13. Accounting Standards (AS 1 to AS 32)

Contents

Volume I

Volume II

ANNOUNCEMENTS OF THE COUNCIL REGARDING STATUS OF VARIOUS DOCUMENTS ISSUED BY THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

Contents

ANNOUNCEMENTS OF THE COUNCIL REGARDING STATUS OF VARIOUS DOCUMENTS ISSUED BY THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

I. Clarification regarding Authority Attached to Documents Issued by the Institute[1]

1. The Institute has, from time to time, issued ‘Guidance Notes’ and ‘Statements’ on a number of matters. With the formation of the Accounting Standards Board and the Auditing Practices Committee[2], ‘Accounting Standards’ and ‘Statements on Standard Auditing Practices’[3] are also being issued.

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[1] Published in the December, 1985 issue of the ‘The Chartered Accountant’.

[2] The Auditing Practices Committee of the Institute of Chartered Accountants of India was established in 1982 with, *inter alia*, the objectives of preparing the Statements on Standard Auditing Practices (SAPs), Guidance Notes on matters related to auditing, etc. At its 226th meeting held on July 2, 2002 at New Delhi, the Council of the Institute of Chartered Accountants of India approved the recommendations of the Auditing Practices Committee to strengthen the role being played by it in the growth and development of the profession of chartered accountancy in India. The Council also approved renaming of the Committee as, “Auditing and Assurance Standards Board” (AASB) with immediate effect to better reflect the activities being undertaken by the Committee. Apart from changes designed to strengthen the process for establishing auditing and assurance standards, such a move would bring about greater transparency in the working of the Auditing Practices Committee now known as the Auditing and Assurance Standards Board (AASB).

The Council also approved the renaming of the Statements on Standard Auditing Practices (SAPs) as, “Auditing and Assurance Standards” (AASs). The ICAI in 2007 issued the ‘Revised Preface to the Standards on Quality Control, Auditing. Review, Other Assurance and Related Services’. Pursuant to issuance of Revised Preface, the ‘Auditing and Assurance Standards’ (AAS) have been renamed as ‘Engagement and Quality Control Standards’. The Engagement Standards comprise:

- Standards on Auditing (SAs) – To be applied in the audit of historical financial information.
- Standards on Review Engagements (SREs) – To be applied in the review of historical financial information.
- Standards on Assurance Engagements (SAEs) – To be applied in assurance engagements, other than audits and reviews of historical financial information.
- Standards on Related Services (SRSs)–To be applied to engagements involving application of agreed-upon procedures to information, compilation engagements, and other related services engagements, as may be specified by the ICAI.

[3] *ibid*.

2. Members have sought guidance regarding the level of authority attached to the various documents issued by the Institute and the degree of compliance required in respect thereof. This note is being issued to provide this guidance.

3. The 'Statements' have been issued with a view to securing compliance by members on matters which, in the opinion of the Council, are critical for the proper discharge of their functions. 'Statements' therefore are mandatory. Accordingly, while discharging their attest function, it will be the duty of the members of the Institute :–

(a) to examine whether 'Statements' relating to accounting matters are complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the 'Statements', 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; and

(b) to ensure that the 'Statements' relating to auditing matters are followed in the audit of financial information covered by their audit reports. If, for any reason, a member has not been able to perform an audit in accordance with such 'Statements', his report should draw attention to the material departures therefrom.

4. A list of 'Statements' issued by the Institute and currently in force is given at the end of this note.[4]

5. 'Guidance Notes' are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so. Similarly, while discharging his attest function,

[4] Subsequent to the issuance of this 'Clarification', various other pronouncements of the Institute have been made mandatory, while some others have been withdrawn. For details of these and other developments, see the Announcements published hereafter and Appendix 1 to this Compendium 'Applicability of Accounting Standards to Various Entities'. With regard to Statements on auditing, 'Handbook of Auditing Pronouncements' issued by the Institute may be referred. It may also be noted that besides statements on accounting and auditing, the Institute has issued statements on other aspects also, namely, Statement on Peer Review and Statement on Continuing Professional Education.

a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.

6. There are however a few guidance notes in case of which the Council has specifically stated that they should be considered as mandatory on members while discharging their attest function. A list of these guidance notes is given below:–

(i) Guidance Note on Treatment of Interest on Deferred Payments read along with the pronouncement of the Council, published in 'The Chartered Accountant', March 1984.[5]

(ii) Provision for Depreciation in respect of Extra or Multiple Shift Allowance, published in 'The Chartered Accountant', May 1984.[6]

7. The 'Accounting Standards' and 'Statements on Standard Auditing Practices'[7] issued by the Accounting Standards Board and the Auditing

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[5] The nomenclature of this document was changed by the Council of the Institute at its 133rd meeting held in April, 1988. The new nomenclature was 'Statement on Treatment of Interest on Deferred Payments'. In view of para 8 of this 'Clarification', with Accounting Standard (AS) 10 on 'Accounting for Fixed Assets', becoming mandatory (see Announcement II) in respect of accounts for periods commencing on or after 1.4.1991, the 'Statement on Treatment of Interest on Deferred Payments' stands automatically withdrawn except in the case of certain specified non-corporate entities where it stands withdrawn in respect of accounts for periods commencing on or after 1.4.1993 (see Announcements III, V and VI in this regard). It may be noted that pursuant to the issuance of Accounting Standard (AS) 16 on 'Borrowing Costs', which came into effect in respect of accounting periods commencing on or after 1-4-2000, paragraph 9.2 and paragraph 20 (except the first sentence) of AS 10, relating to treatment of finance costs including interest, stand withdrawn from that date.

[6] The nomenclature of this document was changed by the Council of the Institute at its 133rd meeting held in April, 1988. The new nomenclature was 'Statement on Provision for Depreciation in respect of Extra or Multiple Shift Allowance'. This statement has been withdrawn in respect of accounting periods commencing on or after 1.4.1989, as per the Guidance Note on Accounting for Depreciation in Companies, issued in pursuance of amendments in the Companies Act, 1956, through Companies (Amendment) Act, 1988.

[7] Refer footnote 2. 'Statements on Standard Auditing Practices' have been renamed as 'Engagement and Quality Control Standards.'

Practices Committee[8], respectively, establish standards which have to be complied with to ensure that financial statements are prepared in accordance with generally accepted accounting standards and that auditors carry out their audits in accordance with the generally accepted auditing practices. They become mandatory on the dates specified either in the respective document or by notification issued by the Council.[9]

8. There can be situations in which certain matters are covered both by a 'Statement' and by an 'Accounting Standard'/'Statement on Standard Auditing Practices'[10]. In such a situation, the 'Statement' shall prevail till the time the relevant 'Accounting Standard'/'Statement on Standard Auditing Practices'[11] becomes mandatory. It is clarified that once an 'Accounting Standard'/ 'Statement on Standard Auditing Practices'[12] becomes mandatory, the concerned 'Statement' or the relevant part thereof shall automatically stand withdrawn.[13]

9. List of statements[14] issued by the Institute and which are mandatory in nature.

1. Statement on Auditing Practices.

2. Statement on Payments to Auditors for Other Services.

3. Statement on the Manufacturing and Other Companies (Auditor's Report) Order, 1975 (Issued under Section 227(4A) of the Companies Act, 1956).

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[8] Refer footnote 2. The 'Auditing Practices Committee' has been renamed as 'Auditing and Assurance Standards Board'.

[9] Subsequent to the publication of this Clarification, the Council has made various Accounting Standards mandatory. The Announcements made by the Council in this regard are reproduced hereafter.

[10] Refer footnote 2. 'Statements on Standard Auditing Practices' have been renamed as 'Engagement and Quality Control Standards'.

[11] *ibid.*

[12] *ibid.*

[13] See also 'Clarification on Status of Accounting Standards and Guidance Notes' (reproduced hereafter as Announcement XIII).

[14] To know the current Status of Statements on auditing 'Handbook of Auditing Pronouncements' issued by the Institute may be referred.

4. Statement on Qualifications in Auditor's Report.

5. Statement on Standard Auditing Practices (SAP-1) on 'Basic Principles Governing an Audit'.

6. Statement on Standard Auditing Practices (SAP-2) on 'Objective and Scope of the Audit of Financial Statements'.

7. Statement on Standard Auditing Practices (SAP-3) on 'Documentation'.

8. Statement on the Responsibility of Joint Auditors.

9. Statement on the Treatment of Retirement Gratuity in Accounts.[15]

10. Statement on the Amendments to Schedule VI to the Companies Act.

11. Statement of Accounting for Foreign Currency Translation.[16]

II. Accounting Standards 1, 7, 8, 9 and 10 Made Mandatory[17]

1. It is hereby notified that the Council of the Institute, at its 144th meeting, held on June 7-9, 1990, has decided that the following Accounting Standards

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[15] This statement was withdrawn from 1.4.1995 pursuant to the issuance of Accounting Standard (AS) 15, 'Accounting for Retirement Benefits in the Financial Statements of Employers'. AS 15 became mandatory in respect of accounting periods commencing on or after 1.4.1995. AS 15 (issued 1995) has been revised in 2005 and titled as 'Employee Benefits'. Subsequently, two limited revisions have been made to AS 15 (revised 2005). AS 15 (revised 2005), after incorporating the said Limited Revisions, came into effect in respect of accounting periods commencing on or after December 7, 2006. Announcement XXXIV in this regard may be referred . AS 15 (revised 2005) is published elsewhere in this Compendium.

[16] This 'Statement' was withdrawn from accounting periods commencing on or after 1.4.1989 on the issuance of Accounting Standard (AS) 11 on 'Accounting for the Effects of Changes in Foreign Exchange Rates'. For current status of AS 11, see Announcement IV read with footnote 40 and Announcements IX, XVIII, XXII, XXXI, XXXII, XXXIII, XXXV, XXXVI, XL, XLIII and XLIV.

[17] Published in July, 1990 issue of 'The Chartered Accountant'.

will become mandatory in respect of accounts for periods commencing on or after 1.4.1991.[18]

(a) AS 1 - Disclosure of Accounting Policies

(b) AS 7 - Accounting for Construction Contracts[19]

(c) AS 8 - Accounting for Research and Development[20]

(d) AS 9 - Revenue Recognition

(e) AS 10 - Accounting for Fixed Assets

2. The Companies Act, 1956, as well as many other statutes require that the financial statements of an enterprise should give a true and fair view of its financial position and working results. This requirement is implicit even in the absence of a specific statutory provision to this effect. However, what constitutes 'true and fair' view has not been defined either in the Companies

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[18] Subsequently, however, the Council decided that these standards should be mandatory for certain enterprises, viz., Sole proprietary concerns, Partnership firms, Societies registered under the Societies Registration Act, Trusts, Hindu undivided families, and Associations of persons, only in respect of accounts for periods commencing on or after 1.4.1993. The Announcement made by the Council in this regard is reproduced hereafter (See Announcement III). This Announcement was partially modified by the Announcement published in January 1994 issue of 'The Chartered Accountant' (See Announcement V). Further, in this regard, the Council issued an Announcement on applicability of accounting standards in the context of section 44AB of the Income Tax Act (See Announcement VI). Also, subsequently, an Announcement on applicability of accounting standards to Charitable and/or Religious Organisations was issued (See Announcement VIII). Further, a Clarification, namely, General Clarification (GC) - 12/2002 on applicability of accounting standards to Co-operative Societies was issued (See Announcement XVI). It may be noted that with the issuance of the Preface to the Statements of Accounting Standards (revised 2004), the Announcement on 'Applicability of Accounting Standards to Charitable and/or Religious Organisations' and GC-12/2002, stand superseded. The revised Preface is published elsewhere in this Compendium.

[19] AS 7 (issued 1983) was revised in 2002 and titled as 'Construction Contracts'. The revised AS 7 is published elsewhere in this Compendium.

[20] AS 8 stands withdrawn from the date of Accounting Standard (AS) 26, 'Intangible Assets', becoming mandatory for the concerned enterprises (see AS 26 published elsewhere in this Compendium).

Act, 1956 or in any other statute. The pronouncements of the Institute seek to describe the accounting principles and the methods of applying these principles in the preparation and presentation of financial statements so that they give a true and fair view.

3. The 'Preface to the Statements of Accounting Standards'[21] issued by the Institute in 1979 states (paragraphs 6.1 and 6.2):

> "6.1 While discharging their attest function, it will be the duty of the members of the Institute to ensure that the Accounting Standards are implemented in the presentation of financial statements covered by their audit reports. In the event of any deviation from the Standards, it will be also their duty to make adequate disclosures in their reports so that the users of such statements may be aware of such deviations.
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> 6.2 In the initial years, the Standards will be recommendatory in character and the Institute will give wide publicity among the users and educate members about the utility of Accounting Standards and the need for compliance with the above disclosure requirements. Once an awareness about these requirements is ensured, steps will be taken, in the course of time, to enforce compliance with accounting standards in the manner outlined in para 6.1 above."

4. In accordance with para 6.2 of the 'Preface to the Statements of Accounting Standards'[22], the Council of the Institute has decided to make Accounting Standards mandatory in a phased manner. Accordingly, the Council has already made two Accounting Standards, viz., Accounting Standard (AS) 4, 'Contingencies and Events Occurring After the Balance Sheet Date'[23] and Accounting Standard (AS) 5, 'Prior Period and

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[21] With the issuance of the Preface to the Statements of Accounting Standards (revised 2004), the Preface to the Statements of Accounting Standards, issued in January, 1979, stands superseded. The revised Preface is published elsewhere in this Compendium.

[22] *ibid.*

[23] This Standard has been revised (published in April, 1995 issue of 'The Chartered Accountant'). The revised standard came into effect in respect of accounting periods commencing on or after 1.4.1995 and is mandatory in nature. 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 the existing Accounting Standards (see Announcement XX).

Extraordinary Items and Changes in Accounting Policies'[24] mandatory in respect of accounts for periods commencing on or after 1.1.87. It has now been decided by the Council to make five more Accounting Standards (listed in para 1 above) mandatory in respect of accounts for periods commencing on or after 1.4.1991.

5. Attention of the members is also invited to the 'Clarification regarding authority attached to the documents issued by the Institute'. According to the said clarification, 'Statements' have been issued with a view to securing compliance by members on matters which in the opinion of the Council are critical for the proper discharge of their functions. 'Statements' therefore are mandatory. Accordingly, while discharging their attest function, it will be the duty of the members of the Institute:

(a) to examine whether 'Statements' relating to accounting matters are complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the 'Statements', 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; and

(b) to ensure that the 'Statements' relating to auditing matters are followed in the audit of financial information covered by their audit reports. If for any reason a member has not been able to perform an audit in accordance with such 'Statements', his report should draw attention to the material departures therefrom.

6. Once an Accounting Standard becomes mandatory, the duties of an auditor with respect to such Standard are the same as those specified at paragraph 5(a) above.

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[24] This Standard has been revised and titled as 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies' (published in February, 1997 issue of 'The Chartered Accountant'). The revised standard came into effect in respect of accounting periods commencing on or after 1.4.1996 and is mandatory in nature. Subsequently, a limited revision has also been made in this standard (published in 'The Chartered Accountant', September 2001, pp. 342).

7. While discharging their attest function, the members of the Institute may keep the following in mind with regard to the above Standards.

AS 1- DISCLOSURE OF ACCOUNTING POLICIES

8. In the case of a company, members should qualify their audit reports in case –

(a) accounting policies required to be disclosed under Schedule VI or any other provisions of the Companies Act, 1956 have not been disclosed, or

(b) accounts have not been prepared on accrual basis, or

(c) the fundamental accounting assumption of going concern has not been followed and this fact has not been disclosed in the financial statements, or

(d) proper disclosures regarding changes in the accounting policies have not been made.

9. Where a company has been given a specific exemption regarding any of the matters stated in paragraph 8 above but the fact of such exemption has not been adequately disclosed in the accounts, the member should mention the fact of exemption in his audit report without necessarily making it a subject matter of audit qualification.

10. If accounting policies have not been disclosed at one place, or if certain significant accounting policies have not been disclosed, by a company on the ground that their disclosure is not required under the Companies Act, 1956, the member should disclose the fact in his audit report without necessarily making it a subject matter of audit qualification. Such a disclosure would not constitute a reservation, qualification or adverse remark except where the auditor has specifically made it a subject matter of audit qualification. Accordingly, in the case of a company, the Board of Directors need not provide information or explanation with regard to such a disclosure (except where the same constitutes a qualification) in their report under sub-section (3) of section 217 of the Companies Act, 1956.

11. In the case of enterprises[25] not governed by the Companies Act, 1956, the member should examine the relevant statute and make suitable qualification in his audit report in case adequate disclosures regarding accounting policies have not been made as per the statutory requirements. Similarly, the member should examine if the fundamental accounting assumptions have been followed in preparing the financial statements or not. In appropriate cases, he should consider whether, keeping in view the requirements of the applicable laws, a qualification in his report is necessary.

12. In the event of non-compliance, by enterprises[26] not governed by the Companies Act, 1956, with the disclosure requirements of AS 1 in situations where the relevant statute does not require such disclosures to be made, the member should make adequate disclosure in his audit report without necessarily making it a subject matter of audit qualification.

ACCOUNTING STANDARDS 7, 8, 9 AND 10

13. Non-compliance with any of the requirements of the above Standards by any enterprise[27] should be a subject matter of qualification except that, to the extent that the disclosure requirements in the relevant standard are in addition to the requirements of the Companies Act, 1956 or any other applicable statute, the member should disclose the fact of non-compliance with such

[25] Subsequently, however, the Council decided that these standards should be mandatory for certain enterprises, viz., Sole proprietary concerns, Partnership firms, Societies registered under the Societies Registration Act, Trusts, Hindu undivided families, and Associations of persons, only in respect of accounts for periods commencing on or after 1.4.1993. The Announcement made by the Council in this regard is reproduced hereafter (See Announcement III). This Announcement was partially modified by the Announcement published in January, 1994 issue of 'The Chartered Accountant' (See Announcement V). Further, in this regard, the Council issued an Announcement on applicability of accounting standards in the context of section 44AB of the Income Tax Act (See Announcement VI). Also, subsequently, an Announcement on applicability of accounting standards to Charitable and/or Religious Organisations was issued (See Announcement VIII). Further, a Clarification, namely, General Clarification (GC) - 12/2002 on applicability of accounting standards to Co-operative Societies was issued (See Announcement XVI). It may be noted that with the issuance of the Preface to the Statements of Accounting Standards (revised 2004), the Announcement on 'Applicability of Accounting Standards to Charitable and /or Religious Organisations' and GC-12/2002 stand superseded. The revised Preface is published elsewhere in this Compendium.

[26] *ibid.*

[27] *ibid*

disclosure requirements in his audit report without necessarily making it a subject matter of audit qualifications. Accordingly, in the case of a company, the Board of Directors need not provide information or explanation with regard to such a disclosure (except where the same constitutes a qualification) in their report under sub-section (3) of section 217 of the Companies Act, 1956.

ACCOUNTING STANDARDS 4, 5 AND 11

14. Accounting Standard (AS) 4, 'Contingencies and Events Occurring after the Balance Sheet Date'[28] and Accounting Standard (AS) 5, 'Prior Period and Extraordinary Items and Changes in Accounting Policies'[29] have already been made mandatory in respect of accounts for periods commencing on or after 1.1.1987. The Council of the Institute has also already announced that Accounting Standard (AS) 11, 'Accounting for the Effects of Changes in Foreign Exchange Rates', will become mandatory in respect of accounts for periods commencing on or after 1.4.1991[30]. It may be clarified that the requirements of paragraph 13 above will also apply in making a qualification/ disclosure in respect of deviations from the requirements of these Accounting Standards.

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[28] This Accounting Standard was revised (published in April, 1995 issue of 'The Chartered Accountant'). The revised standard came into effect in respect of accounting periods commencing on or after 1.4.1995 and is mandatory in nature. 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 present Indian Accounting Standards (see Announcement XX).

[29] This Standard has been revised and titled as 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies' (published in February, 1997 issue of 'The Chartered Accountant'). The revised standard came into effect in respect of accounting periods commencing on or after 1.4.1996 and is mandatory in nature. Subsequently, a limited revision has also been made in this standard (published in 'The Chartered Accountant', September 2001, pp. 342).

[30] The Council subsequently postponed the mandatory application of AS 11 to accounts for the periods commencing on or after 1.4.1993 (See Announcement IV). The standard was subsequently revised in December, 1994, which was published in January, 1995, issue of 'The Chartered Accountant' and was mandatory in respect of accounting periods commencing on or after 1.4.1995. The Council subsequently clarified that this standard is not applicable to forward exchange transactions which are entered into by authorised foreign exchange dealers (see Announcement IX). The Standard has again been revised in 2003 and titled as 'The Effects of Changes in Foreign Exchange Rates', (published in March, 2003, issue of 'The Chartered Accountant'). See footnote 40 and Announcements XVIII, XXII, XXXI, XXXII, XXXIII, XXXV, XXXVI, XL, XLIII and XLIV also.

MANNER OF MAKING QUALIFICATION/DISCLOSURE IN THE AUDIT REPORT[31]

15. In making a qualification/disclosure in the audit report, the auditor should consider the materiality of the relevant item. Thus, the auditor need not make qualification/disclosure in respect of items which, in his judgement, are not material.

16. While making a qualification, the auditor should follow the requirements of the 'Statement on Qualifications in Auditor's Report' issued by the Institute.

17. A disclosure, which is not a subject matter of audit qualification, should be made in the auditor's report in a manner that it is clear to the reader that the disclosure does not constitute an audit qualification. The paragraph containing the auditor's opinion on true and fair view should not include a reference to the paragraph containing the aforesaid disclosure.

EXAMPLES OF QUALIFICATIONS/DISCLOSURES IN THE AUDIT REPORT[32]

18. Given below are some examples which illustrate the manner of making qualification/disclosure in the audit report in case of deviations from the requirements of mandatory Accounting Standards. It may be clarified that these examples are aimed only at illustrating the manner of making qualifications/disclosures and are not intended in any way to be exhaustive.

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[31] Subsequent to issuance of this 'Announcement', various other pronouncements of the Institute have been issued and various developments have taken place. In this regard, it may be noted that the auditor needs to comply with the requirements of SA 700, 'The Auditor's Report on Financial Statements' or SA 700 (Revised), 'Forming an Opinion and Reporting on Financial Statements', SA 705, 'Modifications to the Opinion in the Independent Auditor's Report' and SA 706, 'Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report', as may be applicable, issued by the ICAI while making qualification/ disclosure in the audit report. The Council, in April 2012 decided that the SA 700 (Revised), SA 705 and SA 706 be applicable to audits of financial statements for periods beginning on or after April 1, 2012, instead of April 1, 2011, as originally decided in 2010 at the time of issuance of these Standards. For details, refer 'Handbook of Auditing Pronouncements'.

[32] *ibid*.

Examples of Qualifications

(a) Where proper disclosures regarding changes in accounting policies have not been made by a company.

> "The company has not disclosed in its accounts the fact of change, from this year, in the method of providing depreciation on plant and machinery from straight-line method to written-down value method, as also the effect of this change. As a result of this change, the net profit for the year, the net block as well as the reserves and surplus are lower by Rs……… each as compared to the position which would have prevailed had this change not been made.
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> Subject to the above, we report that ....".

(b) Where a manufacturing company has accounted for interest income on receipt basis.

> "The company has followed the policy of accounting for interest income on receipt basis rather than on accrual basis. As a result, the net profit for the year and the current assets are understated by Rs……… each as compared to the position which would have prevailed if the company had accounted for interest income on accrual basis.
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> Subject to the above, we report that ... ".

(c) Where a company has capitalised financing costs related to certain fixed assets for periods after such assets were ready to be put to use.

> "Interest payable on borrowings related to the acquisition of fixed assets has been capitalised for the periods during which the assets were in use for commercial production. This is contrary to Accounting Standard (AS) 10, 'Accounting for Fixed Assets' issued by the Institute of Chartered Accountants of India.[33] Consequently, the net profit for the

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[33] It may be noted that pursuant to the issuance of Accounting Standard (AS) 16, 'Borrowing Costs', which came into effect in respect of accounting periods commencing on or after 1-4-2000, paragraph 9.2 and paragraph 20 (except the first sentence) of AS 10, relating to treatment of finance costs including interest, stand withdrawn from that date. Accordingly, while qualifying his report on financial statements covering accounting periods commencing on or after April 1, 2000, in the situation envisaged in this example, the auditor should make reference to AS 16 instead of AS 10.

year, the net block and the reserves and surplus have been overstated by Rs.... each as compared to the position which would have prevailed if the company had complied with the requirements of AS 10.

Subject to the above, we report that ....”

Examples of Disclosures

(a) Where a company has not disclosed all significant accounting policies and has also not disclosed the accounting policies at one place.

“The company has disclosed those accounting policies the disclosure of which is required by the Companies Act, 1956. Other significant accounting policies, viz., those relating to treatment of research and development costs and treatment of exchange gains and losses have not been disclosed nor have all the policies been disclosed at one place, which is contrary to Accounting Standard (AS) 1, ‘Disclosure of Accounting Policies’ issued by the Institute of Chartered Accountants of India.

We report that ....”

(b) Where a partnership firm[34] does not make adequate disclosures regarding the revaluation of its fixed assets.

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[34] Subsequently, however, the Council decided that these standards should be mandatory for certain enterprises, viz., Sole proprietary concerns, Partnership firms, Societies registered under the Societies Registration Act, Trusts, Hindu undivided families, and Associations of persons, only in respect of accounts for periods commencing on or after 1.4.1993. The Announcement made by the Council in this regard is reproduced hereafter (See Announcement III). This Announcement was partially modified by the Announcement published in January, 1994 issue of ‘The Chartered Accountant’ (See Announcement V). Further, in this regard, the Council issued an Announcement on applicability of accounting standards in the context of section 44AB of the Income Tax Act (See Announcement VI). Also, subsequently, an Announcement on applicability of accounting standards to Charitable and/ or Religious Organisations was issued (See Announcement VIII). Further, a Clarification, namely, General Clarification (GC)- 12/2002 on applicability of accounting standards to Co-operative Societies was issued (See Announcement XVI). It may be noted that with the issuance of the Preface to the Statements of Accounting Standards (revised 2004), the Announcement on 'Applicability of Accounting Standards to Charitable and/or Religious Organisations' and GC-12/ 2002 stand superseded. The revised Preface is published elsewhere in this Compendium.

"During the year, the enterprise revalued its land and buildings. The revalued amounts of land and buildings are adequately disclosed in the balance sheet. However, the method adopted to compute the revalued amounts has not been disclosed, which is contrary to Accounting Standard (AS) 10, 'Accounting for Fixed Assets' issued by the Institute of Chartered Accountants of India.

We report that ...."

III. Applicability of Mandatory Accounting Standards to Non-corporate Enterprises[35]

In the July 1990 issue of the Journal, the Council had notified its decision to make the following Accounting Standards mandatory in respect of accounts for periods commencing on or after 1.4.1991.

1. AS 1 - Disclosure of Accounting Policies
2. AS 7 - Accounting for Construction Contracts[36]
3. AS 8 - Accounting for Research and Development[37]
4. AS 9 - Revenue Recognition
5. AS 10 - Accounting for Fixed Assets

[35] Published in May, 1991 issue of 'The Chartered Accountant'. This Announcement was partially modified by the Announcement published in January, 1994 issue of 'The Chartered Accountant' (See Announcement V). Further, in this regard, the Council issued an Announcement on applicability of accounting standards in the context of section 44AB of the Income Tax Act (See Announcement VI). Also, subsequently, an Announcement on applicability of accounting standards to Charitable and/or Religious Organisations was issued (See Announcement VIII). Further, a Clarification, namely, General Clarification (GC)- 12/2002 on applicability of accounting standards to Co-operative Societies was issued (See Announcement XVI). It may be noted that with the issuance of the Preface to the Statements of Accounting Standards (revised 2004), the Announcement on 'Applicability of Accounting Standards to Charitable and/or Religious Organisations' and GC-12/2002 stand superseded. The revised Preface is published elsewhere in this Compendium.

[36] AS 7 (issued 1983) was revised in 2002 and titled as 'Construction Contracts'. The revised AS 7 is published elsewhere in this Compendium.

[37] AS 8 stands withdrawn from the date of Accounting Standard (AS) 26, 'Intangible Assets', becoming mandatory, for the concerned enterprises (see AS 26 published elsewhere in this Compendium).

Based on the views expressed at various seminars organised to discuss the implications of accounting and auditing standards as also in the light of several representations received in this behalf, the matter has since been reconsidered by the Council and the following has been decided.

1. Accounting Standards 1, 7, 8, 9, 10 and 11 should be mandatory in respect of accounts for periods beginning on or after 1.4.1991 for companies governed by the Companies Act, 1956 as well as for other enterprises except the following –

(a) Sole proprietary concerns/individuals

(b) Partnership firms

(c) Societies registered under the Societies Registration Act

(d) Trusts

(e) Hindu undivided families

(f) Associations of persons.

2. In respect of the enterprises listed at (a) to (f) above, Accounting Standards 1, 7, 8, 9,10 & 11[38] should be mandatory in respect of accounts for periods beginning on or after 1.4.1993.

3. The Statements on auditing matters should continue to be mandatory in respect of audit of all enterprises.

IV. Accounting Standard 11[39]

The Accounting Standard No. 11 on Accounting for the Effects of Changes in Foreign Exchange Rates which came into effect as recommendatory in respect of accounting periods commencing on or after 1st April, 1989 had been made mandatory in respect of accounts for periods commencing on or after 1st April, 1991.

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[38] Regarding AS 11, see the Announcements made by the Council in this regard at IV, IX, XVIII, XXII, XXXI, XXXII, XXXIII, XXXV, XXXVI, XL, XLIII, and XLIV and footnote 40 for subsequent developments.

[39] Published in 'The Chartered Accountant', June, 1992.

However, in view of the partial convertibility of the rupee recently announced and other related developments in the changed economic environment, it has now been decided to reconsider this Accounting Standard. Accordingly, the Council has resolved that the mandatory application of this Accounting Standard shall stand postponed to accounts for periods commencing on or after 1st April, 1993.

It is expected that reconsideration of this Accounting Standard will have been carried out well before 1st April, 1993 .[40]

V. Mandatory Application of Accounting Standards in respect of Certain Non-corporate Bodies[41]

1. In May 1991 issue of 'The Chartered Accountant', an announcement was carried regarding the decision of the Council of the Institute of Chartered Accountants of India to defer the mandatory application of Accounting Standards 1, 7, 8, 9, 10 and 11 to accounts for periods beginning on or after

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[40] The Standard was subsequently revised in December, 1994 , which was published in January, 1995, issue of 'The Chartered Accountant' and was mandatory in respect of accounting periods commencing on or after 1.4.1995. See Announcement IX also. This Standard has again been revised in 2003, and titled as 'The Effects of Changes in Foreign Exchange Rates', (published in March, 2003, issue of 'The Chartered Accountant'). The revised AS 11(2003) comes into effect in respect of accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date. The revised standard supersedes AS 11 (1994), except that in respect of accounting for transactions in foreign currencies entered into by the reporting enterprise itself or through its branches before the date the revised AS 11 (2003) comes into effect, AS 11 (1994) continues to be applicable. See also Announcements XVIII, XXII, XXXI, XXXII, XXXIII, XXXV, XXXVI, XL, XLIII and XLIV.

[41] Published in 'The Chartered Accountant', January, 1994 (page 639). For auditor's duties in relation to mandatory accounting standards, reference may be made to the Announcement concerning mandatory accounting standards published in the July, 1990 issue of the Journal (See Announcement II). Further, in this regard, the Council issued an Announcement on applicability of accounting standards in the context of section 44AB of the Income Tax Act (See Announcement VI). Also, subsequently, an Announcement on applicability of accounting standards to Charitable and/or Religious Organisations was issued (See Announcement VIII). Further, a Clarification, namely, General Clarification (GC)- 12/2002 on applicability of accounting standards to Co-operative Societies was issued (See Announcement XVI). It may be noted that with the issuance of the Preface to the Statements of Accounting Standards (revised 2004), the Announcement on 'Applicability of Accounting Standards to Charitable and/or Religious Organisations' and GC-12/2002 stand superseded. The revised Preface is published elsewhere in this Compendium.

1.4.1993, in respect of the following:

(a) Sole proprietary concerns/individuals

(b) Partnership firms

(c) Societies registered under the Societies Registration Act

(d) Trusts

(e) Hindu Undivided Families

(f) Associations of persons.

2. The matter was re-considered by the Council at its meeting held in September, 1993 and it was decided, in partial modification of the earlier decision, that the aforesaid Accounting Standards (except Accounting Standard 11, which has already been withdrawn), shall mandatorily apply in respect of general purpose financial statements of the individual/bodies listed at (a) - (f) above for periods beginning on or after 1.4.1993, where such statements are statutorily required to be audited under any law. It may be reiterated that the Institute issues Accounting Standards for use in the presentation of general purpose financial statements issued to the public by such commercial, industrial or business enterprises as may be specified by the Institute from time to time and subject to the attest function of its members. The term "General Purpose Financial Statements" includes balance sheet, statement of profit and loss and other statements and explanatory notes which form part thereof, issued for use of shareholders/members, creditors, employees and public at large.

3. According to Accounting Standard 1, Disclosure of Accounting Policies, 'accrual' is one of the fundamental accounting assumptions. The Standard requires that if any fundamental accounting assumption is not followed in the preparation and presentation of financial statements, the fact should be disclosed. Accordingly, in respect of individual/bodies covered by para 1 above, the auditor should examine whether the financial statements have been prepared on accrual basis. In cases where the statute governing the enterprise requires the preparation and presentation of financial statements on accrual basis but the financial statements have not been so prepared, the auditor should qualify his report. On the other hand, where there is no *statutory requirement* for preparation and presentation of financial statements on accrual basis, and the financial statements have been prepared on a basis other than 'accrual' the auditor should describe in his audit report, the basis of accounting followed, without necessarily making it a subject matter of a

qualification. In such a case the auditor should also examine whether those provisions of the accounting standards which are applicable in the context of the basis of accounting followed by the enterprise have been complied with or not and consider making suitable disclosures/ qualifications in his audit report accordingly.

4. An example of a disclosure in the audit report of an enterprise which follows cash basis of accounting is given below:

> "It is the policy of the enterprise to prepare its financial statements on the cash receipts and disbursements basis. On this basis revenue and the related assets are recognised when received rather than when earned, and expenses are recognised when paid rather than when the obligation is incurred.
>
> In our opinion, the financial statements give a true and fair view of the assets and liabilities arising from cash transactions of ..... at ...... and of the revenue collected and expenses paid during the year then ended on the cash receipts and disbursements basis as described in Note X."

VI. Mandatory Application of Accounting Standards in respect of Tax Audit under Section 44AB of the Income Tax Act, 1961[42]

In an announcement published in January, 1994 issue of 'The Chartered Accountant' (p.639), members had been informed that Accounting Standards 1, 7, 8, 9 and 10 shall mandatorily apply in respect of general purpose financial statements of the individuals/bodies specified in this behalf for periods beginning on or after 1.4.1993, where such statements were statutorily required to be audited under any law[43] (the aforesaid announcement is reproduced below for ready reference). Queries have been received as to whether the mandatory accounting standards apply in respect of financial statements audited under section 44AB of the Income-tax Act, 1961. **It is hereby clarified that the mandatory accounting standards also apply in respect of financial**

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[42] Published in 'The Chartered Accountant', August, 1994 (page 224). For auditor's duties in relation to mandatory accounting standards, reference may be made to the Announcement concerning mandatory accounting standards published in the July, 1990 issue of the Journal (See Announcement II).

[43] It may be noted that Accounting Standards 4 and 5 were made mandatory by the Council of the Institute earlier in respect of accounts for periods commencing on or after 1.1.1987.

statements audited under section 44AB of the Income-tax Act, 1961. Accordingly, members should examine compliance with the mandatory accounting standards when conducting such audit.

Mandatory Application of Accounting Standards in respect of Certain Non-corporate Bodies[44]

1. In May, 1991 issue of 'The Chartered Accountant', an announcement was carried regarding the decision of the Council of the Institute of Chartered Accountants of India to defer the mandatory application of Accounting Standards 1, 7, 8, 9, 10 and 11 to accounts for periods beginning on or after 1.4.1993, in respect of the following:

(a) Sole proprietary concerns/individuals

(b) Partnership firms

(c) Societies registered under the Societies Registration Act

(d) Trusts

(e) Hindu Undivided Families

(f) Associations of persons.

2. The matter was re-considered by the Council at its meeting held in September, 1993 and it was decided, in partial modification of the earlier decision, that the aforesaid Accounting Standards (except Accounting Standard 11, which has already been withdrawn), shall mandatorily apply in respect of general purpose financial statements of the individual/ bodies listed at (a) - (f) above for periods beginning on or after 1.4.1993, where such statements are statutorily required to be audited under any law. It may be reiterated that the Institute issues Accounting Standards for use in presentation of general purpose financial statements issued to the public by such commercial, industrial or business enterprises as may be specified by the Institute from time to time and subject to the attest function of its members. The term "General Purpose Financial Statements" includes balance sheet, statement of profit and loss and other statements and explanatory notes which form part thereof, issued for use of shareholders/members, creditors, employees and public at large.

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[44] Published in 'The Chartered Accountant', January, 1994, pp 639.

3. According to Accounting Standard 1, Disclosure of Accounting Policies, 'accrual' is one of the fundamental accounting assumptions. The Standard requires that if any fundamental accounting assumption is not followed in the preparation and presentation of financial statements, the fact should be disclosed. Accordingly, in respect of individual/bodies covered by para 1 above, the auditor should examine whether the financial statements have been prepared on accrual basis. In cases where the statute governing the enterprise requires the preparation and presentation of financial statements on accrual basis but the financial statements have not been so prepared, the auditor should qualify his report. On the other hand, where there is no statutory requirement for preparation and presentation of financial statements on accrual basis, and the financial statements have been prepared on a basis other than 'accrual' the auditor should describe in his audit report, the basis of accounting followed, without necessarily making it a subject matter of a qualification. In such a case the auditor should also examine whether those provisions of the accounting standards which are applicable in the context of the basis of accounting followed by the enterprise have been complied with or not and consider making suitable disclosures/ qualifications in his audit report accordingly.

4. An example of a disclosure in the audit report of an enterprise which follows cash basis of accounting is given below:

> "It is the policy of the enterprise to prepare its financial statements on the cash receipts and disbursements basis. On this basis revenue and the related assets are recognised when received rather than when earned, and expenses are recognised when paid rather than when the obligation is incurred. In our opinion, the financial statements give a true and fair view of the assets and liabilities arising from cash transactions of .....at .....and of the revenue collected and expenses paid during the year then ended on the cash receipts and disbursements basis as described in Note X."

VII. Accounting Standard (AS) 6 (Revised), Depreciation Accounting, Made Mandatory[45]

Accounting Standard (AS) 6, Depreciation Accounting, was issued by the Accounting Standards Board originally in 1982 and was subsequently revised

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[45] Published in 'The Chartered Accountant', May, 1995 (page 1544). It may be noted that pursuant to AS 26, *Intangible Assets*, becoming mandatory, for the concerned enterprises, AS 6 stands withdrawn insofar as it relates to amortisation (depreciation) of intangible assets (see AS 26 published elsewhere in this Compendium).

in 1994 (please see pages 218-219 of the August 1994 issue of 'The Chartered Accountant').

The Council of the Institute has now decided to make AS 6 mandatory in respect of accounts for periods commencing on or after April l, 1995. The mandatory status of AS 6 implies that while discharging their attest function, it will be the duty of the members of the Institute to examine whether the said Standard has been complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the said 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. For a detailed guidance on the duties of the members in relation to mandatory Accounting Standards, reference may be made to the announcement published in the July 1990 issue of 'The Chartered Accountant'.

