAS 32, Financial Instruments: Presentation, in the following major respects:

As compared to IAS 32, the Re-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~~entity's own equity instruments and buy back of shares by the ~~enterprise~~entity itself for issuance to employees under Employee Share Option Plans.