VIII. Applicability of Accounting Standards to Charitable and/or Religious Organisations[46]

The Accounting Standards Board has received a query as to whether the accounting standards formulated by it are applicable to organisations whose objects are charitable or religious. The Board has considered this query and its views in the matter are set forth in the following paragraphs.

The Preface to the Statements of Accounting Standards[47] states:

> "3.3 The Institute will issue Accounting Standards for use in the presentation of the general purpose financial statements issued to the public by such commercial, industrial or business enterprises as may be specified by the Institute from time to time and subject to the attest function of its members."

The reference to commercial, industrial or business enterprises in the aforesaid paragraph is in the context of the nature of activities carried on by the enterprise rather than with reference to its objects. It is quite possible that an enterprise has charitable objects but it carries on, either wholly or in part, activities of a commercial, industrial or business nature in furtherance of its

[46] As approved by the Council; published in 'The Chartered Accountant', September 1995 (page 79).
With the issuance of the Preface to the Statements of Accounting Standards (revised 2004), this Announcement stands superseded. The revised Preface is published elsewhere in this Compendium.

[47] With the issuance of the Preface to the Statements of Accounting Standards (revised 2004), the Preface to the Statements of Accounting Standards, issued in January, 1979, stands superseded.

objects. The Board believes that Accounting Standards apply in respect of commercial, industrial or business activities of any enterprise, irrespective of whether it is profit oriented or is established for charitable or religious purposes. Accounting Standards will not, however, apply to those activities which are not of commercial, industrial or business nature, (e.g., an activity of collecting donations and giving them to flood affected people.)

It is also clarified that exclusion of an entity from the applicability of the Accounting Standards would be permissible only if no part of the activity of such entity was commercial, industrial or business in nature. For the removal of doubts, it is clarified that even if a very small proportion of the activities of an entity was considered to be commercial, industrial or business in nature, then it could not claim exemption from the application of Accounting Standards. The Accounting Standards would apply to all its activities including those which were not commercial, industrial or business in nature.

IX. Applicability of Accounting Standard 11, *Accounting for the Effects of Changes in Foreign Exchange Rates* to Authorised Foreign Exchange Dealers[48]

Accounting Standard (AS) 11, *Accounting for the Effects of Changes in Foreign Exchange Rates,* as revised in 1995[49], deals with accounting for foreign currency transactions and translation of financial statements of foreign branches. It is hereby clarified that the above Standard is not applicable to forward exchange transactions which are entered into by authorised foreign exchange dealers, in view of the fact that the nature of such transactions has certain special features which need to be addressed specifically.[50] The

[48] Published in 'The Chartered Accountant', April, 1999 (pages 78-79).

[49] This Standard was revised in December, 1994 and published in January, 1995, issue of 'The Chartered Accountant'. This Standard has again been revised in 2003 and titled as 'The Effects of Changes in Foreign Exchange Rates', (published in March, 2003, issue of 'The Chartered Accountant'). The revised AS 11(2003) comes into effect in respect of accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date. The revised Standard supersedes AS 11 (1994), except that in respect of accounting for transactions in foreign currencies entered into by the reporting enterprise itself or through its branches before the date the revised AS 11 (2003) comes into effect, AS 11 (1994) continues to be applicable. See also Announcements XVIII, XXII, XXXI, XXXII, XXXIII, XXXV, XXXVI, XL, XLIII and XLIV.

[50] It may be noted that revised AS 11 (2003) addresses the matter specifically and, accordingly, this Announcement is not relevant to revised AS 11 (2003). See also Announcements XVIII, XXII, XXXI, XXXII, XXXIII, XXXV, XXXVI, XL, XLIII and XLIV.

standard shall, however, apply to translation of financial statements of foreign branches of the foreign exchange dealers.

X. Accounting Standard (AS) 3, Cash Flow Statements, Made Mandatory[51]

The Council, at its 211th meeting, held on September 11-13, 2000, considered the matter relating to making Accounting Standard (AS) 3, Cash Flow Statements, mandatory. The Council decided that AS 3 will be mandatory in nature in respect of accounting periods commencing on or after 1.4.2001 for the following:

(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

(ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs. 50 crores.

XI. Applicability of Accounting Standard (AS) 20, Earnings Per Share[52]

Accounting Standard (AS) 20, 'Earnings Per Share', issued by the Council of the Institute of Chartered Accountants of India, has come into effect in respect of accounting periods commencing on or after 1-4-2001 and is

[51] Published in 'The Chartered Accountant', December 2000, (page 65). It may be noted that the Council, at its 236th meeting, held on September 16-18, 2003, considered the matter relating to applicability of Accounting Standards to Small and Medium Sized Enterprises. As a part of this, the Council decided that Accounting Standard (AS) 3 will not be applicable to Level II and Level III enterprises in its entirety in respect of accounting periods commencing on or after 1-4-2004. Accordingly, this Announcement is not relevant in respect of accounting periods commencing on or after 1-4-2004. See 'Applicability of Accounting Standards' (reproduced as Announcement XVII).

[52] Published in 'The Chartered Accountant', March 2002 (page 1163). Subsequently, this clarification has been numbered as General Clarification (GC)-1/2002 (see 'The Chartered Accountant', June 2002, page 1507). Subsequently, this GC was converted into Accounting Standards Interpretation (ASI) 12 (see 'The Chartered Accountant', March 2004, page 952). Subsequent to Notification of Accounting Standards by the Central Government under the Companies (Accounting Standards) Rules, 2006, ASI 12 has been converted into Guidance Note.

mandatory in nature, from that date, in respect of enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India.

AS 20 does not mandate an enterprise, which has neither equity shares nor potential equity shares which are so listed, to calculate and disclose earnings per share, but, if that enterprise discloses earnings per share for complying with the requirements of any statute or otherwise, it should calculate and disclose earnings per share in accordance with AS 20.

Part IV of the Schedule VI to the Companies Act, 1956[53], requires, among other things, disclosure of earnings per share.

Accordingly, it is hereby clarified that every company, which is required to give information under Part IV of the Schedule VI to the Companies Act, 1956[54], should calculate and disclose earnings per share in accordance with AS 20, whether its equity shares or potential equity shares are listed on a recognised stock exchange in India or not.

XII. Applicability of Accounting Standard (AS) 18, Related Party Disclosures[55]

The Institute has issued Accounting Standard (AS) 18, Related Party Disclosures (published in the October 2000, issue of the Institute's Journal 'The Chartered Accountant'). AS 18 has come into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature for all enterprises.

The Council, at its 224th meeting, held on March 8-10, 2002, reconsidered

[53] Schedule VI to the Companies Act, 1956, has been revised to be effective from 1.4.2011.

[54] *ibid.*

[55] Published in 'The Chartered Accountant', April 2002 (page 1242). The Council, at its 236th meeting, held on September 16-18, 2003, considered the matter relating to applicability of Accounting Standards to Small and Medium Sized Enterprises. As a part of this, the Council decided that AS 18 will not apply to Level II and Level III enterprises in its entirety in respect of accounting periods commencing on or after 1.4.2004. Accordingly, this Announcement is not relevant in respect of accounting periods commencing on or after 1-4-2004. See 'Applicability of Accounting Standards' (reproduced as Announcement XVII). For current Status of applicability of AS 18, see Appendix 1 to this Compendium, 'Applicability of Accounting Standards to Various Entities.'

the applicability of AS 18. The Council decided to make AS 18 mandatory only to the following enterprises and not to all enterprises as at present:

(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

(ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs. 50 crores.

XIII. Clarification on Status of Accounting Standards and Guidance Notes[56]

In a situation where certain matters are covered both by an Accounting Standard and a Guidance Note, issued by the Institute of Chartered Accountants of India, the Guidance Note or the relevant portion thereof will be considered as superseded from the date of the relevant Accounting Standard coming into effect, unless otherwise specified in the Accounting Standard.

Similarly, in a situation where certain matters are covered by a recommendatory Accounting Standard and subsequently, an Accounting Standard is issued which also covers those matters, the recommendatory Accounting Standard or the relevant portion thereof will be considered as superseded from the date of the new Accounting Standard coming into effect, unless otherwise specified in the new Accounting Standard.

In a situation where certain matters are covered by a mandatory Accounting Standard and subsequently, an Accounting Standard is issued which also covers those matters, the earlier Accounting Standard or the relevant portion thereof will be considered as superseded from the date of the new Accounting Standard becoming mandatory, unless otherwise specified in the new Accounting Standard.

[56] Published in 'The Chartered Accountant', April 2002 (page 1242).

XIV. Accounting Standard (AS) 24, Discontinuing Operations[57]

Accounting Standard (AS) 24, Discontinuing Operations, was issued in February 2002 as a recommendatory Accounting Standard. The Council, at its 224th meeting, held on March 8-10, 2002, decided that AS 24 would be mandatory in nature in respect of accounting periods commencing on or after 1-4-2004 for the following:

(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

(ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs. 50 crores.

In respect of all other enterprises, the Accounting Standard would be mandatory in nature in respect of accounting periods commencing on or after 1-4-2005. Earlier application of the accounting standard would be encouraged.

XV. Accounting Standards Specified by the Institute of Chartered Accountants of India under Section 211 of the Companies Act, 1956

(In respect of 'specified' status of Accounting Standards under the Companies Act, 1956, announcements have been made from time to time. The current status of the Accounting Standards for the purposes

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[57] Published in 'The Chartered Accountant', May, 2002 (page 1378). The Council, at its 236th meeting, held on September 16-18, 2003, considered the matter relating to applicability of Accounting Standards to Small and Medium Sized Enterprises. As a part of this, the Council decided that Accounting Standard (AS) 24 will not be applicable to Level II and Level III enterprises in its entirety in respect of accounting periods commencing on or after 1-4-2004 (see 'Applicability of Accounting Standards' (reproduced as Announcement XVII)). Accordingly, this Announcement is no longer relevant. For current Status of applicability of AS 24, see Appendix 1 to this Compendium 'Applicability of Accounting Standards to Various Entities'.

PREVIOUS HOME NEXT

of the Companies Act, 1956, has been included in the Announcement made by the Council specifying Accounting Standard (AS) 3, Cash Flow Statements, for the purposes of the Companies Act, 1956. The text of the Announcement (published in October 2002 issue of 'The Chartered Accountant', page 457) is reproduced below.)

1. Section 211 of the Companies Act, 1956, as amended by the Companies (Amendment) Act, 1999, requires that every profit and loss account and balance sheet of the company shall comply with the accounting standards. For the purpose of Section 211, the expression "accounting standards" means the standards of accounting recommended by the Institute of Chartered Accountants of India as may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards established under sub-section (1) of section 210A of the said Act. Provided that the standards of accounting specified by the Institute of Chartered Accountants of India shall be deemed to be the Accounting Standards until the accounting standards are prescribed by the Central Government under section 211 (3C) of the Act.

2. Accounting Standard (AS) 3, Cash Flow Statements[58], was made mandatory in respect of accounting periods commencing on or after 1.4.2001 for the following:

(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

(ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs. 50 crores. (Announcement published in December 2000 issue of the Institute's Journal.)

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[58] The Council, at its 236th meeting, held on September 16-18, 2003, considered the matter relating to applicability of Accounting Standards to Small and Medium Sized Enterprises. As a part of this, the Council decided that Accounting Standard (AS) 3 will not be applicable to Level II and Level III enterprises in its entirety in respect of accounting periods commencing on or after 1-4-2004. See 'Applicability of Accounting Standards' (reproduced hereafter as Announcement XVII). For the current status of applicability of AS 3 see Announcements XXXVIII, XLII and Appendix 1 to this Compendium.

3. The Council, at its meeting held in September 2002, decided that AS 3 should also be treated as a 'specified' accounting standard for the purpose of section 211 of the Act.[59] Accordingly, the companies in respect of which AS 3 is mandatory, are required to comply with AS 3 under section 211 of the Companies Act, 1956. In view of this, the statutory auditors of such companies are required to give an assertion in respect of compliance with AS 3 along with other 'specified' accounting standards while reporting under section 227 (3)(d) of the Act.

The Council decided that the above position in respect of 'specified' status of AS 3 is applicable in respect of accounting periods commencing on or after 1-4-2002.

4. Accordingly, in view of the announcements published in the Institute's Journal from time to time, in respect of 'specified' status of Accounting Standards, read with this announcement, the extant position is that all the accounting standards, issued by the Institute which have been made mandatory by the Institute as indicated in the respective standards or made mandatory by way of a separate announcement are 'specified' for the purpose of the proviso to section 211 (3C) and section 227 (3)(d) of the Act.

XVI. Applicability of Accounting Standards to Co-operative Societies[60]

The following is the General Clarification (GC) - 12/2002, issued by the Accounting Standards Board of the Institute of Chartered Accountants of India, on applicability of Accounting Standards to co-operative societies:

Paragraph 3.3 of the 'Preface to the Statements of Accounting Standards'[61] provides, inter alia, as below:

[59] It may be noted that the Accounting Standards have been notified on 7th December, 2006, by the Central Government under the Companies (Accounting Standards) Rules, 2006.

[60] Published in October 2002 issue of 'The Chartered Accountant', pp. 313, as General Clarification (GC) - 12/2002.
With the issuance of the Preface to the Statements of Accounting Standards (revised 2004), this Announcement (GC-12/2002) stands superseded.

[61] With the issuance of the Preface to the Statements of Accounting Standards (revised 2004), the Preface to the Statements of Accounting Standards, issued in January, 1979, stands superseded.

> "3.3 The Institute will issue the Accounting Standards for use in the presentation of the general purpose financial statements issued to the public by such commercial, industrial or business enterprises as may be specified by the Institute from time to time and subject to the attest function of its members."

In view of the above, the accounting standards issued by the Institute shall apply in respect of financial statements of co-operative societies, which carry on commercial, industrial or business activities, and are subject to the attest function of the members of the Institute. The Accounting Standards made mandatory by the Institute, as specified in the respective standards or made mandatory by separate announcements, are also mandatory in respect of co-operative societies.

For the removal of doubts, it is clarified that even if a very small proportion of the activities of a co-operative society is considered to be commercial, industrial or business in nature, then it can not claim exemption from the application of Accounting Standards. The Accounting Standards would apply to all its activities including those which are not commercial, industrial or business in nature.

It is reiterated that mandatory status of an accounting standard implies that it will be the duty of the members of the Institute to examine whether the Accounting Standard is complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the 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.

XVII. APPLICABILITY OF ACCOUNTING STANDARDS[62]

The Council, at its 236th meeting, held on September 16-18, 2003, considered the matter relating to applicability of Accounting Standards to Small and

[62] Published in 'The Chartered Accountant', November 2003 (pp. 480-489). It may be noted that, subsequently, the Announcement was partially modified pursuant to a limited revision to AS 20, Earnings Per Share (published in 'The Chartered Accountant', Feb. 2004 (pp. 817-818)). This Announcement incorporates the consequent modifications.

It may be noted that pursuant to notification of Accounting Standards by Central Government, the Institute has issued an Announcement regarding 'Harmonisation of various differences between the Accounting Standards issued by the ICAI and the Accounting Standards notified by the Central Government', which inter alia, deals with applicability of Accounting Standards to various entities. Accordingly, this Announcement stands Superseded (see Announcement XXXVIII). Another Announcement has been issued by the Council for 'Revision in the Criteria for classifying Level II non-corporate entities' (See Announcement XLII).

Medium Sized Enterprises (SMEs). The Council decided the following scheme for applicability of accounting standards to SMEs. This scheme comes into effect in respect of accounting periods commencing on or after 1-4-2004.

1. For the purpose of applicability of Accounting Standards, enterprises are classified into three categories, viz., Level I, Level II and Level III. Level II and Level III enterprises are considered as SMEs. The criteria for different levels are given in Annexure I.

2. Level I enterprises are required to comply fully with all the accounting standards.

3. It has been decided that no relaxation should be given to Level II and Level III enterprises in respect of recognition and measurement principles. Relaxations are provided with regard to disclosure requirements. Accordingly, Level II and Level III enterprises are fully exempted from certain accounting standards which primarily lay down disclosure requirements. In respect of certain other accounting standards, which lay down recognition, measurement and disclosure requirements, relaxations from certain disclosure requirements are given. The exemptions/relaxations are decided to be provided by modifying the applicability portion of the relevant accounting standards. Modifications in the relevant existing accounting standards are given in Annexure II.

4. Applicability of Accounting Standards and exemptions/ relaxations for SMEs

So far, the Institute has issued 29 accounting standards. The applicability of the accounting standards and exemptions/relaxations for SMEs are as follows:

I. Accounting Standards applicable to all enterprises in their entirety (Levels I, II and III)

(i) AS 1, Disclosure of Accounting Policies

(ii) AS 2, Valuation of Inventories

(iii) AS 4, Contingencies and Events Occurring After the Balance Sheet Date

(iv) AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

(v) AS 6, Depreciation Accounting

(vi) AS 7 (revised 2002), Construction Contracts[63]

AS 7 (issued 1983), Accounting for Construction Contracts

(vii) AS 8, Accounting for Research and Development[64]

(viii) AS 9, Revenue Recognition

(ix) AS 10, Accounting for Fixed Assets

(x) AS 11 (revised 2003), The Effects of Changes in Foreign Exchange Rates[65]

AS 11 (revised 1994), Accounting for the Effects of Changes in Foreign Exchange Rates

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[63] The revised AS 7 (2002) came into effect in respect of all contracts entered into during accounting periods commencing on or after 1-4-2003 and is mandatory in nature from that date. Accordingly, the pre-revised AS 7 (issued 1983) is not applicable in respect of such contracts.

[64] AS 8 is withdrawn from the date AS 26, Intangible Assets, becoming mandatory for the concerned enterprises. AS 26 is mandatory in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2003 for the following:

(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

(ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs. 50 crores.

In respect of all other enterprises, AS 26 is mandatory in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2004.

[65] The revised AS 11 (2003) has come into effect in respect of accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date. The revised Standard (2003) supersedes AS 11 (1994), except that in respect of accounting for transactions in foreign currencies entered into by the reporting enterprise itself or through its branches before the date the revised AS 11 (2003) came into effect, AS 11 (1994) continues to be applicable. See also Announcements XVIII, XXII, XXXI, XXXII, XXXIII, XXXV, XXXVI, XL, XLIII and XLIV reproduced hereafter.

(xi) AS 12, Accounting for Government Grants

(xii) AS 13, Accounting for Investments

(xiii) AS 14, Accounting for Amalgamations

(xiv) AS 15, Accounting for Retirement Benefits in the Financial Statements of Employers[66]

(xv) AS 16, Borrowing Costs

(xvi) AS 22, Accounting for Taxes on Income

(xvii) AS 26, Intangible Assets

II. Exemptions/Relaxations for SMEs

(A) Accounting Standards not applicable to Level II and Level III enterprises in their entirety:

(i) AS 3, Cash Flow Statements

(ii) AS 17, Segment Reporting

(iii) AS 18, Related Party Disclosures[68]

(iv) AS 24, Discontinuing Operations.[69]

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[66] AS 15 (issued 1995) has been revised in 2005 and titled as 'Employee Benefits'. Subsequently, two limited revisions have also been made to AS 15 (revised 2005). AS 15 (revised 2005), after incorporating the said Limited Revisions, came into effect in respect of accounting periods commencing on or after December 7, 2006. In AS 15 (revised 2005), certain exemptions/ relaxations from recognition, measurement and disclosure requirements have been provided to SMCs, non-corporate entities falling in Level II and Level III. AS 15 (revised 2005) is published elsewhere in this Compendium.

[67] See Announcement XXI also.

[68] Pursuant to Notification of Accounting Standards by the Central Government, AS 18 is applicable in its entirety to all the companies and non-corporate entities falling in Level I and Level II (See Announcements XXXVIII and XLII).

[69] Pursuant to Notification of Accounting Standards by the Central Government, AS 24 is applicable in its entirety to all the companies and non-corporate entities falling in Level I and Level II (See Announcements XXXVIII and XLII).

(B) Accounting Standards not applicable to Level II and Level III enterprises since the relevant Regulators require compliance with them only by certain Level I enterprises[70] *:*

(i) AS 21, Consolidated Financial Statements

(ii) AS 23, Accounting for Investments in Associates in Consolidated Financial Statements

(iii) AS 27, Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to consolidated financial statements)

(C) Accounting Standards in respect of which relaxations from certain disclosure requirements have been given to Level II and Level III enterprises:

(i) AS 19, Leases

Paragraphs 22(c), (e) and (f); 25(a), (b) and (e); 37(a), (f) and (g); and 46(b), (d) and (e), of AS 19 are not applicable to Level II and Level III enterprises.

(ii) AS 20, Earnings Per Share

As regards AS 20, diluted earnings per share (both including and excluding extraordinary items) and information required by paragraph 48 (ii) of AS 20 are not required to be disclosed by Level II and Level III enterprises if this standard is applicable to these enterprises because they disclose earnings per share. So far as companies are concerned, since all the companies are required to apply AS 20 by virtue of the provisions of Part IV of Schedule VI to the Companies Act, 1956, requiring disclosure of earnings per share, the position is that the companies which do not fall in Level I, would not be required to disclose diluted earnings per share (both including and excluding extraordinary items) and information required by paragraph 48 (ii) of AS 20.

[70] For current status of applicability of AS 21, AS 23 and AS 27 (relating to consolidated financial statements) refer Appendix 1 to the Compendium 'Applicability of Accounting Standards to various Entities'.

(iii) AS 29, Provisions, Contingent Liabilities and Contingent Assets

- Paragraph 67 is not applicable to Level II enterprises
- Paragraphs 66 and 67 are not applicable to Level III enterprises

The above relaxations are incorporated in AS 29 itself.

(D) Accounting Standard applicability of which is deferred for Level II and Level III enterprises:

AS 28, Impairment of Assets [71]

– For Level I Enterprises applicable from 1-4-2004

– For Level II Enterprises applicable from 1-4-2006

– For Level III Enterprises applicable from 1-4-2008

(E) AS 25, Interim Financial Reporting, does not require any enterprise to present interim financial report. It is applicable only if an enterprise is required or elects to prepare and present an interim financial report. However, the recognition and measurement requirements contained in this Standard are applicable to interim financial results, e.g., quarterly financial results required by the SEBI.

At present, in India, enterprises are not required to present interim financial report within the meaning of AS 25. Therefore, no enterprise in India is required to comply with the disclosure and presentation requirements of AS 25 unless it voluntarily presents interim financial report within the meaning of AS 25. The recognition and measurement principles contained in AS 25 are also applicable only to certain Level I enterprises since only these enterprises are required by the concerned regulators to present interim financial results.

In view of the above, at present, AS 25 is not mandatorily applicable to Level II and Level III enterprises in any case.

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[71] Subsequently, the Council of the Institute has decided to provide relaxations from measurement principles contained in AS 28, *Impairment of Assets*, to Level II and Level III enterprises. For full text of the Announcement issued in this regard, reference may be made to Announcement XXIX published hereinafter.

5. An enterprise which does not disclose certain information pursuant to the above exemptions/relaxations, should disclose the fact.

6. Where an enterprise has previously qualified for any exemption/ relaxation (being under Level II or Level III), but no longer qualifies for the relevant exemption/relaxation in the current accounting period, the relevant standards/requirements become applicable from the current period. However, the corresponding previous period figures need not be disclosed.

7. Where an enterprise has been covered in Level I and subsequently, ceases to be so covered, the enterprise will not qualify for exemption/ relaxation available to Level II enterprises, until the enterprise ceases to be covered in Level I for two consecutive years. Similar is the case in respect of an enterprise, which has been covered in Level I or Level II and subsequently, gets covered under Level III.

Annexure I

Criteria for classification of enterprises

Level I Enterprises

Enterprises which fall in any one or more of the following categories, at any time during the accounting period, are classified as Level I enterprises:

(i) Enterprises whose equity or debt securities are listed whether in India or outside India.

(ii) Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.

(iii) Banks including co-operative banks.

(iv) Financial institutions.

(v) Enterprises carrying on insurance business.

(vi) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 50 crore. Turnover does not include 'other income'.

(vii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 10 crore at any time during the accounting period.

(viii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.[72]

Level II Enterprises

Enterprises which are not Level I enterprises but fall in any one or more of the following categories are classified as Level II enterprises:

(i) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 40 lakhs but does not exceed Rs. 50 crore. Turnover does not include 'other income'.

(ii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 1 crore but not in excess of Rs. 10 crore at any time during the accounting period.

(iii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

Level III Enterprises

Enterprises which are not covered under Level I and Level II are considered as Level III enterprises.

[72] The Institute has issued an Announcement in 2005 titled 'Applicability of Accounting Standards to an Unlisted Indian Company, which is a Subsidiary of a Foreign Company Listed Outside India' (published in 'The Chartered Accountant', August 2005 (pp. 338-339)). For full text of the Announcement, reference may be made to Announcement XXVII published hereinafter.

Annexure II

Modifications in the relevant existing accounting standards to address the matter relating to Small and Medium Sized enterprises

Note: Modifications are indicated as strike-throughs for deletions and as underlines for additions.

1. Modifications in AS 3, Cash Flow Statements

The 'applicability' paragraphs of AS 3 stand modified as under:

"~~The following is the text of the revised Accounting Standard (AS) 3, 'Cash Flow Statements', issued by the Council of the Institute of Chartered Accountants of India. This Standard supersedes Accounting Standard (AS) 3, 'Changes in Financial Position', issued in June, 1981.~~

~~In the initial years, this accounting standard will be recommendatory in character. During this period, this standard is recommended for use by companies listed on a recognised stock exchange and other commercial, industrial and business enterprises in the public and private sectors.~~

Accounting Standard (AS) 3, 'Cash Flow Statements' (revised 1997), issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-1997. This Standard supersedes Accounting Standard (AS) 3, 'Changes in Financial Position', issued in June 1981. This Standard is mandatory in nature in respect of accounting periods commencing on or after 1-4-2004[73] for the enterprises which fall in any one or more of the following categories, at any time during the accounting period:

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[73] AS 3 was originally made mandatory in respect of accounting periods commencing on or after 1-4-2001, for the following:

(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

(ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs. 50 crores.

The relevant announcement was published in 'The Chartered Accountant', December 2000, page 65.

(i) Enterprises whose equity or debt securities are listed whether in India or outside India.

(ii) Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.

(iii) Banks including co-operative banks.

(iv) Financial institutions.

(v) Enterprises carrying on insurance business.

(vi) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 50 crore. Turnover does not include 'other income'.

(vii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 10 crore at any time during the accounting period.

(viii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

The enterprises which do not fall in any of the above categories are encouraged, but are not required, to apply this Standard.

Where an enterprise has been covered in any one or more of the above categories and subsequently, ceases to be so covered, the enterprise will not qualify for exemption from application of this Standard, until the enterprise ceases to be covered in any of the above categories for two consecutive years.

Where an enterprise has previously qualified for exemption from application of this Standard (being not covered by any of the above categories) but no longer qualifies for exemption in the current accounting period, this Standard becomes applicable from the current period. However, the corresponding previous period figures need not be disclosed.

An enterprise, which, pursuant to the above provisions, does not present a cash flow statement, should disclose the fact.

The following is the text of the Accounting Standard."

The above modifications come into effect in respect of accounting periods commencing on or after 1-4-2004. Accordingly, the announcement issued by the Council titled as 'Accounting Standard (AS) 3, Cash Flow Statements Made Mandatory', published in the December 2000 issue of the Institute's Journal (page 65) stands withdrawn in respect of accounting periods commencing on or after 1-4-2004.

2. Modifications in AS 17, Segment Reporting

The 'applicability' paragraph of AS 17 stands modified as under:

"~~The following is the text of~~ Accounting Standard (AS) 17, 'Segment Reporting', issued by the Council of the Institute of Chartered Accountants of India, ~~. This Standard~~ comes into effect in respect of accounting periods commencing on or after 1.4.2001. ~~and is mandatory in nature, from that date, in respect of the following:~~

~~(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.~~

~~(ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs. 50 crores.~~

This Standard is mandatory in nature in respect of accounting periods commencing on or after 1-4-2004[74] for the enterprises which fall in any one or more of the following categories, at any time during the accounting period:

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[74] AS 17 was originally made mandatory in respect of accounting periods commencing on or after 1-4-2001 for the following enterprises:

(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

(ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs. 50 crores.

(i) Enterprises whose equity or debt securities are listed whether in India or outside India.

(ii) Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.

(iii) Banks including co-operative banks.

(iv) Financial institutions.

(v) Enterprises carrying on insurance business.

(vi) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 50 crore. Turnover does not include 'other income'.

(vii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 10 crore at any time during the accounting period.

(viii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

The enterprises which do not fall in any of the above categories are not required to apply this Standard.

Where an enterprise has been covered in any one or more of the above categories and subsequently, ceases to be so covered, the enterprise will not qualify for exemption from application of this Standard, until the enterprise ceases to be covered in any of the above categories for two consecutive years.

Where an enterprise has previously qualified for exemption from application of this Standard (being not covered by any of the above categories) but no longer qualifies for exemption in the current accounting period, this Standard becomes applicable from the current period. However, the corresponding previous period figures need not be disclosed.

An enterprise, which, pursuant to the above provisions, does not disclose segment information, should disclose the fact.

The following is the text of the Accounting Standard."

The above modifications come into effect in respect of accounting periods commencing on or after 1-4-2004.

3. Modifications in AS 18, Related Party Disclosures

The 'applicability' paragraph of AS 18 stands modified as under:

"~~The following is the text of Accounting Standard (AS) 18, 'Related Party Disclosures', issued by the Council of the Institute of Chartered Accountants of India. This Standard comes into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature.~~

Accounting Standard (AS) 18, 'Related Party Disclosures', issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2001. This Standard is mandatory in nature in respect of accounting periods commencing on or after 1-4-2004[75] for the enterprises which fall in any one or more of the following categories, at any time during the accounting period:

(i) Enterprises whose equity or debt securities are listed whether in India or outside India.

(ii) Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.

(iii) Banks including co-operative banks.

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[75] AS 18 was earlier made mandatory in respect of accounting periods commencing on or after 1-4-2001 only for the following enterprises:

(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

(ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs. 50 crores.

The relevant announcement was published in 'The Chartered Accountant', April 2002, page 1242.

(iv) Financial institutions.

(v) Enterprises carrying on insurance business.

(vi) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 50 crore. Turnover does not include 'other income'.

(vii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 10 crore at any time during the accounting period.

(viii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

The enterprises which do not fall in any of the above categories are not required to apply this Standard.

Where an enterprise has been covered in any one or more of the above categories and subsequently, ceases to be so covered, the enterprise will not qualify for exemption from application of this Standard, until the enterprise ceases to be covered in any of the above categories for two consecutive years.

Where an enterprise has previously qualified for exemption from application of this Standard (being not covered by any of the above categories) but no longer qualifies for exemption in the current accounting period, this Standard becomes applicable from the current period. However, the corresponding previous period figures need not be disclosed.

An enterprise, which, pursuant to the above provisions, does not make related party disclosures, should disclose the fact.

The following is the text of the Accounting Standard."

The above modifications come into effect in respect of accounting periods commencing on or after 1-4-2004. Accordingly, the announcement issued by the Council titled as 'Applicability of Accounting Standard (AS) 18, Related Party Disclosures', published in the April 2002 issue of the Institute's Journal (page 1242) stands withdrawn in respect of accounting periods commencing on or after 1-4-2004.

4. Modifications in AS 19, Leases

The 'applicability' paragraph of AS 19 stands modified as under:

"~~The following is the text of~~ Accounting Standard (AS) 19, 'Leases', issued by the Council of the Institute of Chartered Accountants of India,~~.~~ ~~This Standard~~ comes into effect in respect of all assets leased during accounting periods commencing on or after 1.4.2001 and is mandatory in nature from that date. Accordingly, the 'Guidance Note on Accounting for Leases' issued by the Institute in 1995, is not applicable in respect of such assets. Earlier application of this Standard is, however, encouraged.

In respect of accounting periods commencing on or after 1-4-2004[76] , an enterprise which does not fall in any of the following categories need not disclose the information required by paragraphs 22(c), (e) and (f); 25(a), (b) and (e); 37(a), (f) and (g); and 46(b), (d) and (e), of this Standard:

(i) Enterprises whose equity or debt securities are listed whether in India or outside India.

(ii) Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.

(iii) Banks including co-operative banks.

(iv) Financial institutions.

(v) Enterprises carrying on insurance business.

(vi) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 50 crore. Turnover does not include 'other income'.

(vii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 10 crore at any time during the accounting period.

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[76] AS 19 was originally made mandatory, in its entirety, for all enterprises in respect of all assets leased during accounting periods commencing on or after 1-4-2001.

(viii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

In respect of an enterprise which falls in any one or more of the above categories, at any time during the accounting period, the Standard is applicable in its entirety.

Where an enterprise has been covered in any one or more of the above categories and subsequently, ceases to be so covered, the enterprise will not qualify for exemption from paragraphs 22(c), (e) and (f); 25(a), (b) and (e); 37(a), (f) and (g); and 46(b), (d) and (e), of this Standard, until the enterprise ceases to be covered in any of the above categories for two consecutive years.

Where an enterprise has previously qualified for exemption from paragraphs 22(c), (e) and (f); 25(a), (b) and (e); 37(a), (f) and (g); and 46(b), (d) and (e), of this Standard (being not covered by any of the above categories) but no longer qualifies for exemption in the current accounting period, this Standard becomes applicable, in its entirety, from the current period. However, the corresponding previous period figures in respect of above paragraphs need not be disclosed.

An enterprise, which, pursuant to the above provisions, does not disclose the information required by paragraphs 22(c), (e) and (f); 25(a), (b) and (e); 37(a), (f) and (g); and 46(b), (d) and (e) should disclose the fact.

The following is the text of the Accounting Standard."

The above modifications come into effect in respect of accounting periods commencing on or after 1-4-2004.

5. Modifications in AS 20, Earnings Per Share

The 'applicability' paragraph of AS 20 stands modified as under:

"Accounting Standard (AS) 20, 'Earnings Per Share', issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature, from that date, in respect of enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India.

An enterprise which has neither equity shares nor potential equity shares which are so listed but which discloses earnings per share, should calculate and disclose earnings per share in accordance with this Standard from the aforesaid date. ~~The following is the text of the Accounting Standard.~~ However, in respect of accounting periods commencing on or after 1-4-2004, if any such enterprise does not fall in any of the following categories, it need not disclose diluted earnings per share (both including and excluding extraordinary items) and information required by paragraph 48 (ii) of this Standard[77]:

(i) Enterprises whose equity securities or potential equity securities are listed outside India and enterprises whose debt securities (other than potential equity securities) are listed whether in India or outside India.

(ii) Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.

(iii) Banks including co-operative banks.

(iv) Financial institutions.

(v) Enterprises carrying on insurance business.

(vi) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 50 crore. Turnover does not include 'other income'.

(vii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 10 crore at any time during the accounting period.

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[77] Originally, no exemption was available to an enterprise, which had neither equity shares nor potential equity shares which were listed on a recognised stock exchange in India, but which disclosed earnings per share. It is clarified that no exemption is available even in respect of accounting periods commencing on or after 1-4-2004 to enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India. It is also clarified that this Standard is not applicable to an enterprise which has neither equity shares nor potential equity shares which are listed on a recognised stock exchange in India and which also does not disclose earnings per share.

(viii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

Where an enterprise (which has neither equity shares nor potential equity shares which are listed on a recognised stock exchange in India but which discloses earnings per share) has been covered in any one or more of the above categories and subsequently, ceases to be so covered, the enterprise will not qualify for exemption from the disclosure of diluted earnings per share (both including and excluding extraordinary items) and paragraph 48 (ii) of this Standard, until the enterprise ceases to be covered in any of the above categories for two consecutive years.

Where an enterprise (which has neither equity shares nor potential equity shares which are listed on a recognised stock exchange in India but which discloses earnings per share) has previously qualified for exemption from the disclosure of diluted earnings per share (both including and excluding extraordinary items) and paragraph 48 (ii) of this Standard (being not covered by any of the above categories) but no longer qualifies for exemption in the current accounting period, this Standard becomes applicable, in its entirety, from the current period. However, the relevant corresponding previous period figures need not be disclosed.

If an enterprise (which has neither equity shares nor potential equity shares which are listed on a recognised stock exchange in India but which discloses earnings per share), pursuant to the above provisions, does not disclose the diluted earnings per share (both including and excluding extraordinary items) and information required by paragraph 48 (ii), it should disclose the fact.

The following is the text of the Accounting Standard."

The above modifications come into effect in respect of accounting periods commencing on or after 1-4-2004.

6. Modifications in AS 24, Discontinuing Operations

The 'applicability' paragraph of AS 24 stands modified as under:

"Accounting Standard (AS) 24, 'Discontinuing Operations', issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2004.

~~is recommendatory in nature at present. The following is the text of the Accounting Standard.~~ This Standard is mandatory in nature in respect of accounting periods commencing on or after 1-4-2004[78] for the enterprises which fall in any one or more of the following categories, at any time during the accounting period:

(i) Enterprises whose equity or debt securities are listed whether in India or outside India.

(ii) Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.

(iii) Banks including co-operative banks.

(iv) Financial institutions.

(v) Enterprises carrying on insurance business.

(vi) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 50 crore. Turnover does not include 'other income'.

(vii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 10 crore at any time during the accounting period.

(viii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

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[78] It was originally decided to make AS 24 mandatory in respect of accounting periods commencing on or after 1-4-2004 for the following:

(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

(ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs. 50 crores.

In respect of all other enterprises, it was originally decided to make the Standard mandatory in respect of accounting periods commencing on or after 1-4-2005.

The relevant announcement was published in 'The Chartered Accountant', May 2002, page 1378.

Earlier application is encouraged.

The enterprises which do not fall in any of the above categories are not required to apply this Standard.

Where an enterprise has been covered in any one or more of the above categories and subsequently, ceases to be so covered, the enterprise will not qualify for exemption from application of this Standard, until the enterprise ceases to be covered in any of the above categories for two consecutive years.

Where an enterprise has previously qualified for exemption from application of this Standard (being not covered by any of the above categories) but no longer qualifies for exemption in the current accounting period, this Standard becomes applicable from the current period. However, the corresponding previous period figures need not be disclosed.

An enterprise, which, pursuant to the above provisions, does not present the information relating to the discontinuing operations, should disclose the fact.

The following is the text of the Accounting Standard."

The above modifications come into effect in respect of accounting periods commencing on or after 1-4-2004. Accordingly, the announcement issued by the Council titled as 'Accounting Standard (AS) 24, Discontinuing Operations', published in the May 2002 issue of the Institute's Journal (page 1378) stands withdrawn in respect of accounting periods commencing on or after 1-4-2004.

7. Modifications in AS 28, Impairment of Assets[79]

The 'applicability' paragraphs of AS 28 stand modified as under:

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[79]With a view to provide relaxations from measurement principles contained in AS 28, *Impairment of Assets*, to Small and Medium-sized Enterprises (SMEs), the Council of the Institute has issued an Announcement titled 'Applicability of Accounting Standard (AS) 28, Impairment of Assets, to Small and Medium Sized Enterprises (SMEs)' (published in 'The Chartered Accountant', November 2005 (pp. 777-778)). For full text of the Announcement, reference may be made to Announcement XXIX published hereinafter.

"Accounting Standard (AS) 28, 'Impairment of Assets', issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2004. ~~and is mandatory in nature from that date for the following:~~

This Standard is mandatory in nature in respect of accounting periods commencing on or after:

(a) 1-4-2004[80], for the enterprises, which fall in any one or more of the following categories, at any time during the accounting period:

(i) Enterprises whose equity or debt securities are listed whether in India or outside India.

(ii) Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.

(iii) Banks including co-operative banks.

(iv) Financial institutions.

(v) Enterprises carrying on insurance business.

(vi) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 50 crore. Turnover does not include 'other income'.

(vii) All commercial, industrial and business reporting enterprises having borrowings including public deposits, in excess of Rs. 10 crore at any time during the accounting period.

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[80] It was originally decided to make AS 28 mandatory in respect of accounting periods commencing on or after 1-4-2004 for the following:

(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

(ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs. 50 crores.

In respect of all other enterprises, it was originally decided to make AS 28 mandatory in respect of accounting periods commencing on or after 1-4-2005.

(viii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

(b) 1-4-2006[81], for the enterprises which do not fall in any of the categories in (a) above but fall in any one or more of the following categories:

(i) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 40 lakhs but does not exceed Rs. 50 crore. Turnover does not include 'other income'.

(ii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 1 crore but not in excess of Rs. 10 crore at any time during the accounting period.

(iii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

(c) 1-4-2008[82], for the enterprises, which do not fall in any of the categories in (a) and (b) above.

~~(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.~~

~~(ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs. 50 crores.~~

~~In respect of all other enterprises, the Accounting Standard comes into effect in respect of accounting periods commencing on or after 1-4-2005 and is mandatory in nature from that date.~~

Earlier application of the Accounting Standard is encouraged.

The following is the text of the Accounting Standard."

The above modifications come into effect in respect of accounting periods commencing on or after 1-4-2004.

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81 *ibid.*

82 *ibid.*

Note: In all the above modifications, the footnote clarifying the implications of 'mandatory' status of an accounting standard, will continue to appear whenever the word 'mandatory' is used for the first time as it presently appears in the respective standards.

XVIII. Treatment of exchange differences under Accounting Standard (AS) 11 (revised 2003), The Effects of Changes in Foreign Exchange Rates vis-à-vis Schedule VI to the Companies Act, 1956[83]

1. The revised Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates, was published in the March 2003 issue of the Institute's Journal, 'The Chartered Accountant', (pp. 916 to 922). Revised AS 11 will come into effect in respect of accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date. The revised Standard will supersede Accounting Standard (AS) 11, Accounting for the Effects of Changes in Foreign Exchange Rates (1994), except that in respect of accounting for transactions in foreign currencies entered into by the reporting enterprise itself or through its branches before the date this Standard comes into effect, AS 11 (1994) will continue to be applicable.

2. In this context, it may be noted that Schedule VI to the Companies Act, 1956, provides, inter alia, that where the original cost and additions and deductions thereto, relate to any fixed asset which has been acquired from a country outside India, and in consequence of a change in the rate of exchange at any time after the acquisition of such asset, there has been an increase or reduction in the liability of the company, as expressed in Indian currency, for making payment towards the whole or a part of the cost of the asset or for repayment of the whole or a part of moneys borrowed by the company from any person, directly or indirectly, in any foreign currency specifically for the purpose of acquiring the assets (being in either case the liability existing immediately before the date on which the change in the rate of exchange takes effect), the amount by which the liability is so increased or reduced during the year, shall be added to, or, as the case may be, deducted from the cost, and the amount arrived at after such addition or deduction shall be taken to be the cost of the fixed asset.

[83] Published in 'The Chartered Accountant', November 2003 (pp. 497). This Announcement has been withdrawn by the Council at its 269th meeting held on July 18, 2007 (See Announcement XXXVI).

3. The revised AS 11 (2003), however, does not require the adjustment of exchange differences in the carrying amount of the fixed assets, in the situations envisaged in Schedule VI to the Companies Act, 1956 (see para 13 of revised AS 11). As per revised AS 11 (2003), such exchange differences are required to be recognised in the statement of profit and loss since it is felt that this treatment is conceptually preferable to that required in Schedule VI and is in consonance with the international position in this regard.

4. It may be mentioned that the Institute has decided to take up this aspect with the Government to consider the same in the revision of Schedule VI to the Companies Act, 1956. It may be noted that where a requirement of an accounting standard is different from the applicable law, the law prevails. Accordingly, a requirement of an accounting standard is not applicable to the extent it is in conflict with the requirement of the relevant law. Thus, pending the amendment, if any, to Schedule VI to the Companies Act, 1956, in respect of the matter, a company adopting the treatment described in paragraph 2 above will still be considered to be complying with AS 11 for the purposes of section 211 of the Act. Accordingly, the auditor of the company should not assert non-compliance with AS 11 (2003) under section 227(3)(d) of the Act in such a case and should not qualify his report in this regard on the true and fair view of the state of the company's affairs and profit or loss of the company under section 227(2) of the Act.

XIX. Applicability of Accounting Standard (AS) 26, Intangible Assets, to intangible items[84]

1. Accounting Standard (AS) 26, 'Intangible Assets', came into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2003 and is mandatory in nature from that date for the following:

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[84] Published in 'The Chartered Accountant', November 2003 (pp. 479). It may be noted that pursuant to a limited revision to AS 26, Intangible Assets, effective in respect of accounting periods commencing on or after 1-4-2003, this Announcement stands superseded to the extent it deals with VRS expenditure, from the aforesaid date (see 'The Chartered Accountant', April 2004 (pp. 1157)).

AS 15 (revised 2005), *inter alia*, deals with treatment of VRS expenditure. AS 15 (revised 2005) comes into effect in respect of accounting periods commencing on or after 01.04.2006. The said Standard is published elsewhere in this Compendium.

(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

(ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs. 50 crores.

In respect of all other enterprises, the Accounting Standard will come into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2004 and will be mandatory in nature from that date.

2. An issue has been raised as to what should be the treatment of the expenditure incurred on intangible items, which were treated as deferred revenue expenditure and ordinarily spread over a period of 3 to 5 years before AS 26 became mandatory and which do not meet the definition of an 'asset' as per AS 26. The examples of such items are expenditure incurred in respect of lump sum payment towards a Voluntary Retirement Scheme (VRS), preliminary expenses etc. In this context, it is clarified as below:

(i) The expenditure incurred on intangible items (referred to in paragraph 2 above) after the date AS 26 became/becomes mandatory (1-4-2003 or 1-4-2004, as the case may be) would have to be expensed when incurred since these do not meet the definition of an 'asset' as per AS 26.

(ii) In respect of the balances of the expenditure incurred on intangible items (referred to in paragraph 2 above) before the date AS 26 became/becomes mandatory, appearing in the balance sheet as on 1-4-2003 or 1-4-2004, as the case may be, paragraphs 99 and 100 of AS 26 are applicable.

In view of the above, it would not be proper to adjust the balances of such items against the revenue reserves as on 1-4-2003 or 1-4-2004, as the case may be, and such items should continue to be expensed over a number of years as originally contemplated, since as per the accounting principles relevant for deferred revenue expenditure in India, such expenditure is spread over a period which is normally less than the period contemplated in paragraph 63 of AS 26.

(iii) In case an enterprise has already adjusted the above referred balances of the intangible items appearing in the balance sheet as on 1-4-2003 against the opening balance of revenue reserves as on 1-4-2003, it should rectify the same on the basis of the above requirements.

XX. Applicability of AS 4 to impairment of assets not covered by present Indian Accounting Standards[85]

1. Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', issued by the Institute in November 2003, comes into effect in respect of accounting periods commencing on or after 1-4-2004. As per AS 29, from the date of this Accounting Standard becoming mandatory, all paragraphs of Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date, that deal with contingencies (viz., paragraphs 1 (a), 2, 3.1, 4 (4.1 to 4.4), 5 (5.1 to 5.6), 6, 7 (7.1 to 7.3), 9.1 (relevant portion), 9.2, 10, 11, 12 and 16), stand withdrawn.

2. Paragraph 7 of AS 29 provides that this Statement defines provisions as liabilities which can be measured only by using a substantial degree of estimation. It further provides that the term 'provision' is also used in the context of items such as depreciation, impairment of assets and doubtful debts: these are adjustments to the carrying amounts of assets and are not addressed in this Statement. In view of this, impairment of assets and doubtful debts are not covered by AS 29.

3. It may be noted that the paragraphs of AS 4 dealing with contingencies also cover provision for contingent loss in case of impairment of assets, not covered by other Accounting Standards, such as, AS 2, Valuation of Inventories, AS 10, Accounting for Fixed Assets, AS 13, Accounting for Investments and AS 28, Impairment of Assets (coming into effect from 1-4-2004). Accordingly, AS 4 deals with impairment of certain assets, for example, the impairment of financial assets like receivables (commonly referred to as the provision for bad and doubtful debts).

4. As may be noted from paragraph 1 above, pursuant to AS 29 coming into effect, the paragraphs of AS 4 that deal with contingencies stand withdrawn. It may further be noted that while impairment of certain assets is covered by some existing Accounting Standards referred to in paragraph 3 above, impairment of financial assets such as receivables, which are not

[85] Published in 'The Chartered Accountant', April 2004 (pp. 1151).

covered by AS 29, is expected to be covered in an Accounting Standard on Financial Instruments: Recognition and Measurement, which is under preparation.

5. In view of the above, it is brought to the notice of the members and others that till the issuance of the proposed Accounting Standard on financial instruments, the paragraphs of AS 4 which deal with contingencies would remain operational to the extent they cover the impairment of assets not covered by other Indian Accounting Standards. Thus, for instance, impairment of receivables (commonly referred to as the provision for bad and doubtful debts) would continue to be covered by AS 4.

XXI. Deferment of the Applicability of AS 22 to Non-corporate Enterprises[86]

Non-corporate enterprises, such as sole proprietors, partnership firms, trusts, Hindu Undivided Families, association of persons and co-operative societies will now be required to follow Accounting Standard (AS) 22, Accounting for Taxes on Income, in respect of accounting periods commencing on or after 1-4-2006. The decision to this effect has been taken by the Council of the Institute of Chartered Accountants of India (ICAI), at its meeting, held on June 24-26, 2004. The applicability of AS 22 has been deferred for those non-corporate enterprises which were required to follow AS 22 in respect of accounting periods commencing on or after 1-4-2003.

It may be noted that the applicability paragraphs of AS 22 provided as below:

> "Accounting Standard (AS) 22, 'Accounting for Taxes on Income', issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2001. It is mandatory in nature for:
>
> (a) All the accounting periods commencing on or after 01.04.2001, in respect of the following:

[86] Published in 'The Chartered Accountant', July 2004 (pp. 119).

(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

(ii) All the enterprises of a group, if the parent presents consolidated financial statements and the Accounting Standard is mandatory in nature in respect of any of the enterprises of that group in terms of (i) above.

(b) All the accounting periods commencing on or after 01.04.2002, in respect of companies not covered by (a) above.

(c) All the accounting periods commencing on or after 01.04.2003, in respect of all other enterprises."

The decision to defer the applicability of AS 22 to enterprises covered by (c) above so as to make it mandatory in respect of accounting periods commencing on or after 1-4-2006 instead of 1-4-2003 has been taken by the Council on a consideration of certain representations and views expressed at various forums. This decision has been taken with a view to provide some more time to such enterprises for effective implementation of AS 22.

XXII. 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[87]

1. The revised Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates, was published in the March 2003 issue of the Institute's Journal, 'The Chartered Accountant' (pp. 916 to 922). AS 11 (revised 2003) has come into effect in respect of accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date.

[87] Issued on the basis of the decision of the Council at its meeting held on June 24-26, 2004.

2. AS 11 (revised 2003) deals, inter alia, with forward exchange contracts. Paragraphs 36 and 37 of AS 11 (revised 2003) deal with accounting for a forward exchange contract or any other financial instrument that is in substance a forward exchange contract, which is not intended for trading or speculation purposes, i.e., it is for hedging purposes. Paragraphs 38 and 39 of AS 11 (revised 2003) deal with forward exchange contracts intended for trading or speculation purposes.

3. An issue has been raised regarding the applicability of AS 11 (revised 2003) to the exchange difference arising on a forward exchange contract or any other financial instrument that is in substance a forward exchange contract (hereinafter the term 'forward exchange contract' is used to include such other financial instruments also), entered into by an enterprise to hedge the foreign currency risk of a firm commitment[88] or a highly probable forecast transaction[89].

4. In this regard, it may be noted that paragraphs 36 and 37 of AS 11 (revised 2003) are not intended to deal with forward exchange contracts which are entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction. Further, paragraphs 38 and 39 are also not applicable in respect of such forward exchange contracts since these contracts are not for trading or speculation purposes. Accordingly, it is clarified 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.[90]

5. It may be noted that the hedge accounting, in its entirety, including hedge of a firm commitment or a highly probable forecast transaction, is proposed to be dealt with in the accounting standard on Financial Instruments: Recognition and Measurement, which is presently under formulation.

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[88] 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.

[89] A forecast transaction is an uncommitted but anticipated future transaction.

[90] It has been separately clarified that AS 11 continues to be applicable to exchange differences in respect of all forward exchange contracts other than those entered into, to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction (published in 'The Chartered Accountant', August 2004, pp. 187). For subsequent developments in this regard, see also Announcements XXXI, XXXII, XXXIII, XXXVI and XL published hereinafter.

XXIII. Elimination of unrealised profits and losses under AS 21, AS 23 and AS 27[91]

Accounting Standard (AS) 21, Consolidated Financial Statements, came into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory from that date if an enterprise presents consolidated financial statements. Paragraph 16 of AS 21 requires that intragroup balances and intragroup transactions and resulting unrealised profits should be eliminated in full. It further provides that unrealised losses resulting from intragroup transactions should also be eliminated unless cost cannot be recovered.

There may be transactions between a parent and its subsidiary(ies) entered into during accounting periods commencing on or after 31-3-2001. While preparing consolidated financial statements, in respect of some of the transactions entered into during accounting periods commencing on or before 31-3-2001, it may not be practicable to eliminate resulting unrealised profits and losses. It has, therefore, been decided that elimination of unrealised profits and losses in respect of transactions entered into during accounting periods commencing on or before 31-3-2001, is encouraged, but not required on practical grounds.

The above position also applies in respect of AS 23, Accounting for Investments in Associates in Consolidated Financial Statements and AS 27, Financial Reporting of Interests in Joint Ventures while applying the 'equity method' and 'proportionate consolidation method' respectively.

XXIV. Disclosures in cases where a Court/Tribunal makes an order sanctioning an accounting treatment which is different from that prescribed by an Accounting Standard[92]

Paragraph 4.2 of the 'Preface to the Statements of Accounting Standards' (revised 2004) provides as under:

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[91] Published in 'The Chartered Accountant', July 2004 (pp. 46).

[92] Published in 'The Chartered Accountant', December 2004 (pp. 825).

> "4.2 The Accounting Standards by their very nature cannot and do not override the local regulations which govern the preparation and presentation of financial statements in the country. However, the ICAI will determine the extent of disclosure to be made in financial statements and the auditor's report thereon. Such disclosure may be by way of appropriate notes explaining the treatment of particular items. Such explanatory notes will be only in the nature of clarification and therefore need not be treated as adverse comments on the related financial statements."

In the case of Companies, Section 211 (3B) of the Companies Act, 1956, provides that "Where the profit and loss account and the balance sheet of the company do not comply with the accounting standards, such companies shall disclose in its profit and loss account and balance sheet, the following, namely:

(a) the deviation from the accounting standards;

(b) the reasons for such deviation; and

(c) the financial effect, if any, arising due to such deviation."

In view of the above, if an item in the financial statements of a Company is treated differently pursuant to an Order made by the Court/Tribunal, as compared to the treatment required by an Accounting Standard, following disclosures should be made in the financial statements of the year in which different treatment has been given:

1. A description of the accounting treatment made along with the reason that the same has been adopted because of the Court/ Tribunal Order.

2. Description of the difference between the accounting treatment prescribed in the Accounting Standard and that followed by the Company.

3. The financial impact, if any, arising due to such a difference.

It is recommended that the above disclosures should be made by enterprises other than companies also in similar situations.

XXV. Treatment of Inter-divisional Transfers[93]

Attention of the members is invited to the definition of the term 'revenue' in Accounting Standard (AS) 9, Revenue Recognition, issued by the Institute of Chartered Accountants of India, which is reproduced below:

> "*Revenue* is the gross inflow of cash, receivables or other consideration **arising in the course of the ordinary activities of an enterprise** from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration." (emphasis supplied)

The use of the word 'enterprise' in the definition of the term 'revenue' clearly implies that the transfers within the enterprise cannot be considered as fulfilling the definition of the term 'revenue'. Thus, the recognition of inter-divisional transfers as sales is an inappropriate accounting treatment and is inconsistent with Accounting Standard (AS) 9, Revenue Recognition. This aspect is further strengthened by considering the recognition criteria laid down in AS 9. Paragraphs 10 and 11 of AS 9, reproduced below, provide as to when revenue from the sale of goods should be recognised:

> ***"10. Revenue from sales or service transactions should be recognised when the requirements as to performance set out in paragraphs 11 and 12 are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.***
>
> ***11. In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:***

[93] Published in 'The Chartered Accountant', May 2005 (pp. 1531).

> *(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and*
>
> *(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods."*

Since in case of inter-divisional transfers, risks and rewards remain within the enterprise and also there is no consideration from the point of view of the enterprise as a whole, the recognition criteria for revenue recognition are also not fulfilled in respect of inter-divisional transfers.

XXVI. Withdrawal of the Statement on Auditing Practices

The Council of the Institute at its 249th meeting held on March 22 to 24, 2005 has decided to withdraw the Statement on Auditing Practices issued in June 1964, published in the Handbook of Auditing Pronouncements (2005 edn). The abovementioned statement has been withdrawn pursuant to the issuance of various Auditing and Assurance Standards and Guidance Notes on the topics covered by the different paragraphs of the said statement.

XXVII. Applicability of Accounting Standards to an Unlisted Indian Company, which is a Subsidiary of a Foreign Company Listed Outside India[94]

1. The Council of the Institute of Chartered Accountants of India has issued an Announcement (see 'The Chartered Accountant', November 2003 (pp. 480-489)) on 'Applicability of Accounting Standards'[95] with a

[94] Published in 'The Chartered Accountant', August 2005 (pp. 338-339).

[95] It may be noted that the Announcement on 'Applicability of Accounting Standards' stands superseded pursuant to issuance of Announcement XXXVIII on 'Harmonisation of Various differences between the Accounting Standards issued by the ICAI and the Accounting Standards notified by the Central Government'. Accordingly, this Announcement should be read in context of Announcement XXXVIII. It may also be noted that the council has issued another Announcement regarding revision in the criteria for classifying Level II non-corporate entities (see Announcement XLII).

view to lay down the scheme of applicability of Accounting Standards to Small and Medium Sized Enterprises (SMEs). As per the said scheme, all accounting standards are applicable to Level I enterprises. Level I enterprises, *inter alia*, include (i) enterprises whose equity or debt securities are listed whether in India or outside India, and (ii) holding or a subsidiary of a Level I enterprise.

2. With regard to above, an issue has been raised as to whether, as per the above scheme, a foreign company which is incorporated and listed outside India would also be considered as a Level I enterprise and consequent to this, whether an unlisted Indian company, which is a subsidiary of this foreign company, would become a Level I enterprise merely because of it being a subsidiary of the said foreign company.

3. It is clarified that, in the above-stated scheme, the term 'enterprise' includes all entities that are required to prepare their financial statements as per the Indian GAAPs. Accordingly, all Indian entities, *i.e.*, the entities which are incorporated in India, are covered in the said scheme. The scheme also covers those foreign entities which are required to prepare their financial statements as per the Indian GAAPs. Thus, in case a foreign company, which is incorporated and listed outside India, is required to prepare its financial statements as per the Indian GAAPs, it will be considered as a Level I enterprise. In such a case, the Indian company, which is a subsidiary of the aforesaid foreign company, would also be considered as a Level I enterprise for the reason that it is a subsidiary of another Level I enterprise. In case the parent foreign company is not required to prepare its financial statements as per the Indian GAAPs, its Indian subsidiary would not be considered to be a Level I enterprise provided it does not meet any other criteria for becoming Level I enterprise as per the said scheme. Thus, in such a situation, the status of the Indian company under the above scheme will be determined independent of the status of its parent foreign company.

XXVIII. Tax effect of expenses/income adjusted directly against the reserves and/or Securities Premium Account[96]

1. It has been noticed that some companies are charging certain expenses, which are otherwise required to be charged to the profit and loss account, directly against reserves and/or Securities Premium Account pursuant to the court orders. In such a case, while the expenses are

[96] Published in 'The Chartered Accountant', September 2005 (pp. 495-496).

charged to reserves and/or Securities Premium Account, the tax benefit arising from admissibility of such expenses for tax purposes is not recognised in the reserves and/or Securities Premium Account. Such a situation may also arise where an enterprise adjusts its reserves to give effect to a change, if any, in accounting policy consequent upon adoption of an Accounting Standard, in accordance with the transitional provisions contained in the standard. Further, a company may adjust an expense against the Securities Premium Account as allowed under the provisions of section 78 of the Companies Act, 1956. A similar situation may arise where, pursuant to a court order or under transitional provisions prescribed in an accounting standard, an income, which should have otherwise been credited to the profit and loss account in accordance with the requirements of generally accepted accounting principles, may have been directly credited to a reserve account or a similar account and the tax effect thereof is not recognised in the reserve account or a similar account.

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

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

XXIX. Applicability of Accounting Standard (AS) 28, Impairment of Assets, to Small and Medium Sized Enterprises (SMEs)[97]

1. Accounting Standard (AS) 28, *Impairment of Assets*, issued by the

[97] Published in 'The Chartered Accountant', November 2005 (pp. 777-778). It may be noted that the term SMEs here refers to SMCs and non-corporate entities falling in Level II and Level III (see Announcement XXXVIII). With regard to revision in the criteria for classifying Level II non-corporate entities, refer Announcement XLII.

Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2004. The Standard is mandatory in nature from different dates for different levels of enterprises as below:

(i) To Level I enterprises- from accounting periods commencing on or after 1.4.2004.

(ii) To Level II enterprises- from accounting periods commencing on or after 1.4.2006.

(iii) To Level III enterprises- from accounting periods commencing on or after 1.4.2008.

The criteria for different levels are given in Annexure I.

2. Considering the feedback received from various interest-groups and the concerns expressed at various forums, it is felt that relaxation should be given to Level II and Level III enterprises (referred to as 'Small and Medium Sized Enterprises' (SMEs)), from the measurement principles contained in AS 28, Impairment of Assets.

3. AS 28 defines, *inter alia*, the following terms:

An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.

Recoverable amount is the higher of an asset's net selling price and its value in use.

Net selling price is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.

Value in use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.

4. The relaxations for SMEs in respect of AS 28 have been decided as below:

(i) Considering that detailed cash flow projections of SMEs are often not readily available, SMEs are allowed to measure the 'value in use' on the basis of reasonable estimate thereof instead of computing the value in use by present value technique. Therefore, the definition of the term 'value in use' in the context of the SMEs would read as follows:

"<u>Value in use</u> is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life, or a reasonable estimate thereof".

(ii) The above change in the definition of 'value in use' implies that instead of using the present value technique, a reasonable estimate of the 'value in use' can be made. Consequently, if an SME chooses to measure the 'value in use' by not using the present value technique, the relevant provisions of AS 28, such as discount rate etc., would not be applicable to such an SME. Further, such an SME need not disclose the information required by paragraph 121(g) of the Standard. Subject to this, the other provisions of AS 28 would be applicable to SMEs.

5. An enterprise, which, pursuant to the above provisions, does not use the present value technique for measuring value in use, should disclose, the fact that it has measured its 'value in use' on the basis of the reasonable estimate thereof and the manner in which the estimate has been arrived at including assumptions that govern the estimate.

6. Where an enterprise has been covered in Level I and subsequently, ceases to be so covered, the enterprise will not qualify for relaxation/ exemption from the applicability of this Standard, until the enterprise ceases to be covered in Level I for two consecutive years.

7. Where an enterprise has previously qualified for the above relaxations (being not covered in Level I) but no longer qualifies for relaxation in the current accounting period, this Standard becomes applicable from the current period without the above relaxations. However, the corresponding previous period figures in respect of the relevant disclosures need not be provided.

The above provisions are applicable in respect of the accounting periods commencing on or after 1-4-2006 (for Level II enterprises) and 1-4-2008 (for Level III enterprises). However, if an enterprise being a Level II enterprise starts applying AS 28 from accounting periods beginning on or after 1-4-2006, it will continue to apply this Standard even if it ceases to be covered in Level II and becomes a Level III enterprise.

Annexure I

Criteria for classification of enterprises

Level I Enterprises

Enterprises which fall in any one or more of the following categories, at any time during the accounting period, are classified as Level I enterprises:

(i) Enterprises whose equity or debt securities are listed whether in India or outside India.

(ii) Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.

(iii) Banks including co-operative banks.

(iv) Financial institutions.

(v) Enterprises carrying on insurance business.

(vi) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 50 crore. Turnover does not include 'other income'.

(vii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 10 crore at any time during the accounting period.

(viii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

Level II Enterprises

Enterprises which are not Level I enterprises but fall in any one or more of the following categories are classified as Level II enterprises:

(i) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 40 lakhs but does not exceed Rs. 50 crore. Turnover does not include 'other income'.

(ii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 1 crore but not in excess of Rs. 10 crore at any time during the accounting period.

(iii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

Level III Enterprises

Enterprises which are not covered under Level I and Level II are considered as Level III enterprises.

XXX. Disclosures regarding Derivative Instruments[98]

1. In recent years, derivative instruments are increasingly being used for trading as well as hedging purposes. A 'derivative' is a financial instrument or other contract 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.

2. Accounting Standard (AS) 1, Disclosure of Accounting Policies, requires that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed. In view of the aforesaid requirement of AS 1, an enterprise should disclose the criteria applied for recognition and measurement of the derivative instruments which are used by the enterprise for hedging or for other purposes and the criteria applied for recognition and measurement of income and expenses arising from such instruments.

3. The Accounting Standards Board of the Institute of Chartered Accountants of India is in the process of developing Accounting Standards on (i) 'Financial Instruments: Presentation', (ii) 'Financial Instruments:

[98] Published in 'The Chartered Accountant', December 2005 (pp. 927).

Disclosures' and (iii) 'Financial Instruments: Recognition and Measurement' which would deal with the presentation, disclosure and recognition and measurements aspects of all financial instruments including derivative instruments.[99] Pending the issuance of the said Accounting Standards, the Institute is of the view that with a view to provide information regarding the extent of risks to which an enterprise is exposed, it should, as a minimum, make following disclosures in its financial statements:

(a) category-wise quantitative data about derivative instruments that are outstanding at the balance sheet date,

(b) the purpose, viz., hedging or speculation, for which such derivative instruments have been acquired, and

(c) the foreign currency exposures that are not hedged by a derivative instrument or otherwise.

Effective Date

4. This Announcement is applicable in respect of financial statements for the accounting period(s) ending on or after March 31, 2006.

XXXI. Accounting for 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[100]

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[99] It may be noted that ICAI has issued the Accounting Standards on Financial Instruments for current status of applicability of these Accounting Standards, see Announcement XLI.

[100] Published in 'The Chartered Accountant', January 2006 (pp. 1090-1091). It may be noted that considering the issue being raised regarding the applicability date of the Announcement, the Institute has decided that this Announcement is applicable in respect of accounting period(s) commencing on or after April 1, 2006 (see Announcement XXXII issued in this regard).

Subsequent to the above, certain representations were received and views were expressed on certain forums regarding the applicability of the Announcement. Considering these representations and views, the Institute had decided to defer the applicability of the Announcement by one year. The Announcement was made applicable in respect of accounting period(s) commencing on or after April 1, 2007 (see Announcement XXXIII issued in this regard).

Applicability of the Announcement was further deferred for one year (See Announcement XXXVI). Pursuant to issuance of AS 30 the Council decided to withdraw the Announcement issued in January 2006 and subsequent Announcements deferring its applicability (See Announcement XL).

1. The Institute of Chartered Accountants of India (ICAI) issued an Announcement on '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[101] or a highly probable forecast transaction[102] (see 'The Chartered Accountant', July 2004 (pp. 110)). As per the Announcement, AS 11 (revised 2003) is not applicable to the exchange differences arising on forward exchange contracts entered into to hedge the foreign currency risks of a firm commitment or a highly probable forecast transaction. It is stated in the Announcement that the hedge accounting, in its entirety, including hedge of a firm commitment or a highly probable forecast transaction, is proposed to be dealt with in the Accounting Standard on 'Financial Instruments: Recognition and Measurement', which is under formulation.

2. It may be noted that as per the above Announcement, AS 11 (revised 2003) is not applicable to the exchange differences arising on the forward exchange contracts entered into to hedge the foreign currency risks of a firm commitment or a highly probable forecast transaction. Accordingly, the premium or discount in respect of such contracts continues to be governed by AS 11 (revised 2003), The Effects of Changes in Foreign Exchange Rates.

3. It has been noted that in the absence of any authoritative pronouncement of the Institute on the subject, different enterprises are accounting for exchange differences arising on such contracts in different ways which is affecting the comparability of financial statements. Keeping this in view, the matter has been reconsidered and the Institute is of the view that pending the issuance of the proposed Accounting Standard on 'Financial Instruments: Recognition and Measurement', which is under formulation, exchange differences arising on the forward exchange contracts entered into to hedge the foreign currency risks of a firm commitment or a highly probable forecast transaction should be recognised in the statement of profit and loss in the reporting period in which the exchange rate changes. Any profit or loss arising on renewal or cancellation of such contracts should be recognised as income or expense for the period.

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[101] 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.

[102] A forecast transaction is an uncommitted but anticipated future transaction.

XXXII. Applicability Date of Announcement on 'Accounting for 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'[103]

1. The Institute of Chartered Accountants of India (ICAI), in January 2006, issued an Announcement on *'Accounting for 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'*. Pending the issue of the proposed Accounting Standard on *'Financial Instruments: Recognition and Measurement'*, which is under formulation, the said Announcement prescribes the accounting treatment which should be followed in respect of the exchange differences arising on the forward exchange contracts entered into to hedge the foreign currency risks of a firm commitment or a highly probable forecast transaction.

2. An issue has been raised regarding the applicability date of the Announcement. The ICAI has considered the issue and it has been decided that this Announcement is applicable in respect of accounting period(s) commencing on or after April 1, 2006. Earlier application of the Announcement is however encouraged.[104]

XXXIII. Deferment of Applicability of Announcement on 'Accounting for 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'[105]

1. The Institute of Chartered Accountants of India (ICAI), in January 2006, issued an Announcement on 'Accounting for exchange differences

[103] Published in 'The Chartered Accountant', February 2006 (pp. 1243).

[104] It may be noted that subsequent to the issuance of this Announcement, certain representations were received and views were expressed on certain forums regarding the applicability of the Announcement issued in January 2006. Considering these representations and views, the Institute had decided to defer the applicability of the said Announcement by one year. The said Announcement was made applicable in respect of accounting period(s) commencing on or after April 1, 2007 (see Announcement XXXIII issued in this regard). Applicaibility of the Announcement was further deferred for one year (See Announcement XXXVI). Pursuant to issuance of AS 30, the Council decided to withdraw the Announcement issued in January 2006 and subsequent Announcements defering its applicability (See Announcement XL).

[105] Published in 'The Chartered Accountant', June 2006 (pp. 1774).

arising on a forward exchange contract entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction'. Pending the issuance of the proposed Accounting Standard on 'Financial Instruments: Recognition and Measurement', which is under formulation, the said Announcement prescribes the accounting treatment which should be followed in respect of the exchange differences arising on the forward exchange contracts entered into to hedge the foreign currency risks of a firm commitment or a highly probable forecast transaction.

2. Considering the issues being raised regarding the applicability date of the Announcement, the ICAI subsequently decided that this Announcement was applicable in respect of accounting period(s) commencing on or after April 1, 2006.

3. Certain representations have been received and views have been expressed on certain forums regarding the applicability of this Announcement. Considering these representations and views, the Council of the ICAI has decided to defer the applicability of this Announcement by one year. This Announcement would now be applicable in respect of accounting period(s) commencing on or after April 1, 2007.[106]

XXXIV Deferment of Applicability of Accounting Standard (AS) 15, Employee Benefits (revised 2005)[107]

The Council of the Institute of Chartered Accountants of India (ICAI), at its 265th meeting held on February 3-4, 2007, decided to defer the date of applicability of Accounting Standard (AS) 15, Employee Benefits (revised 2005), issued by the ICAI, keeping in view the practical difficulties and general hardship being faced by industry. As per the decision, AS 15 comes into effect in respect of accounting periods commencing on or after December 7, 2006 (instead of April 1, 2006, as stated in the said Standard) and is mandatory in nature from that date. Earlier application of the Standard is encouraged.

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[106] It may be noted that applicability of the Announcement issued in January 2006 was further defered for one year (See Announcement XXXVI). Prusuant to issuance of AS30, the Council decided to withdraw the Announcement issued in January 2006 and subsquent Announcements deferring its applicability (See Announcement XL).

[107] Published in 'The Chartered Accountant', March 2001 (pp. 1480).

XXXV Withdrawal of the Announcement issued by the Council on 'Treatment of exchange differences under Accounting Standard (AS) 11 (revised 2003), The Effects of Changes in Foreign Exchange Rates vis-à-vis Schedule VI to the Companies Act, 1956'[108]

1. The Council of the Institute of Chartered Accountants of India had issued an Announcement on 'Treatment of exchange differences under Accounting Standard (AS) 11 (revised 2003), The Effects of Changes in Foreign Exchange Rates vis-à-vis Schedule VI to the Companies Act, 1956', which was published in the November 2003 issue of 'The Chartered Accountant' (pp. 497)[109]

2. Subsequent to the issuance of the above Announcement, the Ministry of Company Affairs (now known as the Ministry of Corporate Affairs) issued the Companies (Accounting Standards) Rules, 2006, by way of Notification in the Official Gazette dated 7th December, 2006. As per Rule 3(2) of the said Rules, the Accounting Standards shall come into effect in respect of accounting periods commencing on or after the publication of these accounting standards under the said Notification.

3. AS 11, as published in the above Government Notification, carries a footnote that "it may be noted that the accounting treatment of exchange differences contained in this Standard is required to be followed irrespective of the relevant provisions of Schedule VI to the Companies Act, 1956".

4. In view of the above footnote to AS 11, the Council of the Institute of Chartered Accountants of India has decided at its 269th meeting held on July 18, 2007, to withdraw the Announcement on 'Treatment of exchange differences under Accounting Standard (AS) 11 (revised 2003), The Effects of Changes in Foreign Exchange Rates vis-à-vis Schedule VI to the Companies Act, 1956', published in 'The Chartered Accountant' of November 2003. Accordingly, the accounting treatment of exchange differences contained in AS 11 notified as above is applicable and not the requirements of Schedule VI to the Act, in respect of accounting periods commencing on or after 7th December, 2006.

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[108] Published in 'The Chartered Accountant', August 2007 (pp. 320).

[109] Also published elsewhere in this Compendium (see Announcement XVIII).

XXXVI Deferment of Applicability of Announcement on 'Accounting for 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'[110]

1. The Institute of Chartered Accountants of India (ICAI), in January 2006, issued an Announcement on 'Accounting for 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'. Pending the issuance of the proposed Accounting Standard on 'Financial Instruments: Recognition and Measurement', which is under formulation, the said Announcement prescribes the accounting treatment which should be followed in respect of the exchange differences arising on the forward exchange contracts entered into to hedge the foreign currency risks of a firm commitment or a highly probable forecast transaction.

2. Subsequently, an Announcement was issued in June 2006, deferring the applicability of the Announcement issued in January 2006, to the accounting period(s) commencing on or after April 1, 2007.

3. As the proposed Accounting Standard on 'Financial Instruments: Recognition and Measurement', is still to be issued by the Council, the matter was reconsidered at the 269th meeting of the Council held on July 18, 2007, whereat it has been decided to further defer the applicability of the Announcement issued in January 2006, to accounting period(s) commencing on or after April 1, 2008.[111]

XXXVII Option to an entity to adopt alternative treatment allowed by way of amendment to the Transitional Provisions of Accounting Standard (AS) 15, Employee Benefits (revised 2005)[112]

An amendment by way of limited revision to Accounting Standard (AS) 15, *Employee Benefits* (revised 2005), has been made with a view to

[110] Published in 'The Chartered Accountant', August 2007 (pp. 320).

[111] It may be noted that pursuant to issuance of AS 30, the Council decided to withdraw the Announcement issued in January 2006 and subsequent Announcements deferring its applicability (See Announcement XL).

[112] Published in 'The Chartered Accountant', December 2007 (pp. 992).

provide, inter alia, an option to an entity to charge additional liability arising upon the first application of the Standard as an expense over a period upto five years with a disclosure of un-recognised amount.

The Council of the Institute of Chartered Accountants of India has decided to give a one time option to the entities which have followed the treatment prescribed under the Transitional Provisions prior to the above-stated amendment to adopt the alternative treatment, allowed by way of the said amendment, from the date the Transitional Provision was so applied. An entity is, however, allowed to exercise this option only during the first accounting year commencing on or after 7th December, 2006. In case an entity chooses to adopt the option, the earlier accounting treatment followed in this respect should be reversed.

XXXVIII Harmonisation of various differences between the Accounting Standards issued by the ICAI and the Accounting Standards notified by the Central Government[113]

The Council has considered the differences between the Accounting Standards issued by the Institute of Chartered Accountants of India and the Accounting Standards notified on 7th December, 2006 by the Central Government under the Companies (Accounting Standards) Rules, 2006. The Council decided the following scheme for harmonisation of differences:

1. Harmonisation of Differences between the Accounting Standards issued by the ICAI and those notified by the Government on account of language, presentation, etc.

The Council noted that following differences between the Accounting Standards issued by the ICAI and those notified by the Government are on account of language, presentation, etc.

(a) The Accounting Standards notified by the Government use the term 'accounting standard' or 'standard' instead of the word 'Statement' used in the Accounting Standards issued by the Institute of Chartered Accountants of India

(b) The Accounting Standards notified by the Government use the heading 'Main Principles' instead of 'Accounting Standard' appearing above the bold-italic paragraphs in respect of the old accounting

[113] Published in 'The Chartered Accountant', February 2008 (pp. 1340).

standards issued by the ICAI. For example, the heading 'Main Principles' appears above paragraphs 24 to 27 of AS 1 notified by the Government (The other accounting standards notified by the Government in which this heading is used are AS 4, AS 6, AS 9, AS 10, AS 12, AS 13 and AS 14).

(c) Paragraph numbers of certain Accounting Standards, notified by the Government have been changed as compared to paragraph numbers of Accounting Standards issued by the ICAI. For instance, in AS 10, issued by the ICAI, numbers of paragraphs 9, 16.3 to 16.7, 37 and 38 appear even though there is no matter in these paragraphs as the same have been withdrawn due to subsequent issuance of Accounting Standards such as AS 16 and AS 26. In other words, the above paragraph numbers remain. However, in the Accounting Standard notified by the Government, the paragraph numbers have been changed by omitting the aforesaid paragraphs.

Also, numbering of certain sub-paragraphs, e.g., (a), (b), (c),…. etc., have been done in the Accounting Standards notified by the Government, whereas these were indicated as 'bullets' in Accounting Standards issued by the ICAI. For example, paragraph 20 of AS 14 and paragraph 24 of AS 18.

(d) The word 'Illustration' has been used in the Accounting Standards notified by the Government instead of 'Examples' as used in various Standards issued by the ICAI. Similarly, the word 'Appendix' used in the Accounting Standards issued by the ICAI, containing various examples at the end of an Accounting Standard, has been replaced by the word 'Illustrations' in the notified Accounting Standards.

(e) Accounting Standards issued by the ICAI, at certain places make reference to the Preface to the Statements of Accounting Standards. Since the Government has not notified the Preface, some of the requirements of the Preface, such as the consideration of materiality, have been included in the 'General Instructions' in the Rules. Accordingly, the Accounting Standards notified by the Government make reference to the General Instructions.

Since points 1(a) to 1(d), as mentioned above do not create any substantive difference between Accounting Standards issued by the ICAI and those notified by the Government, the Council decided to change the Standards issued by the ICAI in order to harmonise the two sets of Accounting Standards. Accordingly, changes are being made in the Accounting Standards and the amended Accounting Standards will be published in the Compendium of Accounting Standards 2008.

With regard to 1(e) above, the Council decided that no amendment was required in the Accounting Standards issued by the ICAI on account of the reference to 'General Instructions' in the Rules notified by the Government as compared to the 'Preface' in the Accounting Standards issued by the ICAI.

2. Harmonisation of differences caused by inclusion of the consensus portion of the Accounting Standards Interpretations (ASIs) issued by the ICAI in the Accounting Standards notified by the Government with certain exceptions.

The Council noted that consensus portion of certain ASIs have been included in the notified Accounting Standards as 'Explanation' to the relevant paragraphs as indicated below:

ASI No.	Title of the ASI	Relevant Paragraph(s) of the Accounting Standards
1	Substantial Period of Time (Re. AS 16)	Paragraph 3.2 of Accounting Standard (AS) 16, *'Borrowing Costs'*
3	Accounting for Taxes on Income in the situations of Tax Holiday under Sections 80-IA and 80-IB of the Income-tax Act, 1961 (Re. AS 22)	Paragraph 13 of Accounting Standard (AS) 22, *'Accounting for Taxes on Income'*
4	Losses under the head Capital Gains (Re. AS 22)	Explanation 2 to paragraph 17 of Accounting Standard (AS) 22, *'Accounting for Taxes on Income'*
5	Accounting for Taxes on Income in the situations of Tax Holiday under Sections 10A and 10B of the Income-tax Act, 1961 (Re. AS 22)	Paragraph 13 of Accounting Standard (AS) 22, *'Accounting for Taxes on Income'*
6	Accounting for Taxes on Income in the context of Section 115JB of the Income-tax Act, 1961 (Re. AS 22)	Paragraph 21 of Accounting Standard (AS) 22, *'Accounting for Taxes on Income'*

7	Disclosure of deferred tax assets and deferred tax liabilities in the balance sheet of a company (Re. AS 22)	Paragraph 30 of Accounting Standard (AS) 22, *'Accounting for Taxes on Income'*
8	Interpretation of the term 'Near Future' (Re. AS 21, AS 23 and AS 27)	Explanation (b) to paragraph 11 of Accounting Standard (AS) 21, *'Consolidated Financial Statements'* Paragraph 7 of Accounting Standard (AS) 23, *'Accounting for Investments in Associates in Consolidated Financial Statements'* Paragraph 28 of Accounting Standard (AS) 27, *'Financial Reporting of Interests in Joint Ventures'*
9	Virtual certainty supported by convincing evidence (Re. AS 22)	Explanation 1 to paragraph 17 of Accounting Standard (AS) 22, *'Accounting for Taxes on Income'*
10	Interpretation of paragraph 4(e) of AS 16 (Re. AS 16)	Paragraph 4(e) of Accounting Standard (AS) 16, *'Borrowing Costs'*
13	Interpretation of paragraphs 26 and 27 of AS 18 (Re. AS 18)	Paragraphs 26 and 27 of Accounting Standard (AS) 18, *'Related Party Disclosures'*
14	Disclosure of Revenue from Sales Transactions (Re. AS 9)	Paragraph 10 of Accounting Standard (AS) 9, *'Revenue Recognition'*
15	Notes to the Consolidated Financial Statements (Re. AS 21)	Paragraph 6 of Accounting Standard (AS) 21, *'Consolidated Financial Statements'*
16	Treatment of Proposed Dividend under AS 23 (Re. AS 23)	Explanation (b) to paragraph 6 of Accounting Standard (AS) 23, *'Accounting for Investments in Associates in Consolidated Financial Statements'*
17	Adjustments to the Carrying Amount of Investment arising from Changes in Equity not Included in the Statement of Profit and Loss of the Associate (Re. AS 23)	Explanation (a) to Paragraph 6 of Accounting Standard (AS) 23, *'Accounting for Investments in Associates in Consolidated Financial Statements'*
18	Consideration of Potential Equity Shares for Determining	Paragraph 4 of Accounting Standard (AS) 23, *'Accounting for Investments*

	whether an Investee is an Associate under AS 23 (Re. AS 23)	*in Associates in Consolidated Financial Statements'*
19	Interpretation of the term 'intermediaries' (Re. AS 18)	Paragraph 13 of Accounting Standard (AS) 18, *'Related Party Disclosures'*
20	Disclosure of Segment Information (Re. AS 17)	Paragraph 38 of Accounting Standard (AS) 17, *'Segment Reporting'*
21	Non-Executive Directors on the Board-whether related parties (Re. AS 18)	Paragraph 14 of Accounting Standard (AS) 18, *'Related Party Disclosures'*
22	Treatment of Interest for determining Segment Expense (Re. AS 17)	Point (b) of the definition of 'Segment Expense' under paragraph 5.6 of Accounting Standard (AS) 17, *'Segment Reporting'*
24	Definition of 'Control' (Re. AS 21)	Paragraph 10 of Accounting Standard (AS) 21, *'Consolidated Financial Statements'*
25	Exclusion of a subsidiary from consolidation (Re. AS 21)	Explanation (a) to paragraph 11 of Accounting Standard (AS) 21, *'Consolidated Financial Statements'*
26	Accounting for taxes on income in the consolidated financial statements (Re. AS 21)	Explanation (a) to paragraph 13 of Accounting Standard (AS) 21, *'Consolidated Financial Statements'*
28	Disclosure of parent's/ venturer's shares in post-acquisition reserves of a subsidiary/jointly controlled entity (Re. AS 21 and AS 27)	Explanation (b) to paragraph 13 of Accounting Standard (AS) 21, *'Consolidated Financial Statements'*Paragraph 32 of Accounting Standard (AS) 27, *'Financial Reporting of Interests in Joint Ventures'*
30	Applicability of AS 29 to Onerous Contracts (Re. AS 29)	Paragraph 1(b) of Accounting Standard (AS) 29, *'Provisions, Contingent Liabilities and Contingent Assets'*

The Council decided to make the consensus portion of the above ASIs a part of the Accounting Standards issued by the Institute. Accordingly, the Accounting Standards are being amended to incorporate the consensus portion of the above mentioned ASIs as 'Explanation' to the relevant paragraphs.

Following ASIs have not been included in the notified Accounting Standards:

(i) ASI 2 Accounting for Machinery Spares (Re. AS 2 and AS 10)

(ii) ASI 11 Accounting for Taxes on Income in case of an Amalgamation (Re. AS 22)

(iii) ASI 12 Applicability of AS 20 (Re. AS 20)

(iv) ASI 23 Remuneration paid to key management personnel – whether a related party transaction (Re. AS 18)

(v) ASI 27 Applicability of AS 25 to Interim Financial Results (Re. AS 25)

(vi) ASI 29 Turnover in case of Contractors (Re. AS 7 (revised 2002))

The Council decided to withdraw the above ASIs and issue the same as Guidance Notes except ASI 2 and ASI 11. Guidance Notes are being separately issued.

3. Harmonisation of differences with regard to applicability of Accounting Standards to various Levels of entities.[114]

The Council noted that as per its Announcement, 'Applicability of Accounting Standards', issued by the ICAI (published in 'The Chartered Accountant', November 2003), there are three levels of entities. Level II entities and Level III entities as per the said Announcement are considered to be the Small and Medium Entities (SMEs). On the other hand, as per the Accounting Standards notified by the Government, there are two levels, namely, Small and Medium-sized Companies (SMCs) as defined in the Rules and companies other than SMCs. Non-SMCs are required to comply with all the Accounting Standards in their entirety, while certain exemptions/ relaxations have been given to SMCs. Certain differences in the criteria for classification of the levels were also noted.

In this regard, the Council decided that the ICAI should continue to have three levels as at present instead of two as per the Government notification, as below:

(a) Level I should be as per the existing Level I, modified keeping in view the definition of SMC under the Government Notification except

[114] An Announcement regarding revision in the criteria for classifying Level II non-corporate entities has been issued by the Council (See Announcement XLII).

co-operative banks should be included along with the banks and reference to industrial, commercial and business reporting entities should be retained as part of the criteria in (vi) and (vii) of the existing ICAI criteria for Level I.

(b) Level II should include companies other than those covered under Level I and the non-corporate entities having the same criteria as at present for ICAI Level II. The exemptions or relaxations available to this Level should be the same as available to SMCs under the Government Notification.

(c) Level III should cover only non-corporates not covered in Levels I and II. Exemptions or relaxations available at Level III as at present should continue to be available at this Level.

(d) Exemptions or relaxations available to enterprises employing less than 50 employees during the year in respect of AS 15, *Employee Benefits* (revised 2005), should continue to be available to non-corporate entities under Levels II and III.

As a consequence to the above decision of the Council to harmonise with the notification:

(i) the harmonised criteria for classification of entities and other instructions regarding SMEs are given in Annexure I;

(ii) applicability of Accounting Standards to companies as per the Government Notification is given in Annexure II; and

(iii) applicability of Accounting Standards to non-corporate entities is given in Annexure III.

The Council decided that the above requirements with regard to SMEs should be applicable to non-corporates for accounting periods commencing on or after 1-4-2008.

Annexure I

Harmonised Criteria for Classification of Entities

(1) Criteria for classification of non-corporate entities as decided by the Institute of Chartered Accountants of India

Level I Entities

Non-corporate entities which fall in any one or more of the following categories, at the end of the relevant accounting period, are classified as Level I entities:

(i) Entities whose equity or debt securities are listed or are in the process of listing on any stock exchange, whether in India or outside India.

(ii) Banks (including co-operative banks), financial institutions or entities carrying on insurance business.

(iii) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees fifty crore in the immediately preceding accounting year.

(iv) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year.

(v) Holding and subsidiary entities of any one of the above.

Level II Entities (SMEs)

Non-corporate entities which are not Level I entities but fall in any one or more of the following categories are classified as Level II entities:

(i) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees forty lakh but does not exceed rupees fifty crore in the immediately preceding accounting year.

(ii) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees one crore but not in excess of rupees ten crore at any time during the immediately preceding accounting year.

(iii) Holding and subsidiary entities of any one of the above.

Level III Entities (SMEs)

Non-corporate entities which are not covered under Level I and Level II are considered as Level III entities.

Additional requirements

(1) An SME which does not disclose certain information pursuant to the exemptions or relaxations given to it should disclose (by way of a note to its financial statements) the fact that it is an SME and has complied with the Accounting Standards insofar as they are applicable to entities falling in Level II or Level III, as the case may be.

(2) Where an entity, being covered in Level II or Level III, had qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the corresponding period of the previous accounting period need not be revised merely by reason of its having ceased to be covered in Level II or Level III, as the case may be. The fact that the entity was covered in Level II or Level III, as the case may be, in the previous period and it had availed of the exemptions or relaxations available to that Level of entities should be disclosed in the notes to the financial statements.

(3) Where an entity has been covered in Level I and subsequently, ceases to be so covered, the entity will not qualify for exemption/relaxation available to Level II entities, until the entity ceases to be covered in Level I for two consecutive years. Similar is the case in respect of an entity, which has been covered in Level I or Level II and subsequently, gets covered under Level III.

(4) If an entity covered in Level II or Level III opts not to avail of the exemptions or relaxations available to that Level of entities in respect of any but not all of the Accounting Standards, it should disclose the Standard(s) in respect of which it has availed the exemption or relaxation.

(5) If an entity covered in Level II or Level III desires to disclose the information not required to be disclosed pursuant to the exemptions or relaxations available to that Level of entities, it should disclose that information in compliance with the relevant Accounting Standard.

(6) An entity covered in Level II or Level III may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard:

Provided that such a partial exemption or relaxation and disclosure should not be permitted to mislead any person or public.

(7) In respect of Accounting Standard (AS) 15, *Employee Benefits*, exemptions/ relaxations are available to Level II and Level III entities, under two sub-classifications, viz., (i) entities whose average number of persons employed during the year is 50 or more, and (ii) entities whose average number of persons employed during the year is less than 50. The requirements stated in paragraphs (1) to (6) above, mutatis mutandis, apply to these sub-classifications.

(2) Criteria for classification of companies under the Companies (Accounting Standards) Rules, 2006

Small and Medium-Sized Company (SMC) as defined in Clause 2(f) of the Companies (Accounting Standards) Rules, 2006:

(f) "Small and Medium Sized Company" (SMC) means, a company-

(i) whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

(ii) which is not a bank, financial institution or an insurance company;

(iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;

(iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and

(v) which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

Explanation: For the purposes of clause (f), a company shall qualify as a Small and Medium Sized Company, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

Non-SMCs

Companies not falling within the definition of SMC are considered as Non-SMCs.

Instructions

A. General Instructions

1. SMCs shall follow the following instructions while complying with Accounting Standards under these Rules:-

1.1 the SMC which does not disclose certain information pursuant to the exemptions or relaxations given to it shall disclose (by way of a note to its financial statements) the fact that it is an SMC and has complied with the Accounting Standards insofar as they are applicable to an SMC on the following lines:

“The Company is a Small and Medium Sized Company (SMC) as defined in the General Instructions in respect of Accounting Standards notified under the Companies Act, 1956. Accordingly, the Company has complied with the Accounting Standards as applicable to a Small and Medium Sized Company.”

1.2 Where a company, being an SMC, has qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the corresponding period of the previous accounting period need not be revised merely by reason of its having ceased to be an SMC. The fact that the company was an SMC in the previous period and it had availed of the exemptions or relaxations available to SMCs shall be disclosed in the notes to the financial statements.

1.3 If an SMC opts not to avail of the exemptions or relaxations available to an SMC in respect of any but not all of the Accounting Standards, it shall disclose the standard(s) in respect of which it has availed the exemption or relaxation.

1.4 If an SMC desires to disclose the information not required to be disclosed pursuant to the exemptions or relaxations available to the SMCs, it shall disclose that information in compliance with the relevant accounting standard.

1.5 The SMC may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard:

Provided that such a partial exemption or relaxation and disclosure shall not be permitted to mislead any person or public.

B. Other Instructions

Rule 5 of the Companies (Accounting Standards) Rules, 2006, provides as below:

> "5. An existing company, which was previously not a Small and Medium Sized Company (SMC) and subsequently becomes an SMC, shall not be qualified for exemption or relaxation in respect of Accounting Standards available to an SMC until the company remains an SMC for two consecutive accounting periods."

Annexure II

Applicability of Accounting Standards to Companies

(I) Accounting Standards applicable to all companies in their entirety for accounting periods commencing on or after 7th December, 2006

AS 1 Disclosures of Accounting Policies

AS 2 Valuation of Inventories

AS 4 Contingencies and Events Occurring After the Balance Sheet Date

AS 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

AS 6 Depreciation Accounting

AS 7 Construction Contracts (revised 2002)

AS 9 Revenue Recognition

AS 10 Accounting for Fixed Assets

AS 11 The Effects of Changes in Foreign Exchange Rates (revised 2003)

AS 12 Accounting for Government Grants

AS 13 Accounting for Investments

AS 14 Accounting for Amalgamations

AS 16 Borrowing Costs

AS 18 Related Party Disclosures

AS 22 Accounting for Taxes on Income

AS 24 Discontinuing Operations

AS 26 Intangible Assets

(II) Exemptions or Relaxations for SMCs as defined in the Notification

(A) Accounting Standards not applicable to SMCs in their entirety:

AS 3 Cash Flow Statements.

AS 17 Segment Reporting

(B) Accounting Standards not applicable to SMCs since the relevant Regulations require compliance with them only by certain Non-SMCs[115]:

(i) AS 21, Consolidated Financial Statements

(ii) AS 23, Accounting for Investments in Associates in Consolidated Financial Statements

(iii) AS 27, Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements)

(C) Accounting Standards in respect of which relaxations from certain requirements have been given to SMCs:

(i) Accounting Standard (AS) 15, Employee Benefits (revised 2005)

(a) paragraphs 11 to 16 of the standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term

[115] Pursuant to the introduction of requirement of preparation of consolidated financial statements in the Companies Act, 2013, AS 21, AS 23 and AS 27 have become applicable to all the companies.

accumulating compensated absences in respect of which employees are not entitled to cash payment for unused entitlement on leaving);

(b) paragraphs 46 and 139 of the Standard which deal with discounting of amounts that fall due more than 12 months after the balance sheet date;

(c) recognition and measurement principles laid down in paragraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such companies should actuarially determine and provide for the accrued liability in respect of defined benefit plans by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard. Such companies should disclose actuarial assumptions as per paragraph 120(l) of the Standard; and

(d) recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long-term employee benefits. However, such companies should actuarially determine and provide for the accrued liability in respect of other long-term employee benefits by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard.

(ii) AS 19, Leases

Paragraphs 22 (c),(e) and (f); 25 (a), (b) and (e); 37 (a) and (f); and 46 (b) and (d) relating to disclosures are not applicable to SMCs.

(iii) AS 20, Earnings Per Share

Disclosure of diluted earnings per share (both including and excluding extraordinary items) is exempted for SMCs.

(iv) AS 28, Impairment of Assets

SMCs are allowed to measure the 'value in use' on the basis of reasonable estimate thereof instead of computing the value in use by present value technique. Consequently, if an SMC chooses to measure the 'value in use' by not using the present value technique, the relevant provisions of AS 28, such as discount rate etc., would not be applicable to such an SMC. Further, such an SMC need not disclose the information required by paragraph 121(g) of the Standard.

(v) AS 29, Provisions, Contingent Liabilities and Contingent Assets

Paragraphs 66 and 67 relating to disclosures are not applicable to SMCs.

(D) AS 25, Interim Financial Reporting, does not require a company to present interim financial report. It is applicable only if a company is required or elects to prepare and present an interim financial report. Only certain Non-SMCs are required by the concerned regulators to present interim financial results, e.g, quarterly financial results required by the SEBI. Therefore, the recognition and measurement requirements contained in this Standard are applicable to those Non-SMCs for preparation of interim financial results.

Annexure III

Applicability of Accounting Standards to Non-corporate Entities (As on 1.4.2008)

(I) Accounting Standards applicable to all Non-corporate Entities in their entirety (Level I, Level II and Level III)

AS 1 Disclosures of Accounting Policies

AS 2 Valuation of Inventories

AS 4 Contingencies and Events Occurring After the Balance Sheet Date

AS 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

AS 6 Depreciation Accounting

AS 7 Construction Contracts (revised 2002)

AS 9 Revenue Recognition

AS 10 Accounting for Fixed Assets

AS 11 The Effects of Changes in Foreign Exchange Rates (revised 2003)

AS 12 Accounting for Government Grants

AS 13 Accounting for Investments

AS 14 Accounting for Amalgamations

AS 16 Borrowing Costs

AS 22 Accounting for Taxes on Income

AS 26 Intangible Assets

(II) Exemptions or Relaxations for Non-corporate Entities falling in Level II and Level III (SMEs)

(A) Accounting Standards not applicable to Non-corporate Entities falling in Level II in their entirety:

AS 3 Cash Flow Statements

AS 17 Segment Reporting

(B) Accounting Standards not applicable to Non-corporate Entities falling in Level III in their entirety:

AS 3 Cash Flow Statements

AS 17 Segment Reporting

AS 18 Related Party Disclosures

AS 24 Discontinuing Operations

(C) Accounting Standards not applicable to all Non-corporate Entities since the relevant Regulators require compliance with them only by certain Level I entities:[116]

(i) AS 21, Consolidated Financial Statements

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[116] AS 21, AS 23 and AS 27 (to the extent these standards relate to preparation of consolidated financial statements) are required to be complied with by a non-corporate entity if the non-corporate entity, pursuant to the requirements of a statute/regulator or voluntarily, prepares and presents consolidated financial statements.

(ii) AS 23, Accounting for Investments in Associates in Consolidated Financial Statements

(iii) AS 27, Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements)

(D) Accounting Standards in respect of which relaxations from certain requirements have been given to Non-corporate Entities falling in Level II and Level III (SMEs):

(i) Accounting Standard (AS) 15, Employee Benefits (revised 2005)

(1) Level II and Level III Non-corporate entities whose average number of persons employed during the year is 50 or more are exempted from the applicability of the following paragraphs:

(a) paragraphs 11 to 16 of the standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment for unused entitlement on leaving);

(b) paragraphs 46 and 139 of the Standard which deal with discounting of amounts that fall due more than 12 months after the balance sheet date;

(c) recognition and measurement principles laid down in paragraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such entities should actuarially determine and provide for the accrued liability in respect of defined benefit plans by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard. Such entities should disclose actuarial assumptions as per paragraph 120(l) of the Standard; and

(d) recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long-term employee benefits. However, such entities should actuarially determine and provide for the accrued liability in respect of other long-term employee benefits by using the Projected Unit Credit

Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard.

(2) Level II and Level III Non-corporate entities whose average number of persons employed during the year is less than 50 are exempted from the applicability of the following paragraphs:

(a) paragraphs 11 to 16 of the standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment for unused entitlement on leaving);

(b) paragraphs 46 and 139 of the Standard which deal with discounting of amounts that fall due more than 12 months after the balance sheet date;

(c) recognition and measurement principles laid down in paragraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such entities may calculate and account for the accrued liability under the defined benefit plans by reference to some other rational method, e.g., a method based on the assumption that such benefits are payable to all employees at the end of the accounting year; and

(d) recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long-term employee benefits. Such entities may calculate and account for the accrued liability under the other long-term employee benefits by reference to some other rational method, e.g., a method based on the assumption that such benefits are payable to all employees at the end of the accounting year.

(ii) AS 19, Leases

Paragraphs 22 (c),(e) and (f); 25 (a), (b) and (e); 37 (a) and (f); and 46 (b) and (d) relating to disclosures are not applicable to non-corporate entities falling in Level II .

Paragraphs 22 (c),(e) and (f); 25 (a), (b) and (e); 37 (a), (f) and (g); and 46 (b), (d) and (e) relating to disclosures are not applicable to Level III entities.

(iii) AS 20, Earnings Per Share

Diluted earnings per share (both including and excluding extraordinary items) is not required to be disclosed by non-corporate entities falling in Level II and Level III and information required by paragraph 48(ii) of AS 20 is not required to be disclosed by Level III entities if this standard is applicable to these entities.

(iv) AS 28, Impairment of Assets

Non-corporate entities falling in Level II and Level III are allowed to measure the 'value in use' on the basis of reasonable estimate thereof instead of computing the value in use by present value technique. Consequently, if a non-corporate entity falling in Level II or Level III chooses to measure the 'value in use' by not using the present value technique, the relevant provisions of AS 28, such as discount rate etc., would not be applicable to such an entity. Further, such an entity need not disclose the information required by paragraph 121(g) of the Standard.

(v) AS 29, Provisions, Contingent Liabilities and Contingent Assets

Paragraphs 66 and 67 relating to disclosures are not applicable to non-corporate entities falling in Level II and Level III.

(E) AS 25, Interim Financial Reporting, does not require a non-corporate entity to present interim financial report. It is applicable only if a non-corporate entity is required or elects to prepare and present an interim financial report. Only certain Level I non-corporate entities are required by the concerned regulators to present interim financial results, e.g., quarterly financial results required by the SEBI. Therefore, the recognition and measurement requirements contained in this Standard are applicable to those Level I non-corporate entities for preparation of interim financial results.

XXXIX ACCOUNTING FOR DERIVATIVES[117]

1. Certain issues have been raised with regard to the foreign currency derivative exposures of various corporates that are not being fully accounted for. These exposures may translate into heavy losses due to

[117] Published in 'The Chartered Accountant', May 2008 (pp. 1945).

fluctuations in the foreign exchange rates. The matter was considered by the Council of the ICAI at its meeting held on March 27-29, 2008. The Council decided to clarify the best practice treatment to be followed for all derivatives, which is contained in the following paragraphs.

2. It may be noted that although the ICAI has issued AS 30, *Financial Instruments: Recognition and Measurement*, which contains accounting for derivatives, it becomes recommendatory from 1.04.2009 and mandatory from 1.04.2011.[118] In this scenario, the Council expressed the view that since the aforesaid Standard contains appropriate accounting for derivatives, the same can be followed by the entities, as the earlier adoption of a standard is always encouraged.

3. In case an entity does not follow AS 30, keeping in view the principle of prudence as enunciated in AS 1, 'Disclosure of Accounting Policies', the entity is required to provide for losses in respect of all outstanding derivative contracts at the balance sheet date by marking them to market.

4. The entity needs to disclose the policy followed with regard to accounting for derivatives in its financial statements.

In case AS 30 is followed by the entity, a disclosure of the amounts recognised in the financial statements should be made.

In case AS 30 is not followed, the losses provided for as suggested in paragraph 3 above should be separately disclosed by the entity.

5. The auditors should consider making appropriate disclosures in their reports if the aforesaid accounting treatment and disclosures are not made.

6. In case of forward contracts to which AS 11, *'The Effects of Changes in Foreign Exchange Rates'*, applies, the entity needs to fully comply with the requirements of AS 11. Accordingly, this Announcement does not apply to such contracts.

7. This clarificatory Announcement applies to financial statements for the period ending March 31, 2008, or thereafter.

[118] For current status of applicability of AS 30, see Announcement XLI.

XL Announcements on 'Accounting for 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' withdrawn.[119]

1. The Institute of Chartered Accountants of India (ICAI), in January 2006, issued an Announcement on 'Accounting for 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'. Pending the issuance of the proposed Accounting Standard on 'Financial Instruments: Recognition and Measurement', which was under formulation, the said Announcement prescribed the accounting treatment which should be followed in respect of the exchange differences arising on the forward exchange contracts entered into to hedge the foreign currency risks of a firm commitment or a highly probable forecast transaction. An Announcement prescribing the applicability date of this Announcement was issued in February 2006.

2. Subsequently, an Announcement was issued in June 2006, deferring the applicability of the Announcement issued in January 2006, to the accounting period(s) commencing on or after April 1, 2007. The Council, at its 269th meeting, held on July 18, 2007, decided to further defer the applicability of the Announcement issued in January 2006, to accounting period(s) commencing on or after April 1, 2008.

3. The Council, at its 277th meeting, held on March 27 to 29, 2008, noted that Accounting Standard (AS) 30, 'Financial Instruments: Recognition and Measurement', has already been issued. Accordingly, it has decided to withdraw all the Announcements mentioned in the above paragraphs.

XLI Application of AS 30, *Financial Instruments: Recognition and Measurement*.[120]

1 AS 30 was issued by the Institute of Chartered Accountants of India (ICAI) in 2007 but has not yet been notified by the Government under Section 211(3C) of the Companies Act, 1956. As per this standard;

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[119] Published in 'The Chartered Accountant', May 2008 (pp. 1944).

[120] Published in 'The Chartered Accountant', April 2011 (pp. 1575).

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

2 AS 30 further states;

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

(i) Guidance Note on Guarantees & Counter Guarantees Given by the Companies.

(ii) Guidance Note on Accounting for Investments in the Financial Statements of Mutual Funds.

(iii) Guidance Note on Accounting for Securitisation.

(iv) Guidance Note on Accounting for Equity Index and Equity Stock Futures and Options."

3 Subsequent to the issuance of AS 30, the world witnessed financial crisis which raised issues with regard to accounting treatment of financial instruments. Accordingly, various accounting standards setting bodies including the ICAI examined these aspects. Insofar as International Accounting Standards Board is concerned certain modifications have been made in the corresponding International Accounting Standard, viz., IAS 39, *Financial Instruments: Recognition and Measurement* . The International Accounting Standards Board has also issued IFRS 9, *Financial Instruments,* which replaces certain requirements contained in IAS 39 and it is expected that ultimately the entire IAS 39 on which AS 30 is based is not expected to be replaced before June 30, 2011 as presently committed by IASB. Accordingly, AS 30 is not expected to continue in its present form including for those entities for which converged Indian Accounting Standards will come into force from 1st April, 2011. In

this changed scenario, the Council has reconsidered the matter regarding the status of the existing AS 30 and has decided to issue the following clarification for the guidance of the Members and others concerned.

4 It is clarified that in respect of the financial statements or other financial information for the accounting periods commencing on or after 1 st April 2009 and ending on or before 31 st March 2011, the status of AS 30 would be as below:

(i) To the extent of accounting treatments covered by any of the existing notified accounting standards (eg. AS 11, AS 13, etc.), the existing accounting standards would continue to prevail over AS 30.

(ii) In cases where a relevant regulatory authority has prescribed specific regulatory requirements (eg. Loan impairment, investment classification or accounting for securitizations by the RBI, etc.), the prescribed regulatory requirements would continue to prevail over AS 30.

(iii) The preparers of the financial statements are encouraged to follow the principles enunciated in the accounting treatments contained in AS 30. The aforesaid is, however, subject to (i) and (ii) above.

5 From 1st April 2011 onwards,

(i) the entities to which converged Indian Accounting Standards will be applied as per the roadmap issued by MCA, the Indian Accounting Standard (Ind AS) 39, *Financial Instruments; Recognition and Measurement,* will apply.

(ii) for entities other than those covered under paragraph 5(i) above, the status of AS 30 will continue as clarified in paragraph 4 above.

6 The abovementioned clarifications would also be relevant to the existing AS 31, *Financial Instruments: Presentation* and AS 32, *Financial Instruments: Disclosures* as well as for Ind AS 32, *Financial Instruments: Presentation* and Ind AS 107, *Financial Instruments: Disclosures*, after 1st April 2011 onwards.

XLII Revision in the criteria for classifying Level II non-corporate entities

1. The Council of the Institute with a view to harmonise the differences between the Accounting Standards issued by the ICAI and the Accounting Standards notified by the Central Government under the Companies (Accounting Standards) Rules, 2006, in February, 2008 issued the announcement titled as ***'Harmonisation of various differences between the Accounting Standards issued by the ICAI and the Accounting Standards notified by the Central Government'***[121] wherein the Council prescribed the criteria for classifying the non-corporate entities into Level I, Level II and Level III. As per the announcement Level II entities are:

2. *Non-corporate entities which are not Level I entities but fall in any one or more of the following categories are classified as Level II entities:*

   (i) All commercial, industrial and business reporting entities, whose turnover (excluding other income) ***exceeds rupees forty lakh but does not exceed rupees fifty crore*** *in the immediately preceding accounting year.*

   (ii) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees one crore but not in excess of rupees ten crore at any time during the immediately preceding accounting year.

   (iii) Holding and subsidiary entities of any one of the above.

3. The Council of the Institute at its 321st meeting held on January 10-12, 2013 at New Delhi, considering recent changes in the enhancement of tax audit limit, decided to change the applicability of Accounting Standards for Level II entities from Rs. 40 lakhs to Rs. 1 Crore with effect from the **accounting year commencing on or after April 01, 2012.**

4. Accordingly, from the accounting year commencing on or after April 1st, 2012, criteria for classification of Level II entities is as follows:-

Level II Entities (SMEs)

Non-corporate entities which are not Level I entities but fall in any

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121 Published in 'The Chartered Accountant', February 2008 (pp. 1340)

one or more of the following categories are classified as Level II entities:

(i) All commercial, industrial and business reporting entities, whose turnover (excluding other income) ***exceeds rupees one crore but does not exceed rupees fifty crore*** *in the immediately preceding accounting year.*

(ii) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees one crore but not in excess of rupees ten crore at any time during the immediately preceding accounting year.

(iii) Holding and subsidiary entities of any one of the above.

XLIII Presentation of Foreign Currency Monetary Item Translation Difference Account

1. In the year 2009, the Ministry of Corporate Affairs amended Accounting Standard (AS) 11, *The Effects of Changes in Foreign Exchange Rates* by inserting Paragraph 46. As per Paragraph 46, in respect of accounting periods commencing on or after 7th December, 2006, and ending on or before 31st March, 2011, at the option of the enterprise, exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, insofar as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortised over the balance period of such long-term asset/liability but not beyond 31st March, 2011, by recognition as income or expense in each such periods.

2. On 29th December, 2011, the MCA, through the Companies (Accounting Standards) Amendment Rules, 2011, further extended the date of amortisation of the balance in the FCMITDA to 31st March, 2020 instead of 31st March, 2011. The MCA on December 29, 2011, inserted paragraph 46A in the AS 11, *The Effects of Changes in Foreign Exchange Rates* through Companies (Accounting Standards) (Second Amendment) Rules, 2011, on similar lines as paragraph 46.

3. As in the Revised Schedule VI format, no line item has been specified for the presentation of "Foreign Currency Monetary Item Translation Difference Account (FCMITDA)", the Council of the Institute at its 324th meeting held on March 24-26, 2013 at New Delhi, considered the issue regarding the presentation of the FCMITDA in the balance sheet.

4. The Council noted that the *Framework on Preparation and Presentation of Financial Statement*s issued by ICAI, defines an asset as follows:

> *"An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise."*

Where the balance in FCMITDA represents foreign currency translation loss, it does not meet the above definition of 'asset' as it is neither a resource nor any future economic benefit would flow to the entity therefrom. Accordingly, such balance cannot be reflected as an asset.

Accordingly, the Council decided that debit or credit balance in FCMITDA should be shown on the "Equity and Liabilities" side of the balance sheet under the head 'Reserves and Surplus' as a separate line item.

5. The aforesaid decision of the Council supersedes the following Frequently Asked Question on AS 11 notification – Companies (Accounting Standards) Amendment Rules, 2009 (G.S.R. 225 (E) dt. 31.3.09) issued by Ministry of Corporate Affairs on May 18, 2009, which was issued by the Accounting Standards Board of ICAI on May 18, 2009:

"(14) How 'Foreign Currency Monetary Item Translation Difference Account' should be presented in the Balance Sheet?

Response

The 'Foreign Currency Monetary Item Translation Difference Account' should be shown as a separate line item in the Balance Sheet, in line with treatment given to Deferred Tax Asset/Liability, i.e. after the head 'Investments' or after the head 'Unsecured Loans' as the case may be and separately from current assets and current liabilities."

XLIV Insertion of new paragraph 46 in AS 11, *The Effects of Changes in Foreign Exchange Rates,* issued by The Institute of Chartered Accountants of India, for their applicability to entities other than companies

1. The Ministry of Corporate Affairs, Government of India, inserted paragraph 46 by notification dated 31st March, 2009 which was subsequently modified in 2011 by notification dated May 11, 2011 and notification dated 29th December, 2011 and paragraph 46A in AS 11, inserted by notification dated 29th December, 2011 after paragraph 45 of AS 11 notified under the Companies (Accounting Standards) Rules, 2006.

2. The Council of the Institute of Chartered Accountants of India (ICAI) considered the proposal for providing the option available to the companies under paragraphs 46 and 46A of AS 11 notified by the Ministry of Corporate Affairs to those entities to which the Accounting Standards notified under Companies Act, 1956 are not applicable. The Council decided that the options available under paragraphs 46 and 46A of AS 11 notified by the Central Government be also made available to the aforementioned entities.

3. In view of the above, paragraphs 46 and 46A introduced in AS 11, modified from time to time, as applicable to companies, shall be deemed to be introduced in AS 11 issued by ICAI for entities to which the Companies Act is not applicable with effect from the accounting periods as stated in paragraph 1 above as follows:

> "46 (1) In respect of accounting periods commencing on or after the 7th December 2006, (such option to be irrevocable and to be applied to all such foreign currency monetary items), the exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and should be depreciated over the balance life of the asset, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortised over the balance period of such long term asset or liability, by recognition as income or expense in each of such

periods, with the exception of exchange differences dealt with in accordance with the provisions of paragraph 15.

(2) To exercise the option referred to in sub-paragraph (1), an asset or liability should be designated as a long term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of twelve months or more at the date of origination of the asset or the liability:

Provided that the option exercised by enterprise should disclose the fact of such option and of the amount remaining to be amortised in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortised."

Preface to the Statements of Accounting Standards

(revised 2004)

Contents

Preface to the Statements of Accounting Standards
(revised 2004)

The following is the text of the Preface to the Statements of Accounting Standards (revised 2004), issued by the Council of the Institute of Chartered Accountants of India.

With the issuance of this revised Preface, the Preface to the Statements of Accounting Standards, issued in January, 1979, stands superseded.

1. Formation of the Accounting Standards Board

1.1 The Institute of Chartered Accountants of India (ICAI), recognising the need to harmonise the diverse accounting policies and practices in use in India, constituted the Accounting Standards Board (ASB) on 21st April, 1977.

1.2 The composition of the ASB is fairly broad-based and ensures participation of all interest-groups in the standard-setting process. Apart from the elected members of the Council of the ICAI nominated on the ASB, the following are represented on the ASB:

(i) Nominee of the Central Government representing the Department of Company Affairs on the Council of the ICAI

(ii) Nominee of the Central Government representing the Office of the Comptroller and Auditor General of India on the Council of the ICAI

(iii) Nominee of the Central Government representing the Central Board of Direct Taxes on the Council of the ICAI

(iv) Representative of the Institute of Cost and Works Accountants of India

(v) Representative of the Institute of Company Secretaries of India

(vi) Representatives of Industry Associations (1 from Associated Chambers of Commerce and Industry (ASSOCHAM), 1 from

Confederation of Indian Industry (CII) and 1 from Federation of Indian Chambers of Commerce and Industry (FICCI)

(vii) Representative of Reserve Bank of India

(viii) Representative of Securities and Exchange Board of India

(ix) Representative of Controller General of Accounts

(x) Representative of Central Board of Excise and Customs

(xi) Representatives of Academic Institutions (1 from Universities and 1 from Indian Institutes of Management)

(xii) Representative of Financial Institutions

(xiii) Eminent professionals co-opted by the ICAI (they may be in practice or in industry, government, education, etc.)

(xiv) Chairman of the Research Committee and the Chairman of the Expert Advisory Committee of the ICAI, if they are not otherwise members of the Accounting Standards Board

(xv) Representative(s) of any other body, as considered appropriate by the ICAI

2. Objectives and Functions of the Accounting Standards Board

2.1 The following are the objectives of the Accounting Standards Board:

(i) To conceive of and suggest areas in which Accounting Standards need to be developed.

(ii) To formulate Accounting Standards with a view to assisting the Council of the ICAI in evolving and establishing Accounting Standards in India.

(iii) To examine how far the relevant International Accounting Standard/International Financial Reporting Standard (see paragraph 2.3 below) can be adapted while formulating the Accounting Standard and to adapt the same.

(iv) To review, at regular intervals, the Accounting Standards from the point of view of acceptance or changed conditions, and, if necessary, revise the same.

(v) To provide, from time to time, interpretations and guidance on Accounting Standards.

(vi) To send comments on various consultative papers such as Exposure Drafts, Discussion Papers etc., issued by International Accounting Standards Board and various other International bodies such as Asian-Oceanian Standard-Setters Group (AOSSG).

(vii) To carry out such other functions relating to Accounting Standards.

2.2 The main function of the ASB is to formulate Accounting Standards so that such standards may be established by the ICAI in India. While formulating the Accounting Standards, the ASB will take into consideration the applicable laws, customs, usages and business environment prevailing in India.

2.3 The ICAI, being a full-fledged member of the International Federation of Accountants (IFAC), is expected, inter alia, to actively promote the International Accounting Standards Board's (IASB) pronouncements in the country with a view to facilitate global harmonisation of accounting standards. Accordingly, while formulating the Accounting Standards, the ASB will give due consideration to International Accounting Standards (IASs) issued by the International Accounting Standards Committee (predecessor body to IASB) or International Financial Reporting Standards (IFRSs) issued by the IASB, as the case may be, and try to integrate them, to the extent possible, in the light of the conditions and practices prevailing in India.

2.4 The Accounting Standards are issued under the authority of the Council of the ICAI. The ASB has also been entrusted with the responsibility of propagating the Accounting Standards and of persuading the concerned parties to adopt them in the preparation and presentation of financial statements. The ASB will provide interpretations and guidance on issues arising from Accounting Standards. The ASB will also review the Accounting Standards at periodical intervals and, if necessary, revise the same.

3. General Purpose Financial Statements

3.1 For discharging its functions, the ASB will keep in view the purposes and limitations of financial statements and the attest function of the auditors. The ASB will enumerate and describe the basic concept to which accounting principles should be oriented and state the accounting principles to which the practices and procedures should conform.

3.2 The ASB will clarify the terms commonly used in financial statements and suggest improvements in the terminology wherever necessary. The ASB will examine the various current alternative practices in vogue and endeavour to eliminate or reduce alternatives within the bounds of rationality.

3.3 Accounting Standards are designed to apply to the general purpose financial statements and other financial reporting, which are subject to the attest function of the members of the ICAI. Accounting Standards apply in respect of any enterprise (whether organised in corporate, co-operative[1] or other forms) engaged in commercial, industrial or business activities, irrespective of whether it is profit oriented or it is established for charitable or religious purposes. Accounting Standards will not, however, apply to enterprises only carrying on the activities which are not of commercial, industrial or business nature, (e.g., an activity of collecting donations and giving them to flood affected people). Exclusion of an enterprise from the applicability of the Accounting Standards would be permissible only if no part of the activity of such enterprise is commercial, industrial or business in nature. Even if a very small proportion of the activities of an enterprise is considered to be commercial, industrial or business in nature, the Accounting Standards would apply to all its activities including those which are not commercial, industrial or business in nature[2].

3.4 The term 'General Purpose Financial Statements' includes balance sheet, statement of profit and loss, a cash flow statement (wherever applicable) and statements and explanatory notes which form part thereof, issued for the use of various stakeholders, Governments and their agencies and the public. References to financial statements in this Preface and in the

[1] With the issuance of this revised Preface, General Clarification (GC) - 12/2002, Applicability of Accounting Standards to Co-operative Societies, issued by the Accounting Standards Board in October 2002, stands superseded.

[2] With the issuance of this revised Preface, Announcement on 'Applicability of Accounting Standards to Charitable and/or Religious Organisations', approved by the Council (published in 'The Chartered Accountant', September 1995 (page 79)), stands superseded.

standards issued from time to time will be construed to refer to General Purpose Financial Statements.

3.5 Responsibility for the preparation of financial statements and for adequate disclosure is that of the management of the enterprise. The auditor's responsibility is to form his opinion and report on such financial statements.

4. Scope of Accounting Standards

4.1 Efforts will be made to issue Accounting Standards which are in conformity with the provisions of the applicable laws, customs, usages and business environment in India. However, if a particular Accounting Standard is found to be not in conformity with law, the provisions of the said law will prevail and the financial statements should be prepared in conformity with such law.

4.2 The Accounting Standards by their very nature cannot and do not override the local regulations which govern the preparation and presentation of financial statements in the country. However, the ICAI will determine the extent of disclosure to be made in financial statements and the auditor's report thereon. Such disclosure may be by way of appropriate notes explaining the treatment of particular items. Such explanatory notes will be only in the nature of clarification and therefore need not be treated as adverse comments on the related financial statements.

4.3 The Accounting Standards are intended to apply only to items which are material. Any limitations with regard to the applicability of a specific Accounting Standard will be made clear by the ICAI from time to time. The date from which a particular Standard will come into effect, as well as the class of enterprises to which it will apply, will also be specified by the ICAI. However, no standard will have retroactive application, unless otherwise stated.

4.4 The Institute will use its best endeavours to persuade the Government, appropriate authorities, industrial and business community to adopt the Accounting Standards in order to achieve uniformity in preparation and presentation of financial statements.

4.5 In formulation of Accounting Standards, the emphasis would be on laying down accounting principles and not detailed rules for application and implementation thereof.

4.6 The Standards formulated by the ASB include paragraphs in bold italic type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. An individual standard should be read in the context of the objective stated in that standard and this Preface.

4.7 The ASB may consider any issue requiring interpretation on any Accounting Standard. Interpretations will be issued under the authority of the Council. The authority of Interpretation is the same as that of Accounting Standard to which it relates.

5. Procedure for Issuing an Accounting Standard

Broadly, the following procedure is adopted for formulating Accounting Standards:

5.1 The ASB determines the broad areas in which Accounting Standards need to be formulated and the priority in regard to the selection thereof.

5.2 In the preparation of Accounting Standards, the ASB will be assisted by Study Groups constituted to consider specific subjects. In the formation of Study Groups, provision will be made for wide participation by the members of the Institute and others.

5.3 The draft of the proposed standard will normally include the following:

(a) Objective of the Standard,

(b) Scope of the Standard,

(c) Definitions of the terms used in the Standard,

(d) Recognition and measurement principles, wherever applicable,

(e) Presentation and disclosure requirements.

5.4 The ASB will consider the preliminary draft prepared by the Study Group and if any revision of the draft is required on the basis of deliberations, the ASB will make the same or refer the same to the Study Group.

5.5 The ASB will circulate the draft of the Accounting Standard to the Council members of the ICAI and the following specified bodies for their comments*:

(i) Department of Company Affairs (DCA)

(ii) Comptroller and Auditor General of India (C&AG)

(iii) Central Board of Direct Taxes (CBDT)

(iv) The Institute of Cost and Works Accountants of India (ICWAI)

(v) The Institute of Company Secretaries of India (ICSI)

(vi) Associated Chambers of Commerce and Industry (ASSOCHAM), Confederation of Indian Industry (CII) and Federation of Indian Chambers of Commerce and Industry (FICCI)

(vii) Reserve Bank of India (RBI)

(viii) Securities and Exchange Board of India (SEBI)

(ix) Standing Conference of Public Enterprises (SCOPE)

(x) Indian Banks' Association (IBA)

(xi) Any other body considered relevant by the ASB keeping in view the nature of the Accounting Standard

5.6 The ASB will hold a meeting with the representatives of specified bodies to ascertain their views on the draft of the proposed Accounting Standard. On the basis of comments received and discussion with the representatives of specified bodies, the ASB will finalise the Exposure Draft of the proposed Accounting Standard*.

5.7 The Exposure Draft of the proposed Standard will be issued for comments by the members of the Institute and the public. The Exposure Draft will specifically be sent to specified bodies (as listed above), stock exchanges, and other interest groups, as appropriate.

5.8 After taking into consideration the comments received, the draft of the proposed Standard will be finalised by the ASB and submitted to the Council of the ICAI.

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* The Council of ICAI, at its 291st meeting held on December 16-17, 2009 decided that procedures in paragraph 5.5 and 5.6 need not be followed in respect of Accounting Standards issued hithertofore.

5.9 The Council of the ICAI will consider the final draft of the proposed Standard, and if found necessary, modify the same in consultation with the ASB. The Accounting Standard on the relevant subject will then be issued by the ICAI.

5.10 For a substantive revision of an Accounting Standard, the procedure followed for formulation of a new Accounting Standard, as detailed above, will be followed.

5.11 Subsequent to issuance of an Accounting Standard, some aspect(s) may require revision which are not substantive in nature. For this purpose, the ICAI may make limited revision to an Accounting Standard. The procedure followed for the limited revision will substantially be the same as that to be followed for formulation of an Accounting Standard, ensuring that sufficient opportunity is given to various interest groups and general public to react to the proposal for limited revision.

6. Compliance with the Accounting Standards

6.1 The Accounting Standards will be mandatory from the respective date(s) mentioned in the Accounting Standard(s). The mandatory status of an Accounting Standard implies that while discharging their attest functions, it will be the duty of the members of the Institute to examine whether the Accounting Standard is complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the 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 deviation.

6.2 Ensuring compliance with the Accounting Standards while preparing the financial statements is the responsibility of the management of the enterprise. Statutes governing certain enterprises require of the enterprises that the financial statements should be prepared in compliance with the Accounting Standards, e.g., the Companies Act, 1956 (section 211), and the Insurance Regulatory and Development Authority (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000.

6.3 Financial Statements cannot be described as complying with the Accounting Standards unless they comply with all the requirements of each applicable Standard.

Framework for the Preparation and Presentation of Financial Statements

Contents

Continued../..

Framework for the Preparation and Presentation of Financial Statements*

The following is the text of the 'Framework for the Preparation and Presentation of Financial Statements' issued by the Accounting Standards Board of the Institute of Chartered Accountants of India.

Introduction

Purpose and Status

1. This Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. The purpose of the Framework is to:

(a) assist preparers of financial statements in applying Accounting Standards and in dealing with topics that have yet to form the subject of an Accounting Standard;

(b) assist the Accounting Standards Board in the development of future Accounting Standards and in its review of existing Accounting Standards;

(c) assist the Accounting Standards Board in promoting harmonisation of regulations, accounting standards and procedures relating to the preparation and presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by Accounting Standards;

(d) assist auditors in forming an opinion as to whether financial statements conform with Accounting Standards;

(e) assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with Accounting Standards; and

(f) provide those who are interested in the work of the Accounting

* Issued in July 2000.

Standards Board with information about its approach to the formulation of Accounting Standards.

2. This Framework is not an Accounting Standard and hence does not define standards for any particular measurement or disclosure issue. Nothing in this Framework overrides any specific Accounting Standard.

3. The Accounting Standards Board recognises that in a limited number of cases there may be a conflict between the Framework and an Accounting Standard. In those cases where there is a conflict, the requirements of the Accounting Standard prevail over those of the Framework. As, however, the Accounting Standards Board will be guided by the Framework in the development of future Standards and in its review of existing Standards, the number of cases of conflict between the Framework and Accounting Standards will diminish through time.

4. The Framework will be revised from time to time on the basis of the experience of the Accounting Standards Board of working with it.

Scope

5. The Framework deals with:

(a) the objective of financial statements;

(b) the qualitative characteristics that determine the usefulness of information provided in financial statements;

(c) definition, recognition and measurement of the elements from which financial statements are constructed; and

(d) concepts of capital and capital maintenance.

6. The Framework is concerned with general purpose financial statements (hereafter referred to as 'financial statements'). Such financial statements are prepared and presented at least annually and are directed toward the common information needs of a wide range of users. Some of these users may require, and have the power to obtain, information in addition to that contained in the financial statements. Many users, however, have to rely on the financial statements as their major source of financial information and such financial statements should, therefore, be prepared and presented with their needs in view. Special purpose financial reports, for example,

prospectuses and computations prepared for taxation purposes, are outside the scope of this Framework. Nevertheless, the Framework may be applied in the preparation of such special purpose reports where their requirements permit.

7. Financial statements form part of the process of financial reporting. A complete set of financial statements normally includes a balance sheet, a statement of profit and loss (also known as 'income statement'), a cash flow statement and those notes and other statements and explanatory material that are an integral part of the financial statements. They may also include supplementary schedules and information based on or derived from, and expected to be read with, such statements. Such schedules and supplementary information may deal, for example, with financial information about business and geographical segments, and disclosures about the effects of changing prices. Financial statements do not, however, include such items as reports by directors, statements by the chairman, discussion and analysis by management and similar items that may be included in a financial or annual report.

8. The Framework applies to the financial statements of all reporting enterprises engaged in commercial, industrial and business activities, whether in the public or in the private sector. A reporting enterprise is an enterprise for which there are users who rely on the financial statements as their major source of financial information about the enterprise.

Users and Their Information Needs

9. The users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public. They use financial statements in order to satisfy some of their information needs. These needs include the following:

(a) *Investors*. The providers of risk capital are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. They are also interested in information which enables them to assess the ability of the enterprise to pay dividends.

(b) *Employees*. Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the enterprise to provide remuneration, retirement benefits and employment opportunities.

(c) *Lenders*. Lenders are interested in information which enables them to determine whether their loans, and the interest attaching to them, will be paid when due.

(d) *Suppliers and other trade creditors*. Suppliers and other creditors are interested in information which enables them to determine whether amounts owing to them will be paid when due. Trade creditors are likely to be interested in an enterprise over a shorter period than lenders unless they are dependent upon the continuance of the enterprise as a major customer.

(e) *Customers*. Customers have an interest in information about the continuance of an enterprise, especially when they have a long-term involvement with, or are dependent on, the enterprise.

(f) *Governments and their agencies*. Governments and their agencies are interested in the allocation of resources and, therefore, the activities of enterprises. They also require information in order to regulate the activities of enterprises and determine taxation policies, and to serve as the basis for determination of national income and similar statistics.

(g) *Public*. Enterprises affect members of the public in a variety of ways. For example, enterprises may make a substantial contribution to the local economy in many ways including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the enterprise and the range of its activities.

10. While all of the information needs of these users cannot be met by financial statements, there are needs which are common to all users. As providers of risk capital to the enterprise, investors need more comprehensive information than other users. The provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

11. The management of an enterprise has the responsibility for the

preparation and presentation of the financial statements of the enterprise. Management is also interested in the information contained in the financial statements even though it has access to additional management and financial information that helps it carry out its planning, decision-making and control responsibilities. Management has the ability to determine the form and content of such additional information in order to meet its own needs. The reporting of such information, however, is beyond the scope of this Framework.

The Objective of Financial Statements

12. The objective of financial statements is to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions.

13. Financial statements prepared for this purpose meet the common needs of most users. However, financial statements do not provide all the information that users may need to make economic decisions since (a) they largely portray the financial effects of past events, and (b) do not necessarily provide non-financial information.

14. Financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of management do so in order that they may make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the enterprise or whether to reappoint or replace the management.

Financial Position, Performance and Cash Flows

15. The economic decisions that are taken by users of financial statements require an evaluation of the ability of an enterprise to generate cash and cash equivalents and of the timing and certainty of their generation. This ability ultimately determines, for example, the capacity of an enterprise to pay its employees and suppliers, meet interest payments, repay loans, and make distributions to its owners. Users are better able to evaluate this ability to generate cash and cash equivalents if they are provided with information that focuses on the financial position, performance and cash flows of an enterprise.

16. The financial position of an enterprise is affected by the economic resources it controls, its financial structure, its liquidity and solvency, and

its capacity to adapt to changes in the environment in which it operates. Information about the economic resources controlled by the enterprise and its capacity in the past to alter these resources is useful in predicting the ability of the enterprise to generate cash and cash equivalents in the future. Information about financial structure is useful in predicting future borrowing needs and how future profits and cash flows will be distributed among those with an interest in the enterprise; it is also useful in predicting how successful the enterprise is likely to be in raising further finance. Information about liquidity and solvency is useful in predicting the ability of the enterprise to meet its financial commitments as they fall due. Liquidity refers to the availability of cash in the near future to meet financial commitments over this period. Solvency refers to the availability of cash over the longer term to meet financial commitments as they fall due.

17. Information about the performance of an enterprise, in particular its profitability, is required in order to assess potential changes in the economic resources that it is likely to control in the future. Information about variability of performance is important in this respect. Information about performance is useful in predicting the capacity of the enterprise to generate cash flows from its existing resource base. It is also useful in forming judgements about the effectiveness with which the enterprise might employ additional resources.

18. Information concerning cash flows of an enterprise is useful in order to evaluate its investing, financing and operating activities during the reporting period. This information is useful in providing the users with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows.

19. Information about financial position is primarily provided in a balance sheet. Information about performance is primarily provided in a statement of profit and loss. Information about cash flows is provided in the financial statements by means of a cash flow statement.

20. The component parts of the financial statements are interrelated because they reflect different aspects of the same transactions or other events. Although each statement provides information that is different from the others, none is likely to serve only a single purpose nor to provide all the information necessary for particular needs of users.

Notes and Supplementary Schedules

21. The financial statements also contain notes and supplementary

schedules and other information. For example, they may contain additional information that is relevant to the needs of users about the items in the balance sheet and statement of profit and loss. They may include disclosures about the risks and uncertainties affecting the enterprise and any resources and obligations not recognised in the balance sheet (such as mineral reserves). Information about business and geographical segments and the effect of changing prices on the enterprise may also be provided in the form of supplementary information.

Underlying Assumptions

Accrual Basis

22. In order to meet their objectives, financial statements are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognised when they occur (and not as cash or a cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past events involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions.

Going Concern

23. The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

Consistency

24. In order to achieve comparability of the financial statements of an enterprise through time, the accounting policies are followed consistently from one period to another; a change in an accounting policy is made only in certain exceptional circumstances.

Qualitative Characteristics of Financial Statements

25. Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

Understandability

26. An essential quality of the information provided in financial statements is that it must be readily understandable by users. For this purpose, it is assumed that users have a reasonable knowledge of business and economic activities and accounting and study the information with reasonable diligence. Information about complex matters that should be included in the financial statements because of its relevance to the economic decision-making needs of users should not be excluded merely on the ground that it may be too difficult for certain users to understand.

Relevance

27. To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

28. The predictive and confirmatory roles of information are interrelated. For example, information about the current level and structure of asset holdings has value to users when they endeavour to predict the ability of the enterprise to take advantage of opportunities and its ability to react to adverse situations. The same information plays a confirmatory role in respect of past predictions about, for example, the way in which the enterprise would be structured or the outcome of planned operations.

29. Information about financial position and past performance is frequently used as the basis for predicting future financial position and performance and other matters in which users are directly interested, such as dividend and wage payments, share price movements and the ability of the enterprise to meet its commitments as they fall due. To have predictive value, information need not be in the form of an explicit forecast. The ability to make predictions from financial statements is enhanced, however, by the manner in which information on past transactions and events is displayed. For example, the predictive value of the statement of profit and loss is

enhanced if unusual, abnormal and infrequent items of income and expense are separately disclosed.

Materiality

30. The relevance of information is affected by its materiality. Information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality depends on the size and nature of the item or error, judged in the particular circumstances of its misstatement. Materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful.

Reliability

31. To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

32. Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading. For example, if the validity and amount of a claim for damages under a legal action against the enterprise are highly uncertain, it may be inappropriate for the enterprise to recognise the amount of the claim in the balance sheet, although it may be appropriate to disclose the amount and circumstances of the claim.

Faithful Representation

33. To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in assets, liabilities and equity of the enterprise at the reporting date which meet the recognition criteria.

34. Most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured or in devising and applying measurement and presentation techniques that can convey messages that correspond with

those transactions and events. In certain cases, the measurement of the financial effects of items could be so uncertain that enterprises generally would not recognise them in the financial statements; for example, although most enterprises generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, however, it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement.

Substance Over Form

35. If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, where rights and beneficial interest in an immovable property are transferred but the documentation and legal formalities are pending, the recording of acquisition/disposal (by the transferee and transferor respectively) would in substance represent the transaction entered into.

Neutrality

36. To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

Prudence

37. The preparers of financial statements have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of receivables, the probable useful life of plant and machinery, and the warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of

liabilities or expenses, because the financial statements would then not be neutral and, therefore, not have the quality of reliability.

Completeness

38. To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

Comparability

39. Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position, performance and cash flows. Users must also be able to compare the financial statements of different enterprises in order to evaluate their relative financial position, performance and cash flows. Hence, the measurement and display of the financial effects of like transactions and other events must be carried out in a consistent way throughout an enterprise and over time for that enterprise and in a consistent way for different enterprises.

40. An important implication of the qualitative characteristic of comparability is that users be informed of the accounting policies employed in the preparation of the financial statements, any changes in those policies and the effects of such changes. Users need to be able to identify differences between the accounting policies for like transactions and other events used by the same enterprise from period to period and by different enterprises. Compliance with Accounting Standards, including the disclosure of the accounting policies used by the enterprise, helps to achieve comparability.

41. The need for comparability should not be confused with mere uniformity and should not be allowed to become an impediment to the introduction of improved accounting standards. It is not appropriate for an enterprise to continue accounting in the same manner for a transaction or other event if the policy adopted is not in keeping with the qualitative characteristics of relevance and reliability. It is also inappropriate for an enterprise to leave its accounting policies unchanged when more relevant and reliable alternatives exist.

42. Users wish to compare the financial position, performance and cash flows of an enterprise over time. Hence, it is important that the financial statements show corresponding information for the preceding period(s).

Constraints on Relevant and Reliable Information

Timeliness

43. If there is undue delay in the reporting of information it may lose its relevance. Management may need to balance the relative merits of timely reporting and the provision of reliable information. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction or other event are known, thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the information needs of users.

Balance between Benefit and Cost

44. The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a judgmental process. Furthermore, the costs do not necessarily fall on those users who enjoy the benefits. Benefits may also be enjoyed by users other than those for whom the information is prepared. For these reasons, it is difficult to apply a cost-benefit test in any particular case. Nevertheless, standard-setters in particular, as well as the preparers and users of financial statements, should be aware of this constraint.

Balance between Qualitative Characteristics

45. In practice, a balancing, or trade-off, between qualitative characteristics is often necessary. Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgment.

True and Fair View

46. Financial statements are frequently described as showing a true and fair view of the financial position, performance and cash flows of an enterprise. Although this Framework does not deal directly with such concepts, the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of such information.

The Elements of Financial Statements

47. Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements. The elements directly related to the measurement of financial position in the balance sheet are assets, liabilities and equity. The elements directly related to the measurement of performance in the statement of profit and loss are income and expenses. The cash flow statement usually reflects elements of statement of profit and loss and changes in balance sheet elements; accordingly, this Framework identifies no elements that are unique to this statement.

48. The presentation of these elements in the balance sheet and the statement of profit and loss involves a process of sub-classification. For example, assets and liabilities may be classified by their nature or function in the business of the enterprise in order to display information in the manner most useful to users for purposes of making economic decisions.

Financial Position

49. The elements directly related to the measurement of financial position are assets, liabilities and equity. These are defined as follows:

(a) An *asset* is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.

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

(c) *Equity* is the residual interest in the assets of the enterprise after deducting all its liabilities.

50. The definitions of an asset and a liability identify their essential features but do not attempt to specify the criteria that need to be met before they are recognised in the balance sheet. Thus, the definitions embrace items that are not recognised as assets or liabilities in the balance sheet because they do not satisfy the criteria for recognition discussed in paragraphs 81 to 97.

In particular, the expectation that future economic benefits will flow to or from an enterprise must be sufficiently certain to meet the probability criterion in paragraph 82 before an asset or liability is recognised.

51. In assessing whether an item meets the definition of an asset, liability or equity, consideration needs to be given to its underlying substance and economic reality and not merely its legal form. Thus, for example, in the case of hire purchase, the substance and economic reality are that the hire purchaser acquires the economic benefits of the use of the asset in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge. Hence, the hire purchase gives rise to items that satisfy the definition of an asset and a liability and are recognised as such in the hire purchaser's balance sheet.

Assets

52. The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the enterprise. The potential may be a productive one that is part of the operating activities of the enterprise. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production.

53. An enterprise usually employs its assets to produce goods or services capable of satisfying the wants or needs of customers; because these goods or services can satisfy these wants or needs, customers are prepared to pay for them and hence contribute to the cash flows of the enterprise. Cash itself renders a service to the enterprise because of its command over other resources.

54. The future economic benefits embodied in an asset may flow to the enterprise in a number of ways. For example, an asset may be:

(a) used singly or in combination with other assets in the production of goods or services to be sold by the enterprise;

(b) exchanged for other assets;

(c) used to settle a liability; or

(d) distributed to the owners of the enterprise.

55. Many assets, for example, plant and machinery, have a physical form. However, physical form is not essential to the existence of an asset; hence patents and copyrights, for example, are assets if future economic benefits are expected to flow from them and if they are controlled by the enterprise.

56. Many assets, for example, receivables and property, are associated with legal rights, including the right of ownership. In determining the existence of an asset, the right of ownership is not essential; thus, for example, an item held under a hire purchase is an asset of the hire purchaser since the hire purchaser controls the benefits which are expected to flow from the item. Although the capacity of an enterprise to control benefits is usually the result of legal rights, an item may nonetheless satisfy the definition of an asset even when there is no legal control. For example, know-how obtained from a development activity may meet the definition of an asset when, by keeping that know-how secret, an enterprise controls the benefits that are expected to flow from it.

57. The assets of an enterprise result from past transactions or other past events. Enterprises normally obtain assets by purchasing or producing them, but other transactions or events may also generate assets; examples include land received by an enterprise from government as part of a programme to encourage economic growth in an area and the discovery of mineral deposits. Transactions or other events expected to occur in the future do not in themselves give rise to assets; hence, for example, an intention to purchase inventory does not, of itself, meet the definition of an asset.

58. There is a close association between incurring expenditure and obtaining assets but the two do not necessarily coincide. Hence, when an enterprise incurs expenditure, this may provide evidence that future economic benefits were sought but is not conclusive proof that an item satisfying the definition of an asset has been obtained. Similarly, the absence of a related expenditure does not preclude an item from satisfying the definition of an asset and thus becoming a candidate for recognition in the balance sheet.

Liabilities

59. An essential characteristic of a liability is that the enterprise has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. This is normally the case, for example, with amounts payable for goods and services received. Obligations

also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. If, for example, an enterprise decides as a matter of policy to rectify faults in its products even when these become apparent after the warranty period has expired, the amounts that are expected to be expended in respect of goods already sold are liabilities.

60. A distinction needs to be drawn between a present obligation and a future commitment. A decision by the management of an enterprise to acquire assets in the future does not, of itself, give rise to a present obligation. An obligation normally arises only when the asset is delivered or the enterprise enters into an irrevocable agreement to acquire the asset. In the latter case, the irrevocable nature of the agreement means that the economic consequences of failing to honour the obligation, for example, because of the existence of a substantial penalty, leave the enterprise with little, if any, discretion to avoid the outflow of resources to another party.

61. The settlement of a present obligation usually involves the enterprise giving up resources embodying economic benefits in order to satisfy the claim of the other party. Settlement of a present obligation may occur in a number of ways, for example, by:

(a) payment of cash;

(b) transfer of other assets;

(c) provision of services;

(d) replacement of that obligation with another obligation; or

(e) conversion of the obligation to equity.

An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights.

62. Liabilities result from past transactions or other past events. Thus, for example, the acquisition of goods and the use of services give rise to trade creditors (unless paid for in advance or on delivery) and the receipt of a bank loan results in an obligation to repay the loan. An enterprise may also recognise future rebates based on annual purchases by customers as liabilities; in this case, the sale of the goods in the past is the transaction that gives rise to the liability.

63. Some liabilities can be measured only by using a substantial degree of estimation. Such liabilities are commonly described as 'provisions'. Examples include provisions for payments to be made under existing warranties and provisions to cover pension obligations.

Equity

64. Although equity is defined in paragraph 49 as a residual, it may be sub-classified in the balance sheet. For example, funds contributed by owners, reserves representing appropriations of retained earnings, unappropriated retained earnings and reserves representing capital maintenance adjustments may be shown separately. Such classifications can be relevant to the decision-making needs of the users of financial statements when they indicate legal or other restrictions on the ability of the enterprise to distribute or otherwise apply its equity. They may also reflect the fact that parties with ownership interests in an enterprise have differing rights in relation to the receipt of dividends or the repayment of capital.

65. The creation of reserves is sometimes required by law in order to give the enterprise and its creditors an added measure of protection from the effects of losses. Reserves may also be created when tax laws grant exemptions from, or reductions in, taxation liabilities if transfers to such reserves are made. The existence and size of such reserves is information that can be relevant to the decision-making needs of users. Transfers to such reserves are appropriations of retained earnings rather than expenses.

66. The amount at which equity is shown in the balance sheet is dependent on the measurement of assets and liabilities. Normally, the aggregate amount of equity only by coincidence corresponds with the aggregate market value of the shares of the enterprise or the sum that could be raised by disposing of either the net assets on a piecemeal basis or the enterprise as a whole on a going concern basis.

67. Commercial, industrial and business activities are often undertaken by means of enterprises such as sole proprietorships, partnerships and trusts and various types of government business undertakings. The legal and regulatory framework for such enterprises is often different from that applicable to corporate enterprises. For example, unlike corporate enterprises, in the case of such enterprises, there may be few, if any, restrictions on the distribution to owners or other beneficiaries of amounts included in equity. Nevertheless, the definition of equity and the other aspects of this Framework that deal with equity are appropriate for such enterprises.

Performance

68. Profit is frequently used as a measure of performance or as the basis for other measures, such as return on investment or earnings per share. The elements directly related to the measurement of profit are income and expenses. The recognition and measurement of income and expenses, and hence profit, depends in part on the concepts of capital and capital maintenance used by the enterprise in preparing its financial statements. These concepts are discussed in paragraphs 101 to 109.

69. Income and expenses are defined as follows:

(a) *Income* is increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

(b) *Expenses* are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

70. The definitions of income and expenses identify their essential features but do not attempt to specify the criteria that need to be met before they are recognised in the statement of profit and loss. Criteria for recognition of income and expenses are discussed in paragraphs 81 to 97.

71. Income and expenses may be presented in the statement of profit and loss in different ways so as to provide information that is relevant for economic decision-making. For example, it is a common practice to distinguish between those items of income and expenses that arise in the course of the ordinary activities of the enterprise and those that do not. This distinction is made on the basis that the source of an item is relevant in evaluating the ability of the enterprise to generate cash and cash equivalents in the future. When distinguishing between items in this way, consideration needs to be given to the nature of the enterprise and its operations. Items that arise from the ordinary activities of one enterprise may be extraordinary in respect of another.

72. Distinguishing between items of income and expense and combining them in different ways also permits several measures of enterprise performance to be displayed. These have differing degrees of inclusiveness.

For example, the statement of profit and loss could display gross margin, profit from ordinary activities before taxation, profit from ordinary activities after taxation, and net profit.

Income

73. The definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an enterprise and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent.

74. Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an enterprise. Gains represent increases in economic benefits and as such are no different in nature from revenue. Hence, they are not regarded as a separate element in this Framework.

75. The definition of income includes unrealised gains. Gains also include, for example, those arising on the disposal of fixed assets. When gains are recognised in the statement of profit and loss, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions.

76. Various kinds of assets may be received or enhanced by income; examples include cash, receivables and goods and services received in exchange for goods and services supplied. Income may also result in the settlement of liabilities. For example, an enterprise may provide goods and services to a lender in settlement of an obligation to repay an outstanding loan.

Expenses

77. The definition of expenses encompasses those expenses that arise in the course of the ordinary activities of the enterprise, as well as losses. Expenses that arise in the course of the ordinary activities of the enterprise include, for example, cost of goods sold, wages, and depreciation. They take the form of an outflow or depletion of assets or enhancement of liabilities.

78. Losses represent other items that meet the definition of expenses and may, or may not, arise in the course of the ordinary activities of the enterprise. Losses represent decreases in economic benefits and as such they are no different in nature from other expenses. Hence, they are not regarded as a separate element in this Framework.

79. Losses include, for example, those resulting from disasters such as fire and flood, as well as those arising on the disposal of fixed assets. The definition of expenses also includes unrealised losses. When losses are recognised in the statement of profit and loss, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions.

Capital Maintenance Adjustments

80. The revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity. While these increases or decreases meet the definition of income and expenses, they are not included in the statement of profit and loss under certain concepts of capital maintenance. Instead, these items are included in equity as capital maintenance adjustments or revaluation reserves. These concepts of capital maintenance are discussed in paragraphs 101 to 109 of this Framework.

Recognition of the Elements of Financial Statements

81. Recognition is the process of incorporating in the balance sheet or statement of profit and loss an item that meets the definition of an element and satisfies the criteria for recognition set out in paragraph 82. It involves the depiction of the item in words and by a monetary amount and the inclusion of that amount in the totals of balance sheet or statement of profit and loss. Items that satisfy the recognition criteria should be recognised in the balance sheet or statement of profit and loss. The failure to recognise such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material.

82. An item that meets the definition of an element should be recognised if:

(a) it is probable that any future economic benefit associated with the item will flow to or from the enterprise; and

(b) the item has a cost or value that can be measured with reliability.

83. In assessing whether an item meets these criteria and therefore qualifies for recognition in the financial statements, regard needs to be given to the materiality considerations discussed in paragraph 30. The interrelationship between the elements means that an item that meets the definition and

recognition criteria for a particular element, for example, an asset, automatically requires the recognition of another element, for example, income or a liability.

The Probability of Future Economic Benefits

84. The concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the enterprise. The concept is in keeping with the uncertainty that characterises the environment in which an enterprise operates. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available when the financial statements are prepared. For example, when it is probable that a receivable will be realised, it is then justifiable, in the absence of any evidence to the contrary, to recognise the receivable as an asset. For a large population of receivables, however, some degree of non-payment is normally considered probable; hence, an expense representing the expected reduction in economic benefits is recognised.

Reliability of Measurement

85. The second criterion for the recognition of an item is that it possesses a cost or value that can be measured with reliability as discussed in paragraphs 31 to 38 of this Framework. In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. When, however, a reasonable estimate cannot be made, the item is not recognised in the balance sheet or statement of profit and loss. For example, the damages payable in a lawsuit may meet the definitions of both a liability and an expense as well as the probability criterion for recognition; however, if it is not possible to measure the claim reliably, it should not be recognised as a liability or as an expense.

86. An item that, at a particular point in time, fails to meet the recognition criteria in paragraph 82 may qualify for recognition at a later date as a result of subsequent circumstances or events.

87. An item that possesses the essential characteristics of an element but fails to meet the criteria for recognition may nonetheless warrant disclosure in the notes, explanatory material or supplementary schedules. This is appropriate when knowledge of the item is considered to be relevant to the

evaluation of the financial position, performance and cash flows of an enterprise by the users of financial statements. Thus, in the example given in paragraph 85, the existence of the claim would need to be disclosed in the notes, explanatory material or supplementary schedules.

Recognition of Assets

88. An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably.

89. An asset is not recognised in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the enterprise beyond the current accounting period. Instead, such a transaction results in the recognition of an expense in the statement of profit and loss. This treatment does not imply either that the intention of management in incurring expenditure was other than to generate future economic benefits for the enterprise or that management was misguided. The only implication is that the degree of certainty that economic benefits will flow to the enterprise beyond the current accounting period is insufficient to warrant the recognition of an asset.

Recognition of Liabilities

90. A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in the particular circumstances, may qualify for recognition. In such circumstances, recognition of liabilities entails recognition of related assets or expenses.

Recognition of Income

91. Income is recognised in the statement of profit and loss when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the

PREVIOUS HOME NEXT

recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable).

92. The procedures normally adopted in practice for recognising income, for example, the requirement that revenue should be earned, are applications of the recognition criteria in this Framework. Such procedures are generally directed at restricting the recognition as income to those items that can be measured reliably and have a sufficient degree of certainty.

Recognition of Expenses

93. Expenses are recognised in the statement of profit and loss when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase of liabilities or a decrease in assets (for example, the accrual of employees' salaries or the depreciation of plant and machinery).

94. Many expenses are recognised in the statement of profit and loss on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events; for example, the various components of expense making up the cost of goods sold are recognised at the same time as the income derived from the sale of the goods. However, the application of the matching concept under this Framework does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities.

95. When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the statement of profit and loss on the basis of systematic and rational allocation procedures. This is often necessary in recognising the expenses associated with the using up of assets such as plant and machinery, goodwill, patents and trademarks; in such cases, the expense is referred to as depreciation or amortisation. These allocation procedures are intended to recognise expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire.

96. An expense is recognised immediately in the statement of profit and loss when an expenditure produces no future economic benefits. An expense is also recognised to the extent that future economic benefits from an expenditure do not qualify, or cease to qualify, for recognition in the balance sheet as an asset.

97. An expense is recognised in the statement of profit and loss in those cases also where a liability is incurred without the recognition of an asset, for example, in the case of a liability under a product warranty.

Measurement of the Elements of Financial Statements

98. Measurement is the process of determining the monetary amounts at which the elements of financial statements are to be recognised and carried in the balance sheet and statement of profit and loss. This involves the selection of the particular basis of measurement.

99. A number of different measurement bases are employed to different degrees and in varying combinations in financial statements. They include the following:

(a) *Historical cost*. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

(b) *Current cost*. Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset were acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

(c) *Realisable (settlement) value*. Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values, that is, the undiscounted amounts of cash or cash equivalents expected to be required to settle the liabilities in the normal course of business.

(d) *Present value*. Assets are carried at the present value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

100. The measurement basis most commonly adopted by enterprises in preparing their financial statements is historical cost. This is usually combined with other measurement bases. For example, inventories are usually carried at the lower of cost and net realisable value and pension liabilities are carried at their present value. Furthermore, the current cost basis may be used as a response to the inability of the historical cost accounting model to deal with the effects of changing prices of non-monetary assets.

Concepts of Capital and Capital Maintenance

Concepts of Capital

101. Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the enterprise. Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the enterprise based on, for example, units of output per day.

102. The selection of the appropriate concept of capital by an enterprise should be based on the needs of the users of its financial statements. Thus, a financial concept of capital should be adopted if the users of financial statements are primarily concerned with the maintenance of nominal invested capital or the purchasing power of invested capital. If, however, the main concern of users is with the operating capability of the enterprise, a physical concept of capital should be used. The concept chosen indicates the goal to be attained in determining profit, even though there may be some measurement difficulties in making the concept operational.

Concepts of Capital Maintenance and the Determination of Profit

103. The concepts of capital described in paragraph 101 give rise to the following concepts of capital maintenance:

(a) *Financial capital maintenance*. Under this concept, a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.

(b) *Physical capital maintenance*. Under this concept, a profit is earned only if the physical productive capacity (or operating capability) of the enterprise at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

104. The concept of capital maintenance is concerned with how an enterprise defines the capital that it seeks to maintain. It provides the linkage between the concepts of capital and the concepts of profit because it provides the point of reference by which profit is measured; it is a prerequisite for distinguishing between an enterprise's return *on* capital and its return *of* capital; only inflows of assets in excess of amounts needed to maintain capital can be regarded as profit and therefore as a return on capital. Hence, profit is the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income. If expenses exceed income, the residual amount is a net loss.

105. The physical capital maintenance concept requires the adoption of the current cost basis of measurement. The financial capital maintenance concept, however, does not require the use of a particular basis of measurement. Selection of the basis under this concept is dependent on the type of financial capital that the enterprise is seeking to maintain.

106. The principal difference between the two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities of the enterprise. In general terms, an enterprise has maintained

PREVIOUS HOME NEXT

its capital if it has as much capital at the end of the period as it had at the beginning of the period. Any amount over and above that required to maintain the capital at the beginning of the period is profit.

107. Under the concept of financial capital maintenance where capital is defined in terms of nominal monetary units, profit represents the increase in nominal money capital over the period. Thus, increases in the prices of assets held over the period, conventionally referred to as holding gains, are, conceptually, profits. They may not be recognised as such, however, until the assets are disposed of in an exchange transaction. When the concept of financial capital maintenance is defined in terms of constant purchasing power units, profit represents the increase in invested purchasing power over the period. Thus, only that part of the increase in the prices of assets that exceeds the increase in the general level of prices is regarded as profit. The rest of the increase is treated as a capital maintenance adjustment and, hence, as part of equity.

108. Under the concept of physical capital maintenance when capital is defined in terms of the physical productive capacity, profit represents the increase in that capital over the period. All price changes affecting the assets and liabilities of the enterprise are viewed as changes in the measurement of the physical productive capacity of the enterprise; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit.

109. The selection of the measurement bases and concept of capital maintenance will determine the accounting model used in the preparation of the financial statements. Different accounting models exhibit different degrees of relevance and reliability and, as in other areas, management must seek a balance between relevance and reliability. This Framework is applicable to a range of accounting models and provides guidance on preparing and presenting the financial statements under the chosen model.

Accounting Standard (AS) 1
(issued 1979)

Disclosure of Accounting Policies

Contents

Accounting Standard (AS) 1
(issued 1979)

Disclosure of Accounting Policies

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

Introduction

1. This Standard deals with the disclosure of significant accounting policies followed in preparing and presenting financial statements.

2. The view presented in the financial statements of an enterprise of its state of affairs and of the profit or loss can be significantly affected by the accounting policies followed in the preparation and presentation of the financial statements. The accounting policies followed vary from enterprise to enterprise. Disclosure of significant accounting policies followed is necessary if the view presented is to be properly appreciated.

3. The disclosure of some of the accounting policies followed in the preparation and presentation of the financial statements is required by law in some cases.

4. The Institute of Chartered Accountants of India has, in Standards issued by it, recommended the disclosure of certain accounting policies, e.g., translation policies in respect of foreign currency items.

5. In recent years, a few enterprises in India have adopted the practice of including in their annual reports to shareholders a separate statement of accounting policies followed in preparing and presenting the financial statements.

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[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.

6. In general, however, accounting policies are not at present regularly and fully disclosed in all financial statements. Many enterprises include in the Notes on the Accounts, descriptions of some of the significant accounting policies. But the nature and degree of disclosure vary considerably between the corporate and the non-corporate sectors and between units in the same sector.

7. Even among the few enterprises that presently include in their annual reports a separate statement of accounting policies, considerable variation exists. The statement of accounting policies forms part of accounts in some cases while in others it is given as supplementary information.

8. The purpose of this Standard is to promote better understanding of financial statements by establishing through an accounting standard the disclosure of significant accounting policies and the manner in which accounting policies are disclosed in the financial statements. Such disclosure would also facilitate a more meaningful comparison between financial statements of different enterprises.

Explanation

Fundamental Accounting Assumptions

9. Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.

10. The following have been generally accepted as fundamental accounting assumptions:—

a. Going Concern

The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.

b. Consistency

It is assumed that accounting policies are consistent from one period to another.

c. Accrual

Revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate. (The considerations affecting the process of matching costs with revenues under the accrual assumption are not dealt with in this standard.)

Nature of Accounting Policies

11. The accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.

12. There is no single list of accounting policies which are applicable to all circumstances. The differing circumstances in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and methods of applying those principles acceptable. The choice of the appropriate accounting principles and the methods of applying those principles in the specific circumstances of each enterprise calls for considerable judgement by the management of the enterprise.

13. The various standards of the Institute of Chartered Accountants of India combined with the efforts of government and other regulatory agencies and progressive managements have reduced in recent years the number of acceptable alternatives particularly in the case of corporate enterprises. While continuing efforts in this regard in future are likely to reduce the number still further, the availability of alternative accounting principles and methods of applying those principles is not likely to be eliminated altogether in view of the differing circumstances faced by the enterprises.

Areas in Which Differing Accounting Policies are Encountered

14. The following are examples of the areas in which different accounting policies may be adopted by different enterprises.

(a) Methods of depreciation, depletion and amortisation

(b) Treatment of expenditure during construction

(c) Conversion or translation of foreign currency items

(d) Valuation of inventories

(e) Treatment of goodwill

(f) Valuation of investments

(g) Treatment of retirement benefits

(h) Recognition of profit on long-term contracts

(i) Valuation of fixed assets

(j) Treatment of contingent liabilities.

15. The above list of examples is not intended to be exhaustive.

Considerations in the Selection of Accounting Policies

16. The primary consideration in the selection of accounting policies by an enterprise is that the financial statements prepared and presented on the basis of such accounting policies should represent a true and fair view of the state of affairs of the enterprise as at the balance sheet date and of the profit or loss for the period ended on that date.

17. For this purpose, the major considerations governing the selection and application of accounting policies are:—

a. Prudence

In view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

b. Substance over Form

The accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by the legal form.

c. Materiality

Financial statements should disclose all "material" items, i.e. items the knowledge of which might influence the decisions of the user of the financial statements.

Disclosure of Accounting Policies

18. To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.

19. Such disclosure should form part of the financial statements.

20 It would be helpful to the reader of financial statements if they are all disclosed as such in one place instead of being scattered over several statements, schedules and notes.

21. Examples of matters in respect of which disclosure of accounting policies adopted will be required are contained in paragraph 14. This list of examples is not, however, intended to be exhaustive.

22. Any change in an accounting policy which has a material effect should be disclosed. The amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

23. Disclosure of accounting policies or of changes therein cannot remedy a wrong or inappropriate treatment of the item in the accounts.

Main Principles

24. All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.

25. The disclosure of the significant accounting policies as such should form part of the financial statements and the significant accounting policies should normally be disclosed in one place.

26. Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. In the case of a change in accounting policies which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.

27. If the fundamental accounting assumptions, viz. Going Concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

Accounting Standard (AS) 2
(revised 1999)

Valuation of Inventories

Contents

Accounting Standard (AS) 2*

(revised 1999)

Valuation of Inventories

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

Objective

A primary issue in accounting for inventories is the determination of the value at which inventories are carried in the financial statements until the related revenues are recognised. This Standard deals with the determination of such value, including the ascertainment of cost of inventories and any write-down thereof to net realisable value.

Scope

1. This Standard should be applied in accounting for inventories other than:

> ***(a) work in progress arising under construction contracts, including directly related service contracts (see Accounting Standard (AS) 7, Construction Contracts);***
>
> ***(b) work in progress arising in the ordinary course of business of service providers;***
>
> ***(c) shares, debentures and other financial instruments held as stock-in-trade; and***

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* The Standard was originally issued in June 1981.

[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.

(d) producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries.

2. The inventories referred to in paragraph 1 (d) are measured at net realisable value at certain stages of production. This occurs, for example, when agricultural crops have been harvested or mineral oils, ores and gases have been extracted and sale is assured under a forward contract or a government guarantee, or when a homogenous market exists and there is a negligible risk of failure to sell. These inventories are excluded from the scope of this Standard.

Definitions

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

3.1. <u>Inventories</u> are assets:

(a) held for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

3.2. <u>Net realisable value</u> is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

4. Inventories encompass goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, consumables and loose tools awaiting use in the production process. Inventories do not include machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular; such machinery spares are accounted for in accordance with Accounting Standard (AS) 10, Accounting for Fixed Assets.

Measurement of Inventories

5. Inventories should be valued at the lower of cost and net realisable value.

Cost of Inventories

6. The cost of inventories should comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

Costs of Purchase

7. The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

Costs of Conversion

8. The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour.

9. The allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. The amount of fixed production overheads allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the

period in which they are incurred. In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are assigned to each unit of production on the basis of the actual use of the production facilities.

10. A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products as well as scrap or waste materials, by their nature, are immaterial. When this is the case, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

Other Costs

11. Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories.

12. Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories.

Exclusions from the Cost of Inventories

13. In determining the cost of inventories in accordance with paragraph 6, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

(a) abnormal amounts of wasted materials, labour, or other production costs;

(b) storage costs, unless those costs are necessary in the production process prior to a further production stage;

(c) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and

(d) selling and distribution costs.

Cost Formulas

14. The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by specific identification of their individual costs.

15. Specific identification of cost means that specific costs are attributed to identified items of inventory. This is an appropriate treatment for items that are segregated for a specific project, regardless of whether they have been purchased or produced. However, when there are large numbers of items of inventory which are ordinarily interchangeable, specific identification of costs is inappropriate since, in such circumstances, an enterprise could obtain predetermined effects on the net profit or loss for the period by selecting a particular method of ascertaining the items that remain in inventories.

16. The cost of inventories, other than those dealt with in paragraph 14, should be assigned by using the first-in, first-out (FIFO), or weighted average cost formula. The formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

17. A variety of cost formulas is used to determine the cost of inventories other than those for which specific identification of individual costs is appropriate. The formula used in determining the cost of an item of inventory needs to be selected with a view to providing the fairest possible approximation to the cost incurred in bringing the item to its present location and condition. The FIFO formula assumes that the items of inventory which were purchased or produced first are consumed or sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced. Under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of

similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average may be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances of the enterprise.

Techniques for the Measurement of Cost

18. Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate the actual cost. Standard costs take into account normal levels of consumption of materials and supplies, labour, efficiency and capacity utilisation. They are regularly reviewed and, if necessary, revised in the light of current conditions.

19. The retail method is often used in the retail trade for measuring inventories of large numbers of rapidly changing items that have similar margins and for which it is impracticable to use other costing methods. The cost of the inventory is determined by reducing from the sales value of the inventory the appropriate percentage gross margin. The percentage used takes into consideration inventory which has been marked down to below its original selling price. An average percentage for each retail department is often used.

Net Realisable Value

20. The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined. The cost of inventories may also not be recoverable if the estimated costs of completion or the estimated costs necessary to make the sale have increased. The practice of writing down inventories below cost to net realisable value is consistent with the view that assets should not be carried in excess of amounts expected to be realised from their sale or use.

21. Inventories are usually written down to net realisable value on an item-by-item basis. In some circumstances, however, it may be appropriate to group similar or related items. This may be the case with items of inventory relating to the same product line that have similar purposes or end uses and are produced and marketed in the same geographical area and cannot be practicably evaluated separately from other items in that product line. It is not appropriate to write down inventories based on a classification of

inventory, for example, finished goods, or all the inventories in a particular business segment.

22. Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date.

23. Estimates of net realisable value also take into consideration the purpose for which the inventory is held. For example, the net realisable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realisable value of the excess inventory is based on general selling prices. Contingent losses on firm sales contracts in excess of inventory quantities held and contingent losses on firm purchase contracts are dealt with in accordance with the principles enunciated in Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date[2].

24. Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value.

25. An assessment is made of net realisable value as at each balance sheet date.

[2]Pursuant to AS 29, Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory, 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 Accounting Standards.

Disclosure

26. The financial statements should disclose:

(a) the accounting policies adopted in measuring inventories, including the cost formula used; and

(b) the total carrying amount of inventories and its classification appropriate to the enterprise.

27. Information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users. Common classifications of inventories are raw materials and components, work in progress, finished goods, stores and spares, and loose tools.

Accounting Standard (AS) 3
(revised 1997)

Cash Flow Statements

Contents

Continued../..

Accounting Standard (AS) 3*
(revised 1997)

Cash Flow Statements

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

This Accounting Standard is not mandatory for Small and Medium Sized Companies and non-corporate entities falling in Level II and Level III as defined in Appendix 1 to this Compendium 'Applicability of Accounting Standards to Various Entities.' Such entities are however encouraged to comply with this standard.

Objective

Information about the cash flows of an enterprise is useful in providing users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generation.

The Standard deals with the provision of information about the historical changes in cash and cash equivalents of an enterprise by means of a cash flow statement which classifies cash flows during the period from operating, investing and financing activities.

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* The Standard was originally issued in June 1981 and was titled 'Changes in Financial Position'.

[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.

Scope

1. An enterprise should prepare a cash flow statement and should present it for each period for which financial statements are presented.

2. Users of an enterprise's financial statements are interested in how the enterprise generates and uses cash and cash equivalents. This is the case regardless of the nature of the enterprise's activities and irrespective of whether cash can be viewed as the product of the enterprise, as may be the case with a financial enterprise. Enterprises need cash for essentially the same reasons, however different their principal revenue-producing activities might be. They need cash to conduct their operations, to pay their obligations, and to provide returns to their investors.

Benefits of Cash Flow Information

3. A cash flow statement, when used in conjunction with the other financial statements, provides information that enables users to evaluate the changes in net assets of an enterprise, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities. Cash flow information is useful in assessing the ability of the enterprise to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different enterprises. It also enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effects of using different accounting treatments for the same transactions and events.

4. Historical cash flow information is often used as an indicator of the amount, timing and certainty of future cash flows. It is also useful in checking the accuracy of past assessments of future cash flows and in examining the relationship between profitability and net cash flow and the impact of changing prices.

Definitions

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

5.1. <u>Cash</u> comprises cash on hand and demand deposits with banks.

5.2. <u>Cash equivalents</u> are short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.

5.3. <u>Cash flows</u> are inflows and outflows of cash and cash equivalents.

5.4. <u>Operating activities</u> are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.

5.5 <u>Investing activities</u> are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

5.6 <u>Financing activities</u> are activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise.

Cash and Cash Equivalents

6. Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent, it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Investments in shares are excluded from cash equivalents unless they are, in substance, cash equivalents; for example, preference shares of a company acquired shortly before their specified redemption date (provided there is only an insignificant risk of failure of the company to repay the amount at maturity).

7. Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an enterprise rather than part of its operating, investing and financing activities. Cash management includes the investment of excess cash in cash equivalents.

Presentation of a Cash Flow Statement

8. The cash flow statement should report cash flows during the period classified by operating, investing and financing activities.

9. An enterprise presents its cash flows from operating, investing and financing activities in a manner which is most appropriate to its business. Classification by activity provides information that allows users to assess the impact of those activities on the financial position of the enterprise and the amount of its cash and cash equivalents. This information may also be used to evaluate the relationships among those activities.

10. A single transaction may include cash flows that are classified differently. For example, when the instalment paid in respect of a fixed asset acquired on deferred payment basis includes both interest and loan, the interest element is classified under financing activities and the loan element is classified under investing activities.

Operating Activities

11. The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the enterprise have generated sufficient cash flows to maintain the operating capability of the enterprise, pay dividends, repay loans and make new investments without recourse to external sources of financing. Information about the specific components of historical operating cash flows is useful, in conjunction with other information, in forecasting future operating cash flows.

12. Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the enterprise. Therefore, they generally result from the transactions and other events that enter into the determination of net profit or loss. Examples of cash flows from operating activities are:

(a) cash receipts from the sale of goods and the rendering of services;

(b) cash receipts from royalties, fees, commissions and other revenue;

(c) cash payments to suppliers for goods and services;

(d) cash payments to and on behalf of employees;

(e) cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;

(f) cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and

(g) cash receipts and payments relating to futures contracts, forward contracts, option contracts and swap contracts when the contracts are held for dealing or trading purposes.

13. Some transactions, such as the sale of an item of plant, may give rise to a gain or loss which is included in the determination of net profit or loss. However, the cash flows relating to such transactions are cash flows from investing activities.

14. An enterprise may hold securities and loans dealing or trading purposes, in which case they are similar to inventory acquired specifically for resale. Therefore, cash flows arising from the purchase and sale of dealing or trading securities are classified as operating activities. Similarly, cash advances and loans made by financial enterprises are usually classified as operating activities since they relate to the main revenue-producing activity of that enterprise.

Investing Activities

15. The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Examples of cash flows arising from investing activities are:

(a) cash payments to acquire fixed assets (including intangibles). These payments include those relating to capitalised research and development costs and self-constructed fixed assets;

(b) cash receipts from disposal of fixed assets (including intangibles);

(c) cash payments to acquire shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes);

(d) cash receipts from disposal of shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than receipts from those instruments considered to be cash equivalents and those held for dealing or trading purposes);

(e) cash advances and loans made to third parties (other than advances and loans made by a financial enterprise);

(f) cash receipts from the repayment of advances and loans made to third parties (other than advances and loans of a financial enterprise);

(g) cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and

(h) cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

16. When a contract is accounted for as a hedge of an identifiable position, the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged.

Financing Activities

17. The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of funds (both capital and borrowings) to the enterprise. Examples of cash flows arising from financing activities are:

(a) cash proceeds from issuing shares or other similar instruments;

(b) cash proceeds from issuing debentures, loans, notes, bonds, and other short or long-term borrowings; and

(c) cash repayments of amounts borrowed.

Reporting Cash Flows from Operating Activities

18. An enterprise should report cash flows from operating activities using either:

(a) the direct method, whereby major classes of gross cash receipts and gross cash payments are disclosed; or

(b) the indirect method, whereby net profit or loss is adjusted for

the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

19. The direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method and is, therefore, considered more appropriate than the indirect method. Under the direct method, information about major classes of gross cash receipts and gross cash payments may be obtained either:

(a) from the accounting records of the enterprise; or

(b) by adjusting sales, cost of sales (interest and similar income and interest expense and similar charges for a financial enterprise) and other items in the statement of profit and loss for:

i) changes during the period in inventories and operating receivables and payables;

ii) other non-cash items; and

iii) other items for which the cash effects are investing or financing cash flows.

20. Under the indirect method, the net cash flow from operating activities is determined by adjusting net profit or loss for the effects of:

(a) changes during the period in inventories and operating receivables and payables;

(b) non-cash items such as depreciation, provisions, deferred taxes, and unrealised foreign exchange gains and losses; and

(c) all other items for which the cash effects are investing or financing cash flows.

Alternatively, the net cash flow from operating activities may be presented under the indirect method by showing the operating revenues and expenses excluding non-cash items disclosed in the statement of profit and loss and the changes during the period in inventories and operating receivables and payables.

Reporting Cash Flows from Investing and Financing Activities

21. An enterprise should report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities, except to the extent that cash flows described in paragraphs 22 and 24 are reported on a net basis.

Reporting Cash Flows on a Net Basis

22. Cash flows arising from the following operating, investing or financing activities may be reported on a net basis:

> ***(a) cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the enterprise; and***
>
> ***(b) cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.***

23. Examples of cash receipts and payments referred to in paragraph 22(a) are:

(a) the acceptance and repayment of demand deposits by a bank;

(b) funds held for customers by an investment enterprise; and

(c) rents collected on behalf of, and paid over to, the owners of properties.

Examples of cash receipts and payments referred to in paragraph 22(b) are advances made for, and the repayments of:

(a) principal amounts relating to credit card customers;

(b) the purchase and sale of investments; and

(c) other short-term borrowings, for example, those which have a maturity period of three months or less.

24. Cash flows arising from each of the following activities of a financial enterprise may be reported on a net basis:

> ***(a) cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date;***
>
> ***(b) the placement of deposits with and withdrawal of deposits from other financial enterprises; and***
>
> ***(c) cash advances and loans made to customers and the repayment of those advances and loans.***

Foreign Currency Cash Flows

25. Cash flows arising from transactions in a foreign currency should be recorded in an enterprise's reporting currency by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the cash flow. A rate that approximates the actual rate may be used if the result is substantially the same as would arise if the rates at the dates of the cash flows were used. The effect of changes in exchange rates on cash and cash equivalents held in a foreign currency should be reported as a separate part of the reconciliation of the changes in cash and cash equivalents during the period.

26. Cash flows denominated in foreign currency are reported in a manner consistent with Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates. This permits the use of an exchange rate that approximates the actual rate. For example, a weighted average exchange rate for a period may be used for recording foreign currency transactions.

27. Unrealised gains and losses arising from changes in foreign exchange rates are not cash flows. However, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency is reported in the cash flow statement in order to reconcile cash and cash equivalents at the beginning and the end of the period. This amount is presented separately from cash flows from operating, investing and financing activities and includes the differences, if any, had those cash flows been reported at the end-of-period exchange rates.

Extraordinary Items

28. The cash flows associated with extraordinary items should be classified as arising from operating, investing or financing activities as appropriate and separately disclosed.

29. The cash flows associated with extraordinary items are disclosed separately as arising from operating, investing or financing activities in the cash flow statement, to enable users to understand their nature and effect on the present and future cash flows of the enterprise. These disclosures are in addition to the separate disclosures of the nature and amount of extraordinary items required by Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

Interest and Dividends

30. Cash flows from interest and dividends received and paid should each be disclosed separately. Cash flows arising from interest paid and interest and dividends received in the case of a financial enterprise should be classified as cash flows arising from operating activities. In the case of other enterprises, cash flows arising from interest paid should be classified as cash flows from financing activities while interest and dividends received should be classified as cash flows from investing activities. Dividends paid should be classified as cash flows from financing activities.

31. The total amount of interest paid during the period is disclosed in the cash flow statement whether it has been recognised as an expense in the statement of profit and loss or capitalised in accordance with Accounting Standard (AS) 10, Accounting for Fixed Assets.

32. Interest paid and interest and dividends received are usually classified as operating cash flows for a financial enterprise. However, there is no consensus on the classification of these cash flows for other enterprises. Some argue that interest paid and interest and dividends received may be classified as operating cash flows because they enter into the determination of net profit or loss. However, it is more appropriate that interest paid and interest and dividends received are classified as financing cash flows and investing cash flows respectively, because they are cost of obtaining financial resources or returns on investments.

33. Some argue that dividends paid may be classified as a component of cash flows from operating activities in order to assist users to determine the ability of an enterprise to pay dividends out of operating cash flows. However, it is considered more appropriate that dividends paid should be classified as cash flows from financing activities because they are cost of obtaining financial resources.

Taxes on Income

34. Cash flows arising from taxes on income should be separately disclosed and should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

35. Taxes on income arise on transactions that give rise to cash flows that are classified as operating, investing or financing activities in a cash flow statement. While tax expense may be readily identifiable with investing or financing activities, the related tax cash flows are often impracticable to identify and may arise in a different period from the cash flows of the underlying transactions. Therefore, taxes paid are usually classified as cash flows from operating activities. However, when it is practicable to identify the tax cash flow with an individual transaction that gives rise to cash flows that are classified as investing or financing activities, the tax cash flow is classified as an investing or financing activity as appropriate. When tax cash flow are allocated over more than one class of activity, the total amount of taxes paid is disclosed.

Investments in Subsidiaries, Associates and Joint Ventures

36. When accounting for an investment in an associate or a subsidiary or a joint venture, an investor restricts its reporting in the cash flow statement to the cash flows between itself and the investee/joint venture, for example, cash flows relating to dividends and advances.

Acquisitions and Disposals of Subsidiaries and Other Business Units

37. The aggregate cash flows arising from acquisitions and from

disposals of subsidiaries or other business units should be presented separately and classified as investing activities.

38. An enterprise should disclose, in aggregate, in respect of both acquisition and disposal of subsidiaries or other business units during the period each of the following:

(a) the total purchase or disposal consideration; and

(b) the portion of the purchase or disposal consideration discharged by means of cash and cash equivalents.

39. The separate presentation of the cash flow effects of acquisitions and disposals of subsidiaries and other business units as single line items helps to distinguish those cash flows from other cash flows. The cash flow effects of disposals are not deducted from those of acquisitions.

Non-cash Transactions

40. Investing and financing transactions that do not require the use of cash or cash equivalents should be excluded from a cash flow statement. Such transactions should be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

41. Many investing and financing activities do not have a direct impact on current cash flows although they do affect the capital and asset structure of an enterprise. The exclusion of non-cash transactions from the cash flow statement is consistent with the objective of a cash flow statement as these items do not involve cash flows in the current period. Examples of non-cash transactions are:

(a) the acquisition of assets by assuming directly related liabilities;

(b) the acquisition of an enterprise by means of issue of shares; and

(c) the conversion of debt to equity.

Components of Cash and Cash Equivalents

42. An enterprise should disclose the components of cash and cash

equivalents and should present a reconciliation of the amounts in its cash flow statement with the equivalent items reported in the balance sheet.

43. In view of the variety of cash management practices, an enterprise discloses the policy which it adopts in determining the composition of cash and cash equivalents.

44. The effect of any change in the policy for determining components of cash and cash equivalents is reported in accordance with Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

Other Disclosures

45. An enterprise should disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held by the enterprise that are not available for use by it.

46. There are various circumstances in which cash and cash equivalent balances held by an enterprise are not available for use by it. Examples include cash and cash equivalent balances held by a branch of the enterprise that operates in a country where exchange controls or other legal restrictions apply as a result of which the balances are not available for use by the enterprise.

47. Additional information may be relevant to users in understanding the financial position and liquidity of an enterprise. Disclosure of this information, together with a commentary by management, is encouraged and may include:

(a) the amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities; and

(b) the aggregate amount of cash flows that represent increases in operating capacity separately from those cash flows that are required to maintain operating capacity.

48. The separate disclosure of cash flows that represent increases in operating capacity and cash flows that are required to maintain operating capacity is useful in enabling the user to determine whether the enterprise is

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investing adequately in the maintenance of its operating capacity. An enterprise that does not invest adequately in the maintenance of its operating capacity may be prejudicing future profitability for the sake of current liquidity and distributions to owners.

Illustration I

Cash Flow Statement for an Enterprise other than a Financial Enterprise

This illustration does not form part of the accounting standard. Its purpose is to illustrate the application of the accounting standard.

1. The illustration shows only current period amounts.

2. Information from the statement of profit and loss and balance sheet is provided to show how the statements of cash flows under the direct method and the indirect method have been derived. Neither the statement of profit and loss nor the balance sheet is presented in conformity with the disclosure and presentation requirements of applicable laws and accounting standards. The working notes given towards the end of this illustration are intended to assist in understanding the manner in which the various figures appearing in the cash flow statement have been derived. These working notes do not form part of the cash flow statement and, accordingly, need not be published.

3. The following additional information is also relevant for the preparation of the statement of cash flows (figures are in Rs.'000).

(a) An amount of 250 was raised from the issue of share capital and a further 250 was raised from long term borrowings.

(b) Interest expense was 400 of which 170 was paid during the period. 100 relating to interest expense of the prior period was also paid during the period.

(c) Dividends paid were 1,200.

(d) Tax deducted at source on dividends received (included in the tax expense of 300 for the year) amounted to 40.

(e) During the period, the enterprise acquired fixed assets for 350. The payment was made in cash.

(f) Plant with original cost of 80 and accumulated depreciation of 60 was sold for 20.

(g) Foreign exchange loss of 40 represents the reduction in the carrying amount of a short-term investment in foreign-currency designated bonds arising out of a change in exchange rate between the date of acquisition of the investment and the balance sheet date.

(h) Sundry debtors and sundry creditors include amounts relating to credit sales and credit purchases only.

Balance Sheet as at 31.12.1996

(Rs. '000)

		1996		*1995*
Assets				
Cash on hand and balances with banks		200		25
Short-term investments		670		135
Sundry debtors		1,700		1,200
Interest receivable		100		–
Inventories		900		1,950
Long-term investments		2,500		2,500
Fixed assets at cost	2,180		1,910	
Accumulated depreciation	(1,450)		(1,060)	
Fixed assets (net)		730		850
Total assets		6,800		6,660
Liabilities				
Sundry creditors		150		1,890
Interest payable		230		100
Income taxes payable		400		1,000
Long-term debt		1,110		1,040
Total liabilities		1,890		4,030
Shareholders' Funds				
Share capital		1,500		1,250
Reserves		3,410		1,380
Total shareholders' funds		4,910		2,630
Total liabilities and shareholders' funds		6,800		6,660

Statement of Profit and Loss for the period ended 31.12.1996

	(Rs. '000)
Sales	30,650
Cost of sales	(26,000)
Gross profit	4,650
Depreciation	(450)
Administrative and selling expenses	(910)
Interest expense	(400)
Interest income	300
Dividend income	200
Foreign exchange loss	(40)
Net profit before taxation and extraordinary item	3,350
Extraordinary item – Insurance proceeds from earthquake disaster settlement	180
Net profit after extraordinary item	3,530
Income-tax	(300)
Net profit	3,230

Direct Method Cash Flow Statement [Paragraph 18(a)]

		(Rs. '000) 1996
Cash flows from operating activities		
Cash receipts from customers	30,150	
Cash paid to suppliers and employees	(27,600)	
Cash generated from operations	2,550	
Income taxes paid	(860)	
Cash flow before extraordinary item	1,690	
Proceeds from earthquake disaster settlement	180	
Net cash from operating activities		1,870
Cash flows from investing activities		
Purchase of fixed assets	(350)	
Proceeds from sale of equipment	20	
Interest received	200	
Dividends received	160	
Net cash from investing activities		30

Cash flows from financing activities		
Proceeds from issuance of share capital	250	
Proceeds from long-term borrowings	250	
Repayment of long-term borrowings	(180)	
Interest paid	(270)	
Dividends paid	(1,200)	
Net cash used in financing activities		(1,150)
Net increase in cash and cash equivalents		750
Cash and cash equivalents at beginning of period (see Note 1)		160
Cash and cash equivalents at end of period (see Note 1)		910

Indirect Method Cash Flow Statement [Paragraph 18(b)]

(Rs. '000)

		1996
Cash flows from operating activities		
Net profit before taxation, and extraordinary item	3,350	
Adjustments for:		
Depreciation	450	
Foreign exchange loss	40	
Interest income	(300)	
Dividend income	(200)	
Interest expense	400	
Operating profit before working capital changes	3,740	
Increase in sundry debtors	(500)	
Decrease in inventories	1,050	
Decrease in sundry creditors	(1,740)	
Cash generated from operations	2,550	
Income taxes paid	(860)	
Cash flow before extraordinary item	1,690	
Proceeds from earthquake disaster settlement	180	
Net cash from operating activities		1,870

Cash flows from investing activities		
Purchase of fixed assets	(350)	
Proceeds from sale of equipment	20	
Interest received	200	
Dividends received	160	
Net cash from investing activities		30
Cash flows from financing activities		
Proceeds from issuance of share capital	250	
Proceeds from long-term borrowings	250	
Repayment of long-term borrowings	(180)	
Interest paid	(270)	
Dividends paid	(1,200)	
Net cash used in financing activities		(1,150)
Net increase in cash and cash equivalents		750
Cash and cash equivalents at beginning of period (see Note 1)		160
Cash and cash equivalents at end of period (see Note 1)		910

Notes to the cash flow statement
(direct method and indirect method)

1. *Cash and Cash Equivalents*

Cash and cash equivalents consist of cash on hand and balances with banks, and investments in money-market instruments. Cash and cash equivalents included in the cash flow statement comprise the following balance sheet amounts.

	1996	**1995**
Cash on hand and balances with banks	200	25
Short-term investments	670	135
Cash and cash equivalents	870	160
Effect of exchange rate changes	40	–
Cash and cash equivalents as restated	910	160

Cash and cash equivalents at the end of the period include deposits with banks of 100 held by a branch which are not freely remissible to the company because of currency exchange restrictions.

The company has undrawn borrowing facilities of 2,000 of which 700 may be used only for future expansion.

2. Total tax paid during the year (including tax deducted at source on dividends received) amounted to 900.

Alternative Presentation (indirect method)

As an alternative, in an indirect method cash flow statement, operating profit before working capital changes is sometimes presented as follows:

Revenues excluding investment income	30,650	
Operating expense excluding depreciation	(26,910)	
Operating profit before working capital changes		3,740

Working Notes

The working notes given below do not form part of the cash flow statement and, accordingly, need not be published. The purpose of these working notes is merely to assist in understanding the manner in which various figures in the cash flow statement have been derived. (Figures are in Rs. '000.)

1. Cash receipts from customers

Sales	30,650
Add: Sundry debtors at the beginning of the year	1,200
	31,850
Less : Sundry debtors at the end of the year	1,700
	30,150

2. Cash paid to suppliers and employees

Cost of sales		26,000
Administrative and selling expenses		910
		26,910
Add: Sundry creditors at the beginning of the year	1,890	
Inventories at the end of the year	900	2,790
		29,700
Less: Sundry creditors at the end of the year	150	
Inventories at the beginning of the year	1,950	2,100
		27,600

3. Income taxes paid (including tax deducted at source from dividends received)

Income tax expense for the year (including tax deducted at source from dividends received)	300
Add : Income tax liability at the beginning of the year	1,000
	1,300
Less: Income tax liability at the end of the year	400
	900

Out of 900, tax deducted at source on dividends received (amounting to 40) is included in cash flows from investing activities and the balance of 860 is included in cash flows from operating activities (see paragraph 34).

4. Repayment of long-term borrowings

Long-term debt at the beginning of the year	1,040
Add : Long-term borrowings made during the year	250
	1,290
Less : Long-term borrowings at the end of the year	1,110
	180

5. Interest paid

Interest expense for the year	400
Add: Interest payable at the beginning of the year	100
	500
Less: Interest payable at the end of the year	230
	270

Illustration II

Cash Flow Statement for a Financial Enterprise

This illustration does not form part of the accounting standard. Its purpose is to illustrate the application of the accounting standard.

1. The illustration shows only current period amounts.
2. The illustration is presented using the direct method.

		(Rs. '000) 1996
Cash flows from operating activities		
Interest and commission receipts	28,447	
Interest payments	(23,463)	
Recoveries on loans previously written off	237	
Cash payments to employees and suppliers	(997)	
Operating profit before changes in operating assets	4,224	
(Increase) decrease in operating assets:		
Short-term funds	(650)	
Deposits held for regulatory or monetary control purposes	234	
Funds advanced to customers	(288)	
Net increase in credit card receivables	(360)	
Other short-term securities	(120)	
Increase (decrease) in operating liabilities:		
Deposits from customers	600	
Certificates of deposit	(200)	
Net cash from operating activities before income tax	3,440	
Income taxes paid	(100)	
Net cash from operating activities		3,340
Cash flows from investing activities		
Dividends received	250	
Interest received	300	
Proceeds from sales of permanent investments	1,200	
Purchase of permanent investments	(600)	
Purchase of fixed assets	(500)	
Net cash from investing activities		650

Cash flows from financing activities		
Issue of shares	1,800	
Repayment of long-term borrowings	(200)	
Net decrease in other borrowings	(1,000)	
Dividends paid	(400)	
Net cash from financing activities		200
Net increase in cash and cash equivalents		4,190
Cash and cash equivalents at beginning of perio		4,650
Cash and cash equivalents at end of period		8,840

Accounting Standard (AS) 4
(revised 1995)

Contingencies and Events Occurring After the Balance Sheet Date

Contents

Accounting Standard (AS) 4*
(revised 1995)

Contingencies[1] and Events Occurring After the Balance Sheet Date

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of the Preface to the Statements of Accounting Standards[2] and the 'Applicability of Accounting Standards to Various Entities' (See Appendix 1 to this Compendium).]*

Introduction

1. This Standard deals with the treatment in financial statements of

   (a) contingencies[3], and

   (b) events occurring after the balance sheet date.

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*The Standard was originally issued in November 1982.

[1] 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 this Standard that deal with contingencies (viz. paragraphs 1(a), 2, 3.1, 4 (4.1 to 4.4), 5 (5.1 to 5.6), 6, 7 (7.1 to 7.3), 9.1 (relevant portion), 9.2, 10, 11, 12 and 16) stand 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), would continue to be covered by AS 4. (See Announcement on 'Applicability of AS 4 to impairment of assets not covered by present Accounting Standards' (published in 'The Chartered Accountant', April 2004, pp. 1151)). This Announcement is reproduced under 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.

[2] 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.

[3] See footnote 1.

2. The following subjects, which may result in contingencies, are excluded from the scope of this Standard in view of special considerations applicable to them:

(a) liabilities of life assurance and general insurance enterprises arising from policies issued;

(b) obligations under retirement benefit plans; and

(c) commitments arising from long-term lease contracts.

Definitions

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

3.1 A <u>contingency</u> is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events.

3.2 <u>Events occurring after the balance sheet date</u> are those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company, and, by the corresponding approving authority in the case of any other entity.

Two types of events can be identified:

(a) those which provide further evidence of conditions that existed at the balance sheet date; and

(b) those which are indicative of conditions that arose subsequent to the balance sheet date.

Explanation

4. Contingencies

4.1 The term "contingencies" used in this Standard is restricted to conditions or situations at the balance sheet date, the financial effect of which is to be determined by future events which may or may not occur.

4.2 Estimates are required for determining the amounts to be stated in the financial statements for many on-going and recurring activities of an enterprise. One must, however, distinguish between an event which is certain and one which is uncertain. The fact that an estimate is involved does not, of itself, create the type of uncertainty which characterises a contingency. For example, the fact that estimates of useful life are used to determine depreciation, does not make depreciation a contingency; the eventual expiry of the useful life of the asset is not uncertain. Also, amounts owed for services received are not contingencies as defined in paragraph 3.1, even though the amounts may have been estimated, as there is nothing uncertain about the fact that these obligations have been incurred.

4.3 The uncertainty relating to future events can be expressed by a range of outcomes. This range may be presented as quantified probabilities, but in most circumstances, this suggests a level of precision that is not supported by the available information. The possible outcomes can, therefore, usually be generally described except where reasonable quantification is practicable.

4.4 The estimates of the outcome and of the financial effect of contingencies are determined by the judgement of the management of the enterprise. This judgement is based on consideration of information available up to the date on which the financial statements are approved and will include a review of events occurring after the balance sheet date, supplemented by experience of similar transactions and, in some cases, reports from independent experts.

5. *Accounting Treatment of Contingent Losses*

5.1 The accounting treatment of a contingent loss is determined by the expected outcome of the contingency. If it is likely that a contingency will result in a loss to the enterprise, then it is prudent to provide for that loss in the financial statements.

5.2 The estimation of the amount of a contingent loss to be provided for in the financial statements may be based on information referred to in paragraph 4.4.

5.3 If there is conflicting or insufficient evidence for estimating the amount of a contingent loss, then disclosure is made of the existence and nature of the contingency.

5.4 A potential loss to an enterprise may be reduced or avoided because a contingent liability is matched by a related counter-claim or claim against a third party. In such cases, the amount of the provision is determined after taking into account the probable recovery under the claim if no significant uncertainty as to its measurability or collectability exists. Suitable disclosure regarding the nature and gross amount of the contingent liability is also made.

5.5 The existence and amount of guarantees, obligations arising from discounted bills of exchange and similar obligations undertaken by an enterprise are generally disclosed in financial statements by way of note, even though the possibility that a loss to the enterprise will occur, is remote.

5.6 Provisions for contingencies are not made in respect of general or unspecified business risks since they do not relate to conditions or situations existing at the balance sheet date.

6. Accounting Treatment of Contingent Gains

Contingent gains are not recognised in financial statements since their recognition may result in the recognition of revenue which may never be realised. However, when the realisation of a gain is virtually certain, then such gain is not a contingency and accounting for the gain is appropriate.

7. Determination of the Amounts at which Contingencies are included in Financial Statements

7.1 The amount at which a contingency is stated in the financial statements is based on the information which is available at the date on which the financial statements are approved. Events occurring after the balance sheet date that indicate that an asset may have been impaired, or that a liability may have existed, at the balance sheet date are, therefore, taken into account in identifying contingencies and in determining the amounts at which such contingencies are included in financial statements.

7.2 In some cases, each contingency can be separately identified, and the special circumstances of each situation considered in the determination of the amount of the contingency. A substantial legal claim against the enterprise may represent such a contingency. Among the factors taken into account by management in evaluating such a contingency are the progress of the claim at the date on which the financial statements are approved, the opinions, wherever necessary, of legal experts or other advisers, the experience of the enterprise in similar cases and the experience of other enterprises in similar situations.

7.3 If the uncertainties which created a contingency in respect of an individual transaction are common to a large number of similar transactions, then the amount of the contingency need not be individually determined, but may be based on the group of similar transactions. An example of such contingencies may be the estimated uncollectable portion of accounts receivable. Another example of such contingencies may be the warranties for products sold. These costs are usually incurred frequently and experience provides a means by which the amount of the liability or loss can be estimated with reasonable precision although the particular transactions that may result in a liability or a loss are not identified. Provision for these costs results in their recognition in the same accounting period in which the related transactions took place.

8. Events Occurring after the Balance Sheet Date

8.1 Events which occur between the balance sheet date and the date on which the financial statements are approved, may indicate the need for adjustments to assets and liabilities as at the balance sheet date or may require disclosure.

8.2 Adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date. For example, an adjustment may be made for a loss on a trade receivable account which is confirmed by the insolvency of a customer which occurs after the balance sheet date.

8.3 Adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. An example is the decline in market value of investments between the balance sheet date and the date on which the financial statements are approved. Ordinary fluctuations in market values do not normally relate to the condition of the investments at the balance sheet date, but reflect circumstances which have occurred in the following period.

8.4 Events occurring after the balance sheet date which do not affect the figures stated in the financial statements would not normally require disclosure in the financial statements although they may be of such significance that they may require a disclosure in the report of the approving authority to enable users of financial statements to make proper evaluations and decisions.

8.5 There are events which, although they take place after the balance sheet date, are sometimes reflected in the financial statements because of statutory requirements or because of their special nature. Such items include the amount of dividend proposed or declared by the enterprise after the balance sheet date in respect of the period covered by the financial statements.

8.6 Events occurring after the balance sheet date may indicate that the enterprise ceases to be a going concern. A deterioration in operating results and financial position, or unusual changes affecting the existence or substratum of the enterprise after the balance sheet date (e.g., destruction of a major production plant by a fire after the balance sheet date) may indicate a need to consider whether it is proper to use the fundamental accounting assumption of going concern in the preparation of the financial statements.

9. Disclosure

9.1 The disclosure requirements herein referred to apply only in respect of those contingencies or events which affect the financial position to a material extent.

9.2 If a contingent loss is not provided for, its nature and an estimate of its financial effect are generally disclosed by way of note unless the possibility of a loss is remote (other than the circumstances mentioned in paragraph 5.5). If a reliable estimate of the financial effect cannot be made, this fact is disclosed.

9.3 When the events occurring after the balance sheet date are disclosed in the report of the approving authority, the information given comprises the nature of the events and an estimate of their financial effects or a statement that such an estimate cannot be made.

Main Principles

Contingencies[4]

10. The amount of a contingent loss should be provided for by a charge in the statement of profit and loss if:

(a) it is probable that future events will confirm that, after taking into account any related probable recovery, an asset has been impaired or a liability has been incurred at the balance sheet date, and

(b) a reasonable estimate of the amount of the resulting loss can be made.

11. The existence of a contingent loss should be disclosed in the financial statements if either of the conditions in paragraph 10 is not met, unless the possibility of a loss is remote.

12. Contingent gains should not be recognised in the financial statements.

Events Occurring after the Balance Sheet Date

13. Assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date or that indicate that the fundamental accounting assumption of going concern (i.e., the continuance of existence or substratum of the enterprise) is not appropriate.

14. Dividends stated to be in respect of the period covered by the financial statements, which are proposed or declared by the enterprise after the balance sheet date but before approval of the financial statements, should be adjusted.

15. Disclosure should be made in the report of the approving authority of those events occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise.

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[4] See also footnote 1.

Disclosure

16. If disclosure of contingencies is required by paragraph 11 of this Standard, the following information should be provided:

(a) the nature of the contingency;

(b) the uncertainties which may affect the future outcome;

(c) an estimate of the financial effect, or a statement that such an estimate cannot be made.

17. If disclosure of events occurring after the balance sheet date in the report of the approving authority is required by paragraph 15 of this Standard, the following information should be provided:

(a) the nature of the event;

(b) an estimate of the financial effect, or a statement that such an estimate cannot be made.

Accounting Standard (AS) 5
(revised 1997)

Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

Contents

Accounting Standard (AS) 5*

(revised 1997)

Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

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

Objective

The objective of this Standard is to prescribe the classification and disclosure of certain items in the statement of profit and loss so that all enterprises prepare and present such a statement on a uniform basis. This enhances the comparability of the financial statements of an enterprise over time and with the financial statements of other enterprises. Accordingly, this Standard requires the classification and disclosure of extraordinary and prior period items, and the disclosure of certain items within profit or loss from ordinary activities. It also specifies the accounting treatment for changes in accounting estimates and the disclosures to be made in the financial statements regarding changes in accounting policies.

Scope

1. This Standard should be applied by an enterprise in presenting profit or loss from ordinary activities, extraordinary items and prior

* A limited revision was made in 2001, pursuant to which paragraph 33 has been added in this standard (see footnote 2). The Standard was originally issued in November 1982 and was titled 'Prior Period and Extraordinary Items and Changes in Accounting Policies'.

[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.

period items in the statement of profit and loss, in accounting for changes in accounting estimates, and in disclosure of changes in accounting policies.

2. This Standard deals with, among other matters, the disclosure of certain items of net profit or loss for the period. These disclosures are made in addition to any other disclosures required by other Accounting Standards.

3. This Standard does not deal with the tax implications of extraordinary items, prior period items, changes in accounting estimates, and changes in accounting policies for which appropriate adjustments will have to be made depending on the circumstances.

Definitions

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

4.1. <u>Ordinary activities</u> are any activities which are undertaken by an enterprise as part of its business and such related activities in which the enterprise engages in furtherance of, incidental to, or arising from, these activities.

4.2. <u>Extraordinary items</u> are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.

4.3. <u>Prior period</u> items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

4.4. <u>Accounting policies</u> are the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.

Net Profit or Loss for the Period

5. All items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise.

6. Normally, all items of income and expense which are recognised in a period are included in the determination of the net profit or loss for the period. This includes extraordinary items and the effects of changes in accounting estimates.

7. The net profit or loss for the period comprises the following components, each of which should be disclosed on the face of the statement of profit and loss:

(a) profit or loss from ordinary activities; and

(b) extraordinary items.

Extraordinary Items

8. Extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived.

9. Virtually all items of income and expense included in the determination of net profit or loss for the period arise in the course of the ordinary activities of the enterprise. Therefore, only on rare occasions does an event or transaction give rise to an extraordinary item.

10. Whether an event or transaction is clearly distinct from the ordinary activities of the enterprise is determined by the nature of the event or transaction in relation to the business ordinarily carried on by the enterprise rather than by the frequency with which such events are expected to occur. Therefore, an event or transaction may be extraordinary for one enterprise but not so for another enterprise because of the differences between their respective ordinary activities. For example, losses sustained as a result of an earthquake may qualify as an extraordinary item for many enterprises. However, claims from policyholders arising from an earthquake do not qualify as an extraordinary item for an insurance enterprise that insures against such risks.

11. Examples of events or transactions that generally give rise to extraordinary items for most enterprises are:

– attachment of property of the enterprise; or

– an earthquake.

Profit or Loss from Ordinary Activities

12. When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

13. Although the items of income and expense described in paragraph 12 are not extraordinary items, the nature and amount of such items may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial position and performance. Disclosure of such information is sometimes made in the notes to the financial statements.

14. Circumstances which may give rise to the separate disclosure of items of income and expense in accordance with paragraph 12 include:

(a) the write-down of inventories to net realisable value as well as the reversal of such write-downs;

(b) a restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring;

(c) disposals of items of fixed assets;

(d) disposals of long-term investments;

(e) legislative changes having retrospective application;

(f) litigation settlements; and

(g) other reversals of provisions.

Prior Period Items

15. The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived.

16. The term 'prior period items', as defined in this Standard , refers only to income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. The term does not include other adjustments necessitated by circumstances, which though related to prior periods, are determined in the current period, e.g., arrears payable to workers as a result of revision of wages with retrospective effect during the current period.

17. Errors in the preparation of the financial statements of one or more prior periods may be discovered in the current period. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, or oversight.

18. Prior period items are generally infrequent in nature and can be distinguished from changes in accounting estimates. Accounting estimates by their nature are approximations that may need revision as additional information becomes known. For example, income or expense recognised on the outcome of a contingency which previously could not be estimated reliably does not constitute a prior period item.

19. Prior period items are normally included in the determination of net profit or loss for the current period. An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss.

Changes in Accounting Estimates

20. As a result of the uncertainties inherent in business activities, many financial statement items cannot be measured with precision but can only be estimated. The estimation process involves judgments based on the latest information available. Estimates may be required, for example, of bad debts, inventory obsolescence or the useful lives of depreciable assets. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

21. An estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item.

22. Sometimes, it is difficult to distinguish between a change in an accounting policy and a change in an accounting estimate. In such cases, the change is treated as a change in an accounting estimate, with appropriate disclosure.

23. The effect of a change in an accounting estimate should be included in the determination of net profit or loss in:

(a) the period of the change, if the change affects the period only; or

(b) the period of the change and future periods, if the change affects both.

24. A change in an accounting estimate may affect the current period only or both the current period and future periods. For example, a change in the estimate of the amount of bad debts is recognised immediately and therefore affects only the current period. However, a change in the estimated useful life of a depreciable asset affects the depreciation in the current period and in each period during the remaining useful life of the asset. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods, is recognised in future periods.

25. The effect of a change in an accounting estimate should be classified using the same classification in the statement of profit and loss as was used previously for the estimate.

26. To ensure the comparability of financial statements of different periods, the effect of a change in an accounting estimate which was previously included in the profit or loss from ordinary activities is included in that component of net profit or loss. The effect of a change in an accounting estimate that was previously included as an extraordinary item is reported as an extraordinary item.

27. The nature and amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a

material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed.

Changes in Accounting Policies

28. Users need to be able to compare the financial statements of an enterprise over a period of time in order to identify trends in its financial position, performance and cash flows. Therefore, the same accounting policies are normally adopted for similar events or transactions in each period.

29. A change in an accounting policy should be made only if the adoption of a different accounting policy is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.

30. A more appropriate presentation of events or transactions in the financial statements occurs when the new accounting policy results in more relevant or reliable information about the financial position, performance or cash flows of the enterprise.

31. The following are not changes in accounting policies :

(a) the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, e.g., introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement; and

(b) the adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial.

32. Any change in an accounting policy which has a material effect should be disclosed. The impact of, and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

33. A change in accounting policy consequent upon the adoption of an Accounting Standard should be accounted for in accordance with the specific transitional provisions, if any, contained in that Accounting Standard. However, disclosures required by paragraph 32 of this Standard should be made unless the transitional provisions of any other Accounting Standard require alternative disclosures in this regard.[2]

[2] As a limited revision to AS 5, the Council of the Institute decided to add this paragraph in AS 5 in 2001. This revision came into effect in respect of accounting periods commencing on or after 1.4.2001 (see 'The Chartered Accountant', September 2001, pp. 342).

Accounting Standard (AS) 6
(revised 1994)

Depreciation Accounting

Contents

Accounting Standard (AS) 6*
(revised 1994)

Depreciation Accounting

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

Introduction

1. This Standard deals with depreciation accounting and applies to all depreciable assets, except the following items to which special considerations apply:—

(i) forests, plantations and similar regenerative natural resources;

(ii) wasting assets including expenditure on the exploration for and extraction of minerals, oils, natural gas and similar non-regenerative resources;

(iii) expenditure on research and development;

(iv) goodwill and other intangible assets;

(v) live stock.

This standard also does not apply to land unless it has a limited useful life for the enterprise.

2. Different accounting policies for depreciation are adopted by different enterprises. Disclosure of accounting policies for depreciation followed by

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* Accounting Standard (AS) 6, *Depreciation Accounting*, was issued by the Institute in November 1982.

[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.

an enterprise is necessary to appreciate the view presented in the financial statements of the enterprise.

Definitions

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

3.1 <u>Depreciation</u> is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined.

3.2 <u>Depreciable assets</u> are assets which

(i) are expected to be used during more than one accounting period; and

(ii) have a limited useful life; and

(iii) are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.

3.3 <u>Useful life</u> is either (i) the period over which a depreciable asset is expected to be used by the enterprise; or (ii) the number of production or similar units expected to be obtained from the use of the asset by the enterprise.

3.4 <u>Depreciable amount</u> of a depreciable asset is its historical cost, or other amount substituted for historical cost[2] in the financial statements, less the estimated residual value.

[2] This Standard does not deal with the treatment of the revaluation difference which may arise when historical costs are substituted by revaluations.

Explanation

4. Depreciation has a significant effect in determining and presenting the financial position and results of operations of an enterprise. Depreciation is charged in each accounting period by reference to the extent of the depreciable amount, irrespective of an increase in the market value of the assets.

5. Assessment of depreciation and the amount to be charged in respect thereof in an accounting period are usually based on the following three factors:

(i) historical cost or other amount substituted for the historical cost of the depreciable asset when the asset has been revalued;

(ii) expected useful life of the depreciable asset; and

(iii) estimated residual value of the depreciable asset.

6. Historical cost of a depreciable asset represents its money outlay or its equivalent in connection with its acquisition, installation and commissioning as well as for additions to or improvement thereof. The historical cost of a depreciable asset may undergo subsequent changes arising as a result of increase or decrease in long term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors.

7. The useful life of a depreciable asset is shorter than its physical life and is:

(i) pre-determined by legal or contractual limits, such as the expiry dates of related leases;

(ii) directly governed by extraction or consumption;

(iii) dependent on the extent of use and physical deterioration on account of wear and tear which again depends on operational factors, such as, the number of shifts for which the asset is to be used, repair and maintenance policy of the enterprise etc.; and

(iv) reduced by obsolescence arising from such factors as:

(a) technological changes;

(b) improvement in production methods;

(c) change in market demand for the product or service output of the asset; or

(d) legal or other restrictions.

8. Determination of the useful life of a depreciable asset is a matter of estimation and is normally based on various factors including experience with similar types of assets. Such estimation is more difficult for an asset using new technology or used in the production of a new product or in the provision of a new service but is nevertheless required on some reasonable basis.

9. Any addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is depreciated over the remaining useful life of that asset. As a practical measure, however, depreciation is sometimes provided on such addition or extension at the rate which is applied to an existing asset. Any addition or extension which retains a separate identity and is capable of being used after the existing asset is disposed of, is depreciated independently on the basis of an estimate of its own useful life.

10. Determination of residual value of an asset is normally a difficult matter. If such value is considered as insignificant, it is normally regarded as nil. On the contrary, if the residual value is likely to be significant, it is estimated at the time of acquisition/installation, or at the time of subsequent revaluation of the asset. One of the bases for determining the residual value would be the realisable value of similar assets which have reached the end of their useful lives and have operated under conditions similar to those in which the asset will be used.

11. The quantum of depreciation to be provided in an accounting period involves the exercise of judgement by management in the light of technical, commercial, accounting and legal requirements and accordingly may need periodical review. If it is considered that the original estimate of useful life of an asset requires any revision, the unamortised depreciable amount of the asset is charged to revenue over the revised remaining useful life.

12. There are several methods of allocating depreciation over the useful life of the assets. Those most commonly employed in industrial and commercial enterprises are the straightline method and the reducing balance

PREVIOUS HOME NEXT

method. The management of a business selects the most appropriate method(s) based on various important factors e.g., (i) type of asset, (ii) the nature of the use of such asset and (iii) circumstances prevailing in the business. A combination of more than one method is sometimes used. In respect of depreciable assets which do not have material value, depreciation is often allocated fully in the accounting period in which they are acquired.

13. The statute governing an enterprise may provide the basis for computation of the depreciation. For example, the Companies Act, 1956 lays down the rates of depreciation in respect of various assets. Where the management's estimate of the useful life of an asset of the enterprise is shorter than that envisaged under the provisions of the relevant statute, the depreciation provision is appropriately computed by applying a higher rate. If the management's estimate of the useful life of the asset is longer than that envisaged under the statute, depreciation rate lower than that envisaged by the statute can be applied only in accordance with requirements of the statute.

14. Where depreciable assets are disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, is disclosed separately.

15. The method of depreciation is applied consistently to provide comparability of the results of the operations of the enterprise from period to period. A change from one method of providing depreciation to another is made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When such a change in the method of depreciation is made, depreciation is recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method is adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency is charged in the statement of profit and loss. In case the change in the method results in surplus, the surplus is credited to the statement of profit and loss. Such a change is treated as a change in accounting policy and its effect is quantified and disclosed.

16. Where the historical cost of an asset has undergone a change due to circumstances specified in para 6 above, the depreciation on the revised unamortised depreciable amount is provided prospectively over the residual useful life of the asset.

PREVIOUS HOME NEXT

Disclosure

17. The depreciation methods used, the total depreciation for the period for each class of assets, the gross amount of each class of depreciable assets and the related accumulated depreciation are disclosed in the financial statements alongwith the disclosure of other accounting policies. The depreciation rates or the useful lives of the assets are disclosed only if they are different from the principal rates specified in the statute governing the enterprise.

18. In case the depreciable assets are revalued, the provision for depreciation is based on the revalued amount on the estimate of the remaining useful life of such assets. In case the revaluation has a material effect on the amount of depreciation, the same is disclosed separately in the year in which revaluation is carried out.

19. A change in the method of depreciation is treated as a change in an accounting policy and is disclosed accordingly.[3]

Main Principles

20. The depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset.

21. The depreciation method selected should be applied consistently from period to period. A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When such a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency should be charged in the statement of profit and loss. In case the change in the method results in surplus, the surplus should be credited to the statement of profit and

[3] Refer to AS 5.

loss. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed.

22. The useful life of a depreciable asset should be estimated after considering the following factors:

(i) expected physical wear and tear;

(ii) obsolescence;

(iii) legal or other limits on the use of the asset.

23. The useful lives of major depreciable assets or classes of depreciable assets may be reviewed periodically. Where there is a revision of the estimated useful life of an asset, the unamortised depreciable amount should be charged over the revised remaining useful life.

24. Any addition or extension which becomes an integral part of the existing asset should be depreciated over the remaining useful life of that asset. The depreciation on such addition or extension may also be provided at the rate applied to the existing asset. Where an addition or extension retains a separate identity and is capable of being used after the existing asset is disposed of, depreciation should be provided independently on the basis of an estimate of its own useful life.

25. Where the historical cost of a depreciable asset has undergone a change due to increase or decrease in long term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors, the depreciation on the revised unamortised depreciable amount should be provided prospectively over the residual useful life of the asset.

26. Where the depreciable assets are revalued, the provision for depreciation should be based on the revalued amount and on the estimate of the remaining useful lives of such assets. In case the revaluation has a material effect on the amount of depreciation, the same should be disclosed separately in the year in which revaluation is carried out.

27. If any depreciable asset is disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, should be disclosed separately.

28. The following information should be disclosed in the financial statements:

(i) the historical cost or other amount substituted for historical cost of each class of depreciable assets;

(ii) total depreciation for the period for each class of assets; and

(iii) the related accumulated depreciation.

29. The following information should also be disclosed in the financial statements alongwith the disclosure of other accounting policies:

(i) depreciation methods used; and

(ii) depreciation rates or the useful lives of the assets, if they are different from the principal rates specified in the statute governing the enterprise.

Accounting Standard (AS) 7
(revised 2002)

Construction Contracts

Contents

Accounting Standard (AS) 7*
(revised 2002)

Construction Contracts

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

Objective

The objective of this Standard is to prescribe the accounting treatment of revenue and costs associated with construction contracts. Because of the nature of the activity undertaken in construction contracts, the date at which the contract activity is entered into and the date when the activity is completed usually fall into different accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed. This Standard uses the recognition criteria established in the Framework for the Preparation and Presentation of Financial Statements to determine when contract revenue and contract costs should be recognised as revenue and expenses in the statement of profit and loss. It also provides practical guidance on the application of these criteria.

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* Originally issued in December 1983 and titled as 'Accounting for Construction Contracts'. The Standard was revised in 2002 and came into effect in respect of all contracts entered into during accounting periods commencing on or after 1-4-2003 and is mandatory in nature from that date. Accordingly, Accounting Standard (AS) 7, 'Accounting for Construction Contracts', issued by the Institute in December 1983, is not applicable in respect of such contracts.

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

Scope

1. This Standard should be applied in accounting for construction contracts in the financial statements of contractors.

Definitions

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

2.1 A <u>construction contract</u> is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

2.2 A <u>fixed price contract</u> is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.

2.3 A <u>cost plus contract</u> is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus percentage of these costs or a fixed fee.

3. A construction contract may be negotiated for the construction of a single asset such as a bridge, building, dam, pipeline, road, ship or tunnel. A construction contract may also deal with the construction of a number of assets which are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use; examples of such contracts include those for the construction of refineries and other complex pieces of plant or equipment.

4. For the purposes of this Standard, construction contracts include:

(a) contracts for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects; and

(b) contracts for destruction or restoration of assets, and the restoration of the environment following the demolition of assets.

5. Construction contracts are formulated in a number of ways which, for the purposes of this Standard, are classified as fixed price contracts and cost plus contracts. Some construction contracts may contain characteristics of both a fixed price contract and a cost plus contract, for example, in the case of a cost plus contract with an agreed maximum price. In such circumstances, a contractor needs to consider all the conditions in paragraphs 22 and 23 in order to determine when to recognise contract revenue and expenses.

Combining and Segmenting Construction Contracts

6. The requirements of this Standard are usually applied separately to each construction contract. However, in certain circumstances, it is necessary to apply the Standard to the separately identifiable components of a single contract or to a group of contracts together in order to reflect the substance of a contract or a group of contracts.

7. When a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:

> ***(a) separate proposals have been submitted for each asset;***
>
> ***(b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and***
>
> ***(c) the costs and revenues of each asset can be identified.***

8. A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:

> ***(a) the group of contracts is negotiated as a single package;***
>
> ***(b) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and***
>
> ***(c) the contracts are performed concurrently or in a continuous sequence.***

9. A contract may provide for the construction of an additional asset at

the option of the customer or may be amended to include the construction of an additional asset. The construction of the additional asset should be treated as a separate construction contract when:

(a) the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or

(b) the price of the asset is negotiated without regard to the original contract price.

Contract Revenue

10. Contract revenue should comprise:

(a) the initial amount of revenue agreed in the contract; and

(b) variations in contract work, claims and incentive payments:

(i) to the extent that it is probable that they will result in revenue; and

(ii) they are capable of being reliably measured.

11. Contract revenue is measured at the consideration received or receivable. The measurement of contract revenue is affected by a variety of uncertainties that depend on the outcome of future events. The estimates often need to be revised as events occur and uncertainties are resolved. Therefore, the amount of contract revenue may increase or decrease from one period to the next. For example:

(a) a contractor and a customer may agree to variations or claims that increase or decrease contract revenue in a period subsequent to that in which the contract was initially agreed;

(b) the amount of revenue agreed in a fixed price contract may increase as a result of cost escalation clauses;

(c) the amount of contract revenue may decrease as a result of penalties arising from delays caused by the contractor in the completion of the contract; or

(d) when a fixed price contract involves a fixed price per unit of output, contract revenue increases as the number of units is increased.

12. A variation is an instruction by the customer for a change in the scope of the work to be performed under the contract. A variation may lead to an increase or a decrease in contract revenue. Examples of variations are changes in the specifications or design of the asset and changes in the duration of the contract. A variation is included in contract revenue when:

(a) it is probable that the customer will approve the variation and the amount of revenue arising from the variation; and

(b) the amount of revenue can be reliably measured.

13. A claim is an amount that the contractor seeks to collect from the customer or another party as reimbursement for costs not included in the contract price. A claim may arise from, for example, customer caused delays, errors in specifications or design, and disputed variations in contract work. The measurement of the amounts of revenue arising from claims is subject to a high level of uncertainty and often depends on the outcome of negotiations. Therefore, claims are only included in contract revenue when:

(a) negotiations have reached an advanced stage such that it is probable that the customer will accept the claim; and

(b) the amount that it is probable will be accepted by the customer can be measured reliably.

14. Incentive payments are additional amounts payable to the contractor if specified performance standards are met or exceeded. For example, a contract may allow for an incentive payment to the contractor for early completion of the contract. Incentive payments are included in contract revenue when:

(a) the contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and

(b) the amount of the incentive payment can be measured reliably.

Contract Costs

15. Contract costs should comprise:

(a) costs that relate directly to the specific contract;

(b) ***costs that are attributable to contract activity in general and can be allocated to the contract; and***

(c) ***such other costs as are specifically chargeable to the customer under the terms of the contract.***

16. Costs that relate directly to a specific contract include:

(a) site labour costs, including site supervision;

(b) costs of materials used in construction;

(c) depreciation of plant and equipment used on the contract;

(d) costs of moving plant, equipment and materials to and from the contract site;

(e) costs of hiring plant and equipment;

(f) costs of design and technical assistance that is directly related to the contract;

(g) the estimated costs of rectification and guarantee work, including expected warranty costs; and

(h) claims from third parties.

These costs may be reduced by any incidental income that is not included in contract revenue, for example income from the sale of surplus materials and the disposal of plant and equipment at the end of the contract.

17. Costs that may be attributable to contract activity in general and can be allocated to specific contracts include:

(a) insurance;

(b) costs of design and technical assistance that is not directly related to a specific contract; and

(c) construction overheads.

Such costs are allocated using methods that are systematic and rational and are applied consistently to all costs having similar characteristics. The allocation is based on the normal level of construction activity. Construction overheads include costs such as the preparation and processing of construction personnel payroll. Costs that may be attributable to contract activity in general and can be allocated to specific contracts also include borrowing costs as per Accounting Standard (AS) 16, Borrowing Costs.

18. Costs that are specifically chargeable to the customer under the terms of the contract may include some general administration costs and development costs for which reimbursement is specified in the terms of the contract.

19. Costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract. Such costs include:

(a) general administration costs for which reimbursement is not specified in the contract;

(b) selling costs;

(c) research and development costs for which reimbursement is not specified in the contract; and

(d) depreciation of idle plant and equipment that is not used on a particular contract.

20. Contract costs include the costs attributable to a contract for the period from the date of securing the contract to the final completion of the contract. However, costs that relate directly to a contract and which are incurred in securing the contract are also included as part of the contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained. When costs incurred in securing a contract are recognised as an expense in the period in which they are incurred, they are not included in contract costs when the contract is obtained in a subsequent period.

Recognition of Contract Revenue and Expenses

21. When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35.

22. In the case of a fixed price contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:

- *(a) total contract revenue can be measured reliably;*
- *(b) it is probable that the economic benefits associated with the contract will flow to the enterprise;*
- *(c) both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and*
- *(d) the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.*

23. In the case of a cost plus contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:

- *(a) it is probable that the economic benefits associated with the contract will flow to the enterprise; and*
- *(b) the contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.*

24. The recognition of revenue and expenses by reference to the stage of completion of a contract is often referred to as the percentage of completion method. Under this method, contract revenue is matched with the contract

costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed. This method provides useful information on the extent of contract activity and performance during a period.

25. Under the percentage of completion method, contract revenue is recognised as revenue in the statement of profit and loss in the accounting periods in which the work is performed. Contract costs are usually recognised as an expense in the statement of profit and loss in the accounting periods in which the work to which they relate is performed. However, any expected excess of total contract costs over total contract revenue for the contract is recognised as an expense immediately in accordance with paragraph 35.

26. A contractor may have incurred contract costs that relate to future activity on the contract. Such contract costs are recognised as an asset provided it is probable that they will be recovered. Such costs represent an amount due from the customer and are often classified as contract work in progress.

27. When an uncertainty arises about the collectability of an amount already included in contract revenue, and already recognised in the statement of profit and loss, the uncollectable amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense rather than as an adjustment of the amount of contract revenue.

28. An enterprise is generally able to make reliable estimates after it has agreed to a contract which establishes:

(a) each party's enforceable rights regarding the asset to be constructed;

(b) the consideration to be exchanged; and

(c) the manner and terms of settlement.

It is also usually necessary for the enterprise to have an effective internal financial budgeting and reporting system. The enterprise reviews and, when necessary, revises the estimates of contract revenue and contract costs as the contract progresses. The need for such revisions does not necessarily indicate that the outcome of the contract cannot be estimated reliably.

29. The stage of completion of a contract may be determined in a variety of ways. The enterprise uses the method that measures reliably the work performed. Depending on the nature of the contract, the methods may include:

(a) the proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs; or

(b) surveys of work performed; or

(c) completion of a physical proportion of the contract work.

Progress payments and advances received from customers may not necessarily reflect the work performed.

30. When the stage of completion is determined by reference to the contract costs incurred upto the reporting date, only those contract costs that reflect work performed are included in costs incurred upto the reporting date. Examples of contract costs which are excluded are:

(a) contract costs that relate to future activity on the contract, such as costs of materials that have been delivered to a contract site or set aside for use in a contract but not yet installed, used or applied during contract performance, unless the materials have been made specially for the contract; and

(b) payments made to subcontractors in advance of work performed under the subcontract.

31. When the outcome of a construction contract cannot be estimated reliably:

(a) revenue should be recognised only to the extent of contract costs incurred of which recovery is probable; and

(b) contract costs should be recognised as an expense in the period in which they are incurred.

An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35.

32. During the early stages of a contract it is often the case that the outcome of the contract cannot be estimated reliably. Nevertheless, it may be probable

that the enterprise will recover the contract costs incurred. Therefore, contract revenue is recognised only to the extent of costs incurred that are expected to be recovered. As the outcome of the contract cannot be estimated reliably, no profit is recognised. However, even though the outcome of the contract cannot be estimated reliably, it may be probable that total contract costs will exceed total contract revenue. In such cases, any expected excess of total contract costs over total contract revenue for the contract is recognised as an expense immediately in accordance with paragraph 35.

33. Contract costs recovery of which is not probable are recognised as an expense immediately. Examples of circumstances in which the recoverability of contract costs incurred may not be probable and in which contract costs may, therefore, need to be recognised as an expense immediately include contracts:

(a) which are not fully enforceable, that is, their validity is seriously in question;

(b) the completion of which is subject to the outcome of pending litigation or legislation;

(c) relating to properties that are likely to be condemned or expropriated;

(d) where the customer is unable to meet its obligations; or

(e) where the contractor is unable to complete the contract or otherwise meet its obligations under the contract.

34. When the uncertainties that prevented the outcome of the contract being estimated reliably no longer exist, revenue and expenses associated with the construction contract should be recognised in accordance with paragraph 21 rather than in accordance with paragraph 31.

Recognition of Expected Losses

35. When it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately.

36. The amount of such a loss is determined irrespective of:

(a) whether or not work has commenced on the contract;

(b) the stage of completion of contract activity; or

(c) the amount of profits expected to arise on other contracts which are not treated as a single construction contract in accordance with paragraph 8.

Changes in Estimates

37. The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates of contract revenue and contract costs. Therefore, the effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract, is accounted for as a change in accounting estimate (see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies). The changed estimates are used in determination of the amount of revenue and expenses recognised in the statement of profit and loss in the period in which the change is made and in subsequent periods.

Disclosure

38. An enterprise should disclose:

(a) the amount of contract revenue recognised as revenue in the period;

(b) the methods used to determine the contract revenue recognised in the period; and

(c) the methods used to determine the stage of completion of contracts in progress.

39. An enterprise should disclose the following for contracts in progress at the reporting date:

(a) the aggregate amount of costs incurred and recognised profits (less recognised losses) upto the reporting date;

(b) the amount of advances received; and

(c) the amount of retentions.

40. Retentions are amounts of progress billings which are not paid until the satisfaction of conditions specified in the contract for the payment of

PREVIOUS HOME NEXT

such amounts or until defects have been rectified. Progress billings are amounts billed for work performed on a contract whether or not they have been paid by the customer. Advances are amounts received by the contractor before the related work is performed.

41. An enterprise should present:

(a) the gross amount due from customers for contract work as an asset; and

(b) the gross amount due to customers for contract work as a liability.

42. The gross amount due from customers for contract work is the net amount of:

(a) costs incurred plus recognised profits; less

(b) the sum of recognised losses and progress billings

for all contracts in progress for which costs incurred plus recognised profits (less recognised losses) exceeds progress billings.

43. The gross amount due to customers for contract work is the net amount of:

(a) the sum of recognised losses and progress billings; less

(b) costs incurred plus recognised profits

for all contracts in progress for which progress billings exceed costs incurred plus recognised profits (less recognised losses).

44. An enterprise discloses any contingencies in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date[2]. Contingencies may arise from such items as warranty costs, penalties or possible losses.

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[2] Pursuant to AS 29, Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory, 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 Accounting Standards.

Illustration

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

Disclosure of Accounting Policies

The following are illustrations of accounting policy disclosures:

Revenue from fixed price construction contracts is recognised on the percentage of completion method, measured by reference to the percentage of labour hours incurred upto the reporting date to estimated total labour hours for each contract.

Revenue from cost plus contracts is recognised by reference to the recoverable costs incurred during the period plus the fee earned, measured by the proportion that costs incurred upto the reporting date bear to the estimated total costs of the contract.

The Determination of Contract Revenue and Expenses

The following illustration illustrates one method of determining the stage of completion of a contract and the timing of the recognition of contract revenue and expenses (see paragraphs 21 to 34 of the Standard). (Amounts shown hereinbelow are in Rs. lakhs)

A construction contractor has a fixed price contract for Rs. 9,000 to build a bridge. The initial amount of revenue agreed in the contract is Rs. 9,000. The contractor's initial estimate of contract costs is Rs. 8,000. It will take 3 years to build the bridge.

By the end of year 1, the contractor's estimate of contract costs has increased to Rs. 8,050.

In year 2, the customer approves a variation resulting in an increase in contract revenue of Rs. 200 and estimated additional contract costs of Rs. 150. At the end of year 2, costs incurred include Rs. 100 for standard materials stored at the site to be used in year 3 to complete the project.

The contractor determines the stage of completion of the contract by calculating the proportion that contract costs incurred for work performed upto the reporting date bear to the latest estimated total contract costs. A summary of the financial data during the construction period is as follows:

(amount in Rs. lakhs)

	Year 1	Year 2	Year 3
Initial amount of revenue agreed in contract	9,000	9,000	9,000
Variation	—	200	200
Total contract revenue	9,000	9,200	9,200
Contract costs incurred upto the reporting date	2,093	6,168	8,200
Contract costs to complete	5,957	2,032	—
Total estimated contract costs	8,050	8,200	8,200
Estimated Profit	950	1,000	1,000
Stage of completion	26%	74%	100%

The stage of completion for year 2 (74%) is determined by excluding from contract costs incurred for work performed upto the reporting date, Rs. 100 of standard materials stored at the site for use in year 3.

The amounts of revenue, expenses and profit recognised in the statement of profit and loss in the three years are as follows:

	Recognised in Prior years	Recognised in current year
Year 1		
Revenue (9,000x .26)	2,340	2,340
Expenses (8,050x .26)	2,093	2,093
Profit	247	247

Year 2

Revenue (9,200x .74)	6,808	2,340	4,468
Expenses (8,200x .74)	6,068	2,093	3,975
Profit	740	247	493

Year 3

Revenue (9,200x 1.00)	9,200	6,[illegible]	2,392
Expenses	8,200	6,068	2,132
Profit	1,000	740	260

Contract Disclosures

A contractor has reached the end of its first year of operations. All its contract costs incurred have been paid for in cash and all its progress billings and advances have been received in cash. Contract costs incurred for contracts B, C and E include the cost of materials that have been purchased for the contract but which have not been used in contract performance upto the reporting date. For contracts B, C and E, the customers have made advances to the contractor for work not yet performed.

The status of its five contracts in progress at the end of year 1 is as follows:

	Contract (amount in Rs. lakhs)					
	A	B	C	D	E	Total
Contract Revenue recognised in accordance with paragraph 21	145	520	380	200	55	1,300
Contract Expenses recognised in accordance with paragraph 21	110	450	350	250	55	1,215
Expected Losses recognised in accordance with paragraph 35	—	—	—	40	30	70
Recognised profits less recognised losses	35	70	30	(90)	(30)	15
Contract Costs incurred in the period	110	510	450	250	100	1,420
Contract Costs incurred recognised as contract expenses in the period in accordance with paragraph 21	110	450	350	250	55	1,215
Contract Costs that relate to future activity recognised as an asset in accordance with paragraph 26	—	60	100	—	45	205
Contract Revenue (see above)	145	520	380	200	55	1,300
Progress Billings (paragraph 40)	100	520	380	180	55	1,235
Unbilled Contract Revenue	45	—	—	20	—	65
Advances (paragraph 40)	—	80	20	—	25	125

The amounts to be disclosed in accordance with the Standard are as follows:

Contract revenue recognised as revenue in the period [paragraph 38(a)]	1,300
Contract costs incurred and recognised profits (less recognised losses) upto the reporting date [paragraph 39(a)]	1,435
Advances received [paragraph 39(b)]	125

Gross amount due from customers for contract work—presented as an asset in accordance with paragraph 41(a)	220
Gross amount due to customers for contract work—presented as a liability in accordance with paragraph 41(b)	(20)

The amounts to be disclosed in accordance with paragraphs 39(a), 41(a) and 41(b) are calculated as follows:

(amount in Rs. lakhs)

	A	B	C	D	E	Total
Contract Costs incurred	110	510	450	250	100	1,420
Recognised profits less recognised losses	35	70	30	(90)	(30)	15
	145	580	480	160	70	1,435
Progress billings	100	520	380	180	55	1,235
Due from customers	45	60	100	—	15	220
Due to customers	—	—	—	(20)	—	(20)

The amount disclosed in accordance with paragraph 39(a) is the same as the amount for the current period because the disclosures relate to the first year of operation.

Accounting Standard (AS) 9

(issued 1985)

Revenue Recognition

Contents

Accounting Standard (AS) 9[1]

(issued 1985)

Revenue Recognition

[This Accounting Standard includes paragraphs set in ***bold italic*** *type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of the Preface to the Statements of Accounting Standards[2] and the 'Applicability of Accounting Standards to Various Entities' (See Appendix 1 to this Compendium).]*

Introduction

1. This Standard deals with the bases for recognition of revenue in the statement of profit and loss of an enterprise. The Standard is concerned with the recognition of revenue arising in the course of the ordinary activities of the enterprise from

— the sale of goods,

— the rendering of services, and

— the use by others of enterprise resources yielding interest, royalties and dividends.

2. This Standard does not deal with the following aspects of revenue recognition to which special considerations apply:

(i) Revenue arising from construction contracts;[3]

(ii) Revenue arising from hire-purchase, lease agreements;

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[1] It is reiterated that this Accounting Standard (as is the case of other accounting standards) assumes that the three fundamental accounting assumptions i.e., going concern, consistency and accrual have been followed in the preparation and presentation of financial statements.

[2] 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.

[3] Refer to AS 7 on 'Construction Contracts'.

(iii) Revenue arising from government grants and other similar subsidies;

(iv) Revenue of insurance companies arising from insurance contracts.

3. Examples of items not included within the definition of "revenue" for the purpose of this Standard are:

(i) Realised gains resulting from the disposal of, and unrealised gains resulting from the holding of, non-current assets e.g. appreciation in the value of fixed assets;

(ii) Unrealised holding gains resulting from the change in value of current assets, and the natural increases in herds and agricultural and forest products;

(iii) Realised or unrealised gains resulting from changes in foreign exchange rates and adjustments arising on the translation of foreign currency financial statements;

(iv) Realised gains resulting from the discharge of an obligation at less than its carrying amount;

(v) Unrealised gains resulting from the restatement of the carrying amount of an obligation.

Definitions

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

4.1 <u>Revenue</u> is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise[4] from the sale of goods, from the rendering of services, and from the use by others

[4] The Institute has issued an Announcement in 2005 titled 'Treatment of Inter-divisional Transfers' (published in 'The Chartered Accountant' May 2005, pp. 1531). As per the Announcement, the recognition of inter-divisional transfers as sales is an inappropriate accounting treatment and is inconsistent with Accounting Standard 9. [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.]

of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.

4.2 <u>Completed service contract method</u> is a method of accounting which recognises revenue in the statement of profit and loss only when the rendering of services under a contract is completed or substantially completed.

4.3 <u>Proportionate completion method</u> is a method of accounting which recognises revenue in the statement of profit and loss proportionately with the degree of completion of services under a contract.

Explanation

5. Revenue recognition is mainly concerned with the timing of recognition of revenue in the statement of profit and loss of an enterprise. The amount of revenue arising on a transaction is usually determined by agreement between the parties involved in the transaction. When uncertainties exist regarding the determination of the amount, or its associated costs, these uncertainties may influence the timing of revenue recognition.

6. Sale of Goods

6.1 A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer. Such cases may arise where delivery has been delayed through the fault of either the buyer or the seller and the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such fault. Further, sometimes the parties may agree that the risk will pass at a time different from the time when ownership passes.

6.2 At certain stages in specific industries, such as when agricultural crops have been harvested or mineral ores have been extracted, performance may be substantially complete prior to the execution of the transaction generating revenue. In such cases when sale is assured under a forward contract or a government guarantee or where market exists and there is a negligible risk of failure to sell, the goods involved are often valued at net realisable value. Such amounts, while not revenue as defined in this Standard, are sometimes recognised in the statement of profit and loss and appropriately described.

7. Rendering of Services

7.1 Revenue from service transactions is usually recognised as the service is performed, either by the proportionate completion method or by the completed service contract method.

(i) ***Proportionate completion method***—Performance consists of the execution of more than one act. Revenue is recognised proportionately by reference to the performance of each act. The revenue recognised under this method would be determined on the basis of contract value, associated costs, number of acts or other suitable basis. For practical purposes, when services are provided by an indeterminate number of acts over a specific period of time, revenue is recognised on a straight line basis over the specific period unless there is evidence that some other method better represents the pattern of performance.

(ii) ***Completed service contract method***—Performance consists of the execution of a single act. Alternatively, services are performed in more than a single act, and the services yet to be performed are so significant in relation to the transaction taken as a whole that performance cannot be deemed to have been completed until the execution of those acts. The completed service contract method is relevant to these patterns of performance and accordingly revenue is recognised when the sole or final act takes place and the service becomes chargeable.

8. The Use by Others of Enterprise Resources Yielding Interest, Royalties and Dividends

8.1 The use by others of such enterprise resources gives rise to:

(i) interest—charges for the use of cash resources or amounts due to the enterprise;

(ii) royalties—charges for the use of such assets as know-how, patents, trade marks and copyrights;

(iii) dividends—rewards from the holding of investments in shares.

8.2 Interest accrues, in most circumstances, on the time basis determined by the amount outstanding and the rate applicable. Usually, discount or premium on debt securities held is treated as though it were accruing over the period to maturity.

8.3 Royalties accrue in accordance with the terms of the relevant agreement and are usually recognised on that basis unless, having regard to the substance of the transactions, it is more appropriate to recognise revenue on some other systematic and rational basis.

8.4 Dividends from investments in shares are not recognised in the statement of profit and loss until a right to receive payment is established.

8.5 When interest, royalties and dividends from foreign countries require exchange permission and uncertainty in remittance is anticipated, revenue recognition may need to be postponed.

9. Effect of Uncertainties on Revenue Recognition

9.1 Recognition of revenue requires that revenue is measurable and that at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.

9.2 Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments.

9.3 When the uncertainty relating to collectability arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.

9.4 An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

9.5 When recognition of revenue is postponed due to the effect of uncertainties, it is considered as revenue of the period in which it is properly recognised.

Main Principles

10. Revenue from sales or service transactions should be recognised when the requirements as to performance set out in paragraphs 11 and 12 are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.

Explanation :

The amount of revenue from sales transactions (turnover) should be disclosed in the following manner on the face of the statement of profit or loss :

Turnover (Gross)	*XX*	
Less: Excise Duty	*XX*	
Turnover (Net)		*XX*

The amount of excise duty to be deducted from the turnover should be the total excise duty for the year except the excise duty related to the difference

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between the closing start and opening stock. The excise duty related to the difference between the closing stock and opening stock should be recognised separately in the statement of profit or loss, with an explanatory note in the notes to accounts to explain the nature of the two amounts of excise duty.

11. In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

12. In a transaction involving the rendering of services, performance should be measured either under the completed service contract method or under the proportionate completion method, whichever relates the revenue to the work accomplished. Such performance should be regarded as being achieved when no significant uncertainty exists regarding the amount of the consideration that will be derived from rendering the service.

13. Revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends should only be recognised when no significant uncertainty as to measurability or collectability exists. These revenues are recognised on the following bases:

(i) Interest	:	*on a time proportion basis taking into account the amount outstanding and the rate applicable.*
(ii) Royalties	:	*on an accrual basis in accordance with the terms of the relevant agreement.*
(iii) Dividends from investments in shares	:	*when the owner's right to receive payment is established.*

Disclosure

14. In addition to the disclosures required by Accounting Standard 1 on 'Disclosure of Accounting Policies' (AS 1), an enterprise should also disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.

Illustrations

These illustrations do not form part of the Accounting Standard. Their purpose is to illustrate the application of the Standard to a number of commercial situations in an endeavour to assist in clarifying application of the Standard.

A. Sale of Goods

1. Delivery is delayed at buyer's request and buyer takes title and accepts billing

Revenue should be recognised notwithstanding that physical delivery has not been completed so long as there is every expectation that delivery will be made. However, the item must be on hand, identified and ready for delivery to the buyer at the time the sale is recognised rather than there being simply an intention to acquire or manufacture the goods in time for delivery.

2. Delivered subject to conditions

(a) installation and inspection i.e. goods are sold subject to installation, inspection etc.

Revenue should normally not be recognised until the customer accepts delivery and installation and inspection are complete. In some cases, however, the installation process may be so simple in nature that it may be appropriate to recognise the sale notwithstanding that installation is not yet completed (e.g. installation of a factory-tested television receiver normally only requires unpacking and connecting of power and antennae).

(b) on approval

Revenue should not be recognised until the goods have been formally accepted by the buyer or the buyer has done an act adopting the transaction or the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed.

(c) guaranteed sales i.e. delivery is made giving the buyer an unlimited right of return

Recognition of revenue in such circumstances will depend on the substance of the agreement. In the case of retail sales offering a guarantee of "money back if not completely satisfied" it may be appropriate to recognise the sale but to make a suitable provision for returns based on previous experience. In other cases, the substance of the agreement may amount to a sale on consignment, in which case it should be treated as indicated below.

(d) consignment sales i.e. a delivery is made whereby the recipient undertakes to sell the goods on behalf of the consignor

Revenue should not be recognised until the goods are sold to a third party.

(e) cash on delivery sales

Revenue should not be recognised until cash is received by the seller or his agent.

3. Sales where the purchaser makes a series of instalment payments to the seller, and the seller delivers the goods only when the final payment is received

Revenue from such sales should not be recognised until goods are delivered. However, when experience indicates that most such sales have been consummated, revenue may be recognised when a significant deposit is received.

4. Special order and shipments i.e. where payment (or partial payment) is received for goods not presently held in stock e.g. the stock is still to be manufactured or is to be delivered directly to the customer from a third party

Revenue from such sales should not be recognised until goods are manufactured, identified and ready for delivery to the buyer by the third party.

5. Sale/repurchase agreements i.e. where seller concurrently agrees to repurchase the same goods at a later date

For such transactions that are in substance a financing agreement, the resulting cash inflow is not revenue as defined and should not be recognised as revenue.

6. Sales to intermediate parties i.e. where goods are sold to distributors, dealers or others for resale

Revenue from such sales can generally be recognised if significant risks of ownership have passed; however in some situations the buyer may in substance be an agent and in such cases the sale should be treated as a consignment sale.

7. Subscriptions for publications

Revenue received or billed should be deferred and recognised either on a straight line basis over time or, where the items delivered vary in value from period to period, revenue should be based on the sales value of the item delivered in relation to the total sales value of all items covered by the subscription.

8. Instalment sales

When the consideration is receivable in instalments, revenue attributable to the sales price exclusive of interest should be recognised at the date of sale. The interest element should be recognised as revenue, proportionately to the unpaid balance due to the seller.

9. Trade discounts and volume rebates

Trade discounts and volume rebates received are not encompassed within the definition of revenue, since they represent a reduction of cost. Trade discounts and volume rebates given should be deducted in determining revenue.

B. Rendering of Services

1. Installation Fees

In cases where installation fees are other than incidental to the sale of a product, they should be recognised as revenue only when the equipment is installed and accepted by the customer.

2. Advertising and insurance agency commissions

Revenue should be recognised when the service is completed. For advertising agencies, media commissions will normally be recognised when the related advertisement or commercial appears before the public and the necessary intimation is received by the agency, as opposed to production commission, which will be recognised when the project is completed. Insurance agency commissions should be recognised on the effective commencement or renewal dates of the related policies.

3. Financial service commissions

A financial service may be rendered as a single act or may be provided over a period of time. Similarly, charges for such services may be made as a single amount or in stages over the period of the service or the life of the transaction to which it relates. Such charges may be settled in full when made or added to a loan or other account and settled in stages. The recognition of such revenue should therefore have regard to:

(a) whether the service has been provided "once and for all" or is on a "continuing" basis;

(b) the incidence of the costs relating to the service;

(c) when the payment for the service will be received. In general, commissions charged for arranging or granting loan or other facilities should be recognised when a binding obligation has been entered into. Commitment, facility or loan management fees which relate to continuing obligations or services should normally be recognised over the life of the loan or facility having regard to the amount of the obligation outstanding, the nature of the services provided and the timing of the costs relating thereto.

4. Admission fees

Revenue from artistic performances, banquets and other special events should be recognised when the event takes place. When a subscription to a number of events is sold, the fee should be allocated to each event on a systematic and rational basis.

5. Tuition fees

Revenue should be recognised over the period of instruction.

6. Entrance and membership fees

Revenue recognition from these sources will depend on the nature of the services being provided. Entrance fee received is generally capitalised. If the membership fee permits only membership and all other services or products are paid for separately, or if there is a separate annual subscription, the fee should be recognised when received. If the membership fee entitles the member to services or publications to be provided during the year, it should be recognised on a systematic and rational basis having regard to the timing and nature of all services provided.

Accounting Standard (AS) 10
(issued 1985)

Accounting for Fixed Assets

Contents

Accounting Standard (AS) 10

(issued 1985)

Accounting for Fixed Assets

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

Introduction

1. Financial Statements disclose certain information relating to fixed assets. In many enterprises these assets are grouped into various categories, such as land, buildings, plant and machinery, vehicles, furniture and fittings, goodwill, patents, trade marks and designs. This standard deals with accounting for such fixed assets except as described in paragraphs 2 to 5 below.

2. This standard does not deal with the specialised aspects of accounting for fixed assets that arise under a comprehensive system reflecting the effects of changing prices but applies to financial statements prepared on historical cost basis.

3. This standard does not deal with accounting for the following items to which special considerations apply:

(i) forests, plantations and similar regenerative natural resources;

(ii) wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources;

(iii) expenditure on real estate development; and

[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.

(iv) livestock.

Expenditure on individual items of fixed assets used to develop or maintain the activities covered in (i) to (iv) above, but separable from those activities, are to be accounted for in accordance with this Standard.

4. This standard does not cover the allocation of the depreciable amount of fixed assets to future periods since this subject is dealt with in Accounting Standard 6 on 'Depreciation Accounting'.

5. This standard does not deal with the treatment of government grants and subsidies, and assets under leasing rights. It makes only a brief reference to the capitalisation of borrowing costs and to assets acquired in an amalgamation or merger. These subjects require more extensive consideration than can be given within this Standard.

Definitions

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

6.1 Fixed asset is an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business.

6.2 Fair market value is the price that would be agreed to in an open and unrestricted market between knowledgeable and willing parties dealing at arm's length who are fully informed and are not under any compulsion to transact.

6.3 Gross book value of a fixed asset is its historical cost or other amount substituted for historical cost in the books of account or financial statements. When this amount is shown net of accumulated depreciation, it is termed as net book value.

Explanation

7. Fixed assets often comprise a significant portion of the total assets of an enterprise, and therefore are important in the presentation of financial position. Furthermore, the determination of whether an expenditure

represents an asset or an expense can have a material effect on an enterprise's reported results of operations.

8. Identification of Fixed Assets

8.1 The definition in paragraph 6.1 gives criteria for determining whether items are to be classified as fixed assets. Judgement is required in applying the criteria to specific circumstances or specific types of enterprises. It may be appropriate to aggregate individually insignificant items, and to apply the criteria to the aggregate value. An enterprise may decide to expense an item which could otherwise have been included as fixed asset, because the amount of the expenditure is not material.

8.2 Stand-by equipment and servicing equipment are normally capitalised. Machinery spares are usually charged to the profit and loss statement as and when consumed. However, if such spares can be used only in connection with an item of fixed asset and their use is expected to be irregular, it may be appropriate to allocate the total cost on a systematic basis over a period not exceeding the useful life of the principal item.

8.3 In certain circumstances, the accounting for an item of fixed asset may be improved if the total expenditure thereon is allocated to its component parts, provided they are in practice separable, and estimates are made of the useful lives of these components. For example, rather than treat an aircraft and its engines as one unit, it may be better to treat the engines as a separate unit if it is likely that their useful life is shorter than that of the aircraft as a whole.

9. Components of Cost

9.1 The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price. Examples of directly attributable costs are:

(i) site preparation;

(ii) initial delivery and handling costs;

(iii) installation cost, such as special foundations for plant; and

(iv) professional fees, for example fees of architects and engineers.

The cost of a fixed asset may undergo changes subsequent to its acquisition or construction on account of exchange fluctuations, price adjustments, changes in duties or similar factors.

9.2 Administration and other general overhead expenses are usually excluded from the cost of fixed assets because they do not relate to a specific fixed asset. However, in some circumstances, such expenses as are specifically attributable to construction of a project or to the acquisition of a fixed asset or bringing it to its working condition, may be included as part of the cost of the construction project or as a part of the cost of the fixed asset.

9.3 The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalised as an indirect element of the construction cost. However, the expenditure incurred after the plant has begun commercial production, i.e., production intended for sale or captive consumption, is not capitalised and is treated as revenue expenditure even though the contract may stipulate that the plant will not be finally taken over until after the satisfactory completion of the guarantee period.

9.4 If the interval between the date a project is ready to commence commercial production and the date at which commercial production actually begins is prolonged, all expenses incurred during this period are charged to the profit and loss statement. However, the expenditure incurred during this period is also sometimes treated as deferred revenue expenditure to be amortised over a period not exceeding 3 to 5 years after the commencement of commercial production.[2]

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[2] It may be noted that this paragraph relates to "all expenses" incurred during the period. This expenditure would also include borrowing costs incurred during the said period. Since Accounting Standard (AS) 16, Borrowing Costs, specifically deals with the treatment of borrowing costs, the treatment provided by AS 16 would prevail over the provisions in this respect contained in this paragraph as these provisions are general in nature and apply to "all expenses".

10. Self-constructed Fixed Assets

10.1 In arriving at the gross book value of self-constructed fixed assets, the same principles apply as those described in paragraphs 9.1 to 9.4. Included in the gross book value are costs of construction that relate directly to the specific asset and costs that are attributable to the construction activity in general and can be allocated to the specific asset. Any internal profits are eliminated in arriving at such costs.

11. Non-monetary Consideration

11.1 When a fixed asset is acquired in exchange for another asset, its cost is usually determined by reference to the fair market value of the consideration given. It may be appropriate to consider also the fair market value of the asset acquired if this is more clearly evident. An alternative accounting treatment that is sometimes used for an exchange of assets, particularly when the assets exchanged are similar, is to record the asset acquired at the net book value of the asset given up; in each case an adjustment is made for any balancing receipt or payment of cash or other consideration.

11.2 When a fixed asset is acquired in exchange for shares or other securities in the enterprise, it is usually recorded at its fair market value, or the fair market value of the securities issued, whichever is more clearly evident.

12. Improvements and Repairs

12.1 Frequently, it is difficult to determine whether subsequent expenditure related to fixed asset represents improvements that ought to be added to the gross book value or repairs that ought to be charged to the profit and loss statement. Only expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross book value, e.g., an increase in capacity.

12.2 The cost of an addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is usually added to its gross book value. Any addition or extension, which has a separate identity and is capable of being used after the existing asset is disposed of, is accounted for separately.

13. Amount Substituted for Historical Cost

13.1 Sometimes financial statements that are otherwise prepared on a historical cost basis include part or all of fixed assets at a valuation in substitution for historical costs and depreciation is calculated accordingly. Such financial statements are to be distinguished from financial statements prepared on a basis intended to reflect comprehensively the effects of changing prices.

13.2 A commonly accepted and preferred method of restating fixed assets is by appraisal, normally undertaken by competent valuers. Other methods sometimes used are indexation and reference to current prices which when applied are cross checked periodically by appraisal method.

13.3 The revalued amounts of fixed assets are presented in financial statements either by restating both the gross book value and accumulated depreciation so as to give a net book value equal to the net revalued amount or by restating the net book value by adding therein the net increase on account of revaluation. An upward revaluation does not provide a basis for crediting to the profit and loss statement the accumulated depreciation existing at the date of revaluation.

13.4 Different bases of valuation are sometimes used in the same financial statements to determine the book value of the separate items within each of the categories of fixed assets or for the different categories of fixed assets. In such cases, it is necessary to disclose the gross book value included on each basis.

13.5 Selective revaluation of assets can lead to unrepresentative amounts being reported in financial statements. Accordingly, when revaluations do not cover all the assets of a given class, it is appropriate that the selection of assets to be revalued be made on a systematic basis. For example, an enterprise may revalue a whole class of assets within a unit.

13.6 It is not appropriate for the revaluation of a class of assets to result in the net book value of that class being greater than the recoverable amount of the assets of that class.

13.7 An increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests under the heading of revaluation reserves and is regarded as not available for distribution. A decrease in net book value arising on revaluation of fixed assets is charged to profit and loss statement except that, to the extent that such a decrease is considered to be related to a previous increase on revaluation that is included in revaluation reserve, it is sometimes charged against that earlier increase. It sometimes happens that an increase to be recorded is a reversal of a previous decrease arising on revaluation which has been charged to profit and loss statement in which case the increase is credited to profit and loss statement to the extent that it offsets the previously recorded decrease.

14. Retirements and Disposals

14.1 An item of fixed asset is eliminated from the financial statements on disposal.

14.2 Items of fixed assets that have been retired from active use and are held for disposal are stated at the lower of their net book value and net realisable value and are shown separately in the financial statements. Any expected loss is recognised immediately in the profit and loss statement.

14.3 In historical cost financial statements, gains or losses arising on disposal are generally recognised in the profit and loss statement.

14.4 On disposal of a previously revalued item of fixed asset, the difference between net disposal proceeds and the net book value is normally charged or credited to the profit and loss statement except that, to the extent such a loss is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it is charged directly to that account. The amount standing in revaluation reserve following the retirement or disposal of an asset which relates to that asset may be transferred to general reserve.

15. Valuation of Fixed Assets in Special Cases

15.1 In the case of fixed assets acquired on hire purchase terms, although legal ownership does not vest in the enterprise, such assets are recorded at their cash value, which, if not readily available, is calculated by assuming an appropriate rate of interest. They are shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof.[3]

15.2 Where an enterprise owns fixed assets jointly with others (otherwise than as a partner in a firm), the extent of its share in such assets, and the proportion in the original cost, accumulated depreciation and written down value are stated in the balance sheet. Alternatively, the *pro rata* cost of such jointly owned assets is grouped together with similar fully owned assets. Details of such jointly owned assets are indicated separately in the fixed assets register.

15.3 Where several assets are purchased for a consolidated price, the consideration is apportioned to the various assets on a fair basis as determined by competent valuers.

16. Fixed Assets of Special Types

16.1 Goodwill, in general, is recorded in the books only when some consideration in money or money's worth has been paid for it. Whenever a business is acquired for a price (payable either in cash or in shares or otherwise) which is in excess of the value of the net assets of the business taken over, the excess is termed as 'goodwill'. Goodwill arises from business connections, trade name or reputation of an enterprise or from other intangible benefits enjoyed by an enterprise.

16.2 As a matter of financial prudence, goodwill is written off over a period. However, many enterprises do not write off goodwill and retain it as an asset.

17. Disclosure

17.1 Certain specific disclosures on accounting for fixed assets are already required by Accounting Standard 1 on 'Disclosure of Accounting Policies' and Accounting Standard 6 on 'Depreciation Accounting'.

[3] Accounting Standard (AS) 19, Leases, came into effect in respect of assets leased during accounting periods commencing on or after 1-4-2001. AS 19 also applies to assets acquired on hire purchase during accounting periods commencing on or after 1-4-2001. Accordingly, this paragraph is not applicable in respect of assets acquired on hire purchase during accounting periods commencing on or after 1-4-2001.

17.2 Further disclosures that are sometimes made in financial statements include:

(i) gross and net book values of fixed assets at the beginning and end of an accounting period showing additions, disposals, acquisitions and other movements;

(ii) expenditure incurred on account of fixed assets in the course of construction or acquisition; and

(iii) revalued amounts substituted for historical costs of fixed assets, the method adopted to compute the revalued amounts, the nature of any indices used, the year of any appraisal made, and whether an external valuer was involved, in case where fixed assets are stated at revalued amounts.

Main Principles

18. The items determined in accordance with the definition in paragraph 6.1 of this Standard should be included under fixed assets in financial statements.

19. The gross book value of a fixed asset should be either historical cost or a revaluation computed in accordance with this Standard. The method of accounting for fixed assets included at historical cost is set out in paragraphs 20 to 26; the method of accounting of revalued assets is set out in paragraphs 27 to 32.

20. The cost of a fixed asset should comprise its purchase price and any attributable cost of bringing the asset to its working condition for its intended use.

21. The cost of a self-constructed fixed asset should comprise those costs that relate directly to the specific asset and those that are attributable to the construction activity in general and can be allocated to the specific asset.

22. When a fixed asset is acquired in exchange or in part exchange for another asset, the cost of the asset acquired should be recorded either at fair market value or at the net book value of the asset given up, adjusted for any balancing payment or receipt of cash or other consideration. For

these purposes fair market value may be determined by reference either to the asset given up or to the asset acquired, whichever is more clearly evident. Fixed asset acquired in exchange for shares or other securities in the enterprise should be recorded at its fair market value, or the fair market value of the securities issued, whichever is more clearly evident.

23. Subsequent expenditures related to an item of fixed asset should be added to its book value only if they increase the future benefits from the existing asset beyond its previously assessed standard of performance.

24. Material items retired from active use and held for disposal should be stated at the lower of their net book value and net realisable value and shown separately in the financial statements.

25. Fixed asset should be eliminated from the financial statements on disposal or when no further benefit is expected from its use and disposal.

26. Losses arising from the retirement or gains or losses arising from disposal of fixed asset which is carried at cost should be recognised in the profit and loss statement.

27. When a fixed asset is revalued in financial statements, an entire class of assets should be revalued, or the selection of assets for revaluation should be made on a systematic basis. This basis should be disclosed.

28. The revaluation in financial statements of a class of assets should not result in the net book value of that class being greater than the recoverable amount of assets of that class.

29. When a fixed asset is revalued upwards, any accumulated depreciation existing at the date of the revaluation should not be credited to the profit and loss statement.

30. An increase in net book value arising on revaluation of fixed assets should be credited directly to owners' interests under the head of revaluation reserve, except that, to the extent that such increase is related to and not greater than a decrease arising on revaluation previously recorded as a charge to the profit and loss statement, it may be credited to the profit and loss statement. A decrease in net book value arising on revaluation of fixed asset should be charged directly to the profit and loss statement except that to the extent that such a decrease is related to

an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it may be charged directly to that account.

31. The provisions of paragraphs 23, 24 and 25 are also applicable to fixed assets included in financial statements at a revaluation.

32. On disposal of a previously revalued item of fixed asset, the difference between net disposal proceeds and the net book value should be charged or credited to the profit and loss statement except that to the extent that such a loss is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it may be charged directly to that account.

33. Fixed assets acquired on hire purchase terms should be recorded at their cash value, which, if not readily available, should be calculated by assuming an appropriate rate of interest. They should be shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof.[4]

34. In the case of fixed assets owned by the enterprise jointly with others, the extent of the enterprise's share in such assets, and the proportion of the original cost, accumulated depreciation and written down value should be stated in the balance sheet. Alternatively, the pro rata cost of such jointly owned assets may be grouped together with similar fully owned assets with an appropriate disclosure thereof.

35. Where several fixed assets are purchased for a consolidated price, the consideration should be apportioned to the various assets on a fair basis as determined by competent valuers.

36. Goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. Whenever a business is acquired for a price (payable in cash or in shares or otherwise) which is in excess of the value of the net assets of the business taken over, the excess should be termed as 'goodwill'.

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[4] see footnote 3.

Disclosure

37. The following information should be disclosed in the financial statements:

(i) gross and net book values of fixed assets at the beginning and end of an accounting period showing additions, disposals, acquisitions and other movements;

(ii) expenditure incurred on account of fixed assets in the course of construction or acquisition; and

(iii) revalued amounts substituted for historical costs of fixed assets, the method adopted to compute the revalued amounts, the nature of indices used, the year of any appraisal made, and whether an external valuer was involved, in case where fixed assets are stated at revalued amounts.

Accounting Standard (AS) 11
(revised 2003)

The Effects of Changes in Foreign Exchange Rates

Contents

Continued

Accounting Standard (AS) 11*

(revised 2003)

The Effects of Changes in Foreign Exchange Rates

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

Objective

An enterprise may carry on activities involving foreign exchange in two ways. It may have transactions in foreign currencies or it may have foreign operations. In order to include foreign currency transactions and foreign operations in the financial statements of an enterprise, transactions must be expressed in the enterprise's reporting currency and the financial statements of foreign operations must be translated into the enterprise's reporting currency.

The principal issues in accounting for foreign currency transactions and foreign operations are to decide which exchange rate to use and how to recognise in the financial statements the financial effect of changes in exchange rates.

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* Originally issued in 1989 and revised in 1994. The standard was revised again in 2003 and came into effect in respect of accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date. The revised Standard supersedes Accounting Standard (AS) 11, Accounting for the Effects of Changes in Foreign Exchange Rates (1994), except that in respect of accounting for transactions in foreign currencies entered into by the reporting enterprise itself or through its branches before the date this Standard comes into effect, AS 11 (1994) will continue to be applicable.

[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.

Scope

1. This Standard should be applied:

   (a) in accounting for transactions in foreign currencies; and

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

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

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

4. This Standard 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 Standard 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 Standard 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).

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[2] This Standard is applicable to exchange differences on all forward exchange contracts including those entered into to hedge the foreign currency risk of existing assets and liabilities and is not applicable to exchange difference arising on forward exchange contracts entered into to hedge the foreign currency risk of future transactions in respect of which a firm commitments are made or which are highly probable forecast transactions. 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 and a 'forecast transaction' is an uncommitted but anticipated future transaction.

Definitions

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

7.1 Average rate is the mean of the exchange rates in force during a period.

7.2 Closing rate is the exchange rate at the balance sheet date.

7.3 Exchange difference is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates.

7.4 Exchange rate is the ratio for exchange of two currencies.

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.

7.6 Foreign currency is a currency other than the reporting currency of an enterprise.

7.7 Foreign operation is a subsidiary[3], associate[4], joint venture[5] or branch of the reporting enterprise, the activities of which are based or conducted in a country other than the country of the reporting enterprise.

7.8 Forward exchange contract means an agreement to exchange different currencies at a forward rate.

7.9 Forward rate is the specified exchange rate for exchange of two currencies at a specified future date.

7.10 Integral foreign operation is a foreign operation, the activities of which are an integral part of those of the reporting enterprise.

7.11 Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.

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[3] As defined in AS 21, Consolidated Financial Statements.

[4] As defined in AS 23, Accounting for Investments in Associates in Consolidated Financial Statements.

[5] As defined in AS 27, Financial Reporting of Interests in Joint Ventures.

7.12 <u>Net investment in a non-integral foreign operation</u> is the reporting enterprise's share in the net assets of that operation.

7.13 <u>Non-integral foreign operation</u> is a foreign operation that is not an integral foreign operation.

7.14 <u>Non-monetary items</u> are assets and liabilities other than monetary items.

7.15 <u>Reporting currency</u> is the currency used in presenting the financial statements.

Foreign Currency Transactions

Initial Recognition

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;

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

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

9. A foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction.

10. For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.

Reporting at Subsequent Balance Sheet Dates

11. At each balance sheet date:

(a) foreign currency monetary items should be reported using the closing rate. However, in certain circumstances, the closing rate may not reflect with reasonable accuracy the amount in reporting currency that is likely to be realised from, or required to disburse, a foreign currency monetary item at the balance sheet date, e.g., where there are restrictions on remittances or where the closing rate is unrealistic and it is not possible to effect an exchange of currencies at that rate at the balance sheet date. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realised from, or required to disburse, such item at the balance sheet date;

(b) non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction; and

(c) non-monetary items which are carried at fair value or other similar valuation denominated in a foreign currency should be reported using the exchange rates that existed when the values were determined.

12. Cash, receivables, and payables are examples of monetary items. Fixed assets, inventories, and investments in equity shares are examples of non-monetary items. The carrying amount of an item is determined in accordance with the relevant Accounting Standards. For example, certain assets may be measured at fair value or other similar valuation (e.g., net realisable value) or at historical cost. Whether the carrying amount is determined based on fair value or other similar valuation or at historical cost, the amounts so determined for foreign currency items are then reported in the reporting currency in accordance with this Standard. The contingent liability denominated in foreign currency at the balance sheet date is disclosed by using the closing rate.

PREVIOUS HOME NEXT

Recognition of Exchange Differences

13. Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise, with the exception of exchange differences dealt with in accordance with paragraph 15.

14. An exchange difference results when there is a change in the exchange rate between the transaction date and the date of settlement of any monetary items arising from a foreign currency transaction. When the transaction is settled within the same accounting period as that in which it occurred, all the exchange difference is recognised in that period. However, when the transaction is settled in a subsequent accounting period, the exchange difference recognised in each intervening period up to the period of settlement is determined by the change in exchange rates during that period.

Net Investment in a Non-integral Foreign Operation

15. Exchange differences arising on a monetary item that, in substance, forms part of an enterprise's net investment in a non-integral foreign operation should be accumulated in a foreign currency translation reserve in the enterprise's financial statements until the disposal of the net investment, at which time they should be recognised as income or as expenses in accordance with paragraph 31.

16. An enterprise may have a monetary item that is receivable from, or payable to, a non-integral foreign operation. An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension to, or deduction from, the enterprise's net investment in that non-integral foreign operation. Such monetary items may include long-term receivables or loans but do not include trade receivables or trade payables.

Financial Statements of Foreign Operations

Classification of Foreign Operations

17. The method used to translate the financial statements of a foreign operation depends on the way in which it is financed and operates in

PREVIOUS HOME NEXT

relation to the reporting enterprise. For this purpose, foreign operations are classified as either "integral foreign operations" or "non-integral foreign operations".

18. A foreign operation that is integral to the operations of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations. For example, such a foreign operation might only sell goods imported from the reporting enterprise and remit the proceeds to the reporting enterprise. In such cases, a change in the exchange rate between the reporting currency and the currency in the country of foreign operation has an almost immediate effect on the reporting enterprise's cash flow from operations. Therefore, the change in the exchange rate affects the individual monetary items held by the foreign operation rather than the reporting enterprise's net investment in that operation.

19. In contrast, a non-integral foreign operation accumulates cash and other monetary items, incurs expenses, generates income and perhaps arranges borrowings, all substantially in its local currency. It may also enter into transactions in foreign currencies, including transactions in the reporting currency. When there is a change in the exchange rate between the reporting currency and the local currency, there is little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. The change in the exchange rate affects the reporting enterprise's net investment in the non-integral foreign operation rather than the individual monetary and non-monetary items held by the non-integral foreign operation.

20. The following are indications that a foreign operation is a non-integral foreign operation rather than an integral foreign operation:

(a) while the reporting enterprise may control the foreign operation, the activities of the foreign operation are carried out with a significant degree of autonomy from those of the reporting enterprise;

(b) transactions with the reporting enterprise are not a high proportion of the foreign operation's activities;

(c) the activities of the foreign operation are financed mainly from its own operations or local borrowings rather than from the reporting enterprise;

(d) costs of labour, material and other components of the foreign operation's products or services are primarily paid or settled in the local currency rather than in the reporting currency;

(e) the foreign operation's sales are mainly in currencies other than the reporting currency;

(f) cash flows of the reporting enterprise are insulated from the day-to-day activities of the foreign operation rather than being directly affected by the activities of the foreign operation;

(g) sales prices for the foreign operation's products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation; and

(h) there is an active local sales market for the foreign operation's products, although there also might be significant amounts of exports.

The appropriate classification for each operation can, in principle, be established from factual information related to the indicators listed above. In some cases, the classification of a foreign operation as either a non-integral foreign operation or an integral foreign operation of the reporting enterprise may not be clear, and judgement is necessary to determine the appropriate classification.

Integral Foreign Operations

21. The financial statements of an integral foreign operation should be translated using the principles and procedures in paragraphs 8 to 16 as if the transactions of the foreign operation had been those of the reporting enterprise itself.

22. The individual items in the financial statements of the foreign operation are translated as if all its transactions had been entered into by the reporting enterprise itself. The cost and depreciation of tangible fixed assets is translated using the exchange rate at the date of purchase of the asset or, if the asset is carried at fair value or other similar valuation, using the rate that existed on the date of the valuation. The cost of inventories is translated at the exchange rates that existed when those

costs were incurred. The recoverable amount or realisable value of an asset is translated using the exchange rate that existed when the recoverable amount or net realisable value was determined. For example, when the net realisable value of an item of inventory is determined in a foreign currency, that value is translated using the exchange rate at the date as at which the net realisable value is determined. The rate used is therefore usually the closing rate. An adjustment may be required to reduce the carrying amount of an asset in the financial statements of the reporting enterprise to its recoverable amount or net realisable value even when no such adjustment is necessary in the financial statements of the foreign operation. Alternatively, an adjustment in the financial statements of the foreign operation may need to be reversed in the financial statements of the reporting enterprise.

23. For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.

Non-integral Foreign Operations

24. In translating the financial statements of a non-integral foreign operation for incorporation in its financial statements, the reporting enterprise should use the following procedures:

- ***(a) the assets and liabilities, both monetary and non-monetary, of the non-integral foreign operation should be translated at the closing rate;***

- ***(b) income and expense items of the non-integral foreign operation should be translated at exchange rates at the dates of the transactions; and***

- ***(c) all resulting exchange differences should be accumulated in a foreign currency translation reserve until the disposal of the net investment.***

25. For practical reasons, a rate that approximates the actual exchange rates, for example an average rate for the period, is often used to translate income and expense items of a foreign operation.

26. The translation of the financial statements of a non-integral foreign operation results in the recognition of exchange differences arising from:

(a) translating income and expense items at the exchange rates at the dates of transactions and assets and liabilities at the closing rate;

(b) translating the opening net investment in the non-integral foreign operation at an exchange rate different from that at which it was previously reported; and

(c) other changes to equity in the non-integral foreign operation.

These exchange differences are not recognised as income or expenses for the period because the changes in the exchange rates have little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. When a non-integral foreign operation is consolidated but is not wholly owned, accumulated exchange differences arising from translation and attributable to minority interests are allocated to, and reported as part of, the minority interest in the consolidated balance sheet.

27. Any goodwill or capital reserve arising on the acquisition of a non-integral foreign operation is translated at the closing rate in accordance with paragraph 24.

28. A contingent liability disclosed in the financial statements of a non-integral foreign operation is translated at the closing rate for its disclosure in the financial statements of the reporting enterprise.

29. The incorporation of the financial statements of a non-integral foreign operation in those of the reporting enterprise follows normal consolidation procedures, such as the elimination of intra-group balances and intra-group transactions of a subsidiary (see AS 21, Consolidated Financial Statements, and AS 27, Financial Reporting of Interests in Joint Ventures). However, an exchange difference arising on an intra-group monetary item, whether short-term or long-term, cannot be eliminated against a corresponding amount arising on other intra-group balances because the monetary item represents a commitment to convert one currency into another and exposes the reporting enterprise to a gain or loss through currency fluctuations. Accordingly, in the consolidated financial statements

of the reporting enterprise, such an exchange difference continues to be recognised as income or an expense or, if it arises from the circumstances described in paragraph 15, it is accumulated in a foreign currency translation reserve until the disposal of the net investment.

30. When the financial statements of a non-integral foreign operation are drawn up to a different reporting date from that of the reporting enterprise, the non-integral foreign operation often prepares, for purposes of incorporation in the financial statements of the reporting enterprise, statements as at the same date as the reporting enterprise. When it is impracticable to do this, AS 21, Consolidated Financial Statements, allows the use of financial statements drawn up to a different reporting date provided that the difference is no greater than six months and adjustments are made for the effects of any significant transactions or other events that occur between the different reporting dates. In such a case, the assets and liabilities of the non-integral foreign operation are translated at the exchange rate at the balance sheet date of the non-integral foreign operation and adjustments are made when appropriate for significant movements in exchange rates up to the balance sheet date of the reporting enterprises in accordance with AS 21. The same approach is used in applying the equity method to associates and in applying proportionate consolidation to joint ventures in accordance with AS 23, Accounting for Investments in Associates in Consolidated Financial Statements and AS 27, Financial Reporting of Interests in Joint Ventures.

Disposal of a Non-integral Foreign Operation

31. On the disposal of a non-integral foreign operation, the cumulative amount of the exchange differences which have been deferred and which relate to that operation should be recognised as income or as expenses in the same period in which the gain or loss on disposal is recognised.

32. An enterprise may dispose of its interest in a non-integral foreign operation through sale, liquidation, repayment of share capital, or abandonment of all, or part of, that operation. The payment of a dividend forms part of a disposal only when it constitutes a return of the investment. In the case of a partial disposal, only the proportionate share of the related accumulated exchange differences is included in the gain or loss. A write-down of the carrying amount of a non-integral foreign operation does not constitute a partial disposal. Accordingly, no part of the deferred foreign exchange gain or loss is recognised at the time of a write-down.

Change in the Classification of a Foreign Operation

33. When there is a change in the classification of a foreign operation, the translation procedures applicable to the revised classification should be applied from the date of the change in the classification.

34. The consistency principle requires that foreign operation once classified as integral or non-integral is continued to be so classified. However, a change in the way in which a foreign operation is financed and operates in relation to the reporting enterprise may lead to a change in the classification of that foreign operation. When a foreign operation that is integral to the operations of the reporting enterprise is reclassified as a non-integral foreign operation, exchange differences arising on the translation of non-monetary assets at the date of the reclassification are accumulated in a foreign currency translation reserve. When a non-integral foreign operation is reclassified as an integral foreign operation, the translated amounts for non-monetary items at the date of the change are treated as the historical cost for those items in the period of change and subsequent periods. Exchange differences which have been deferred are not recognised as income or expenses until the disposal of the operation.

All Changes in Foreign Exchange Rates

Tax Effects of Exchange Differences

35. Gains and losses on foreign currency transactions and exchange differences arising on the translation of the financial statements of foreign operations may have associated tax effects which are accounted for in accordance with AS 22, Accounting for Taxes on Income.

Forward Exchange Contracts[6]

36. An enterprise may enter into a forward exchange contract or another financial instrument that is in substance a forward exchange contract, which is not intended for trading or speculation purposes, to establish the amount of the reporting currency required or available at the settlement date of a transaction. The premium or discount arising at

[6] See footnote 2.

the inception of such a forward exchange contract should be amortised as expense or income over the life of the contract. Exchange differences on such a contract should be recognised in the statement of profit and loss in the reporting period in which the exchange rates change. Any profit or loss arising on cancellation or renewal of such a forward exchange contract should be recognised as income or as expense for the period.

37. The risks associated with changes in exchange rates may be mitigated by entering into forward exchange contracts. Any premium or discount arising at the inception of a forward exchange contract is accounted for separately from the exchange differences on the forward exchange contract. The premium or discount that arises on entering into the contract is measured by the difference between the exchange rate at the date of the inception of the forward exchange contract and the forward rate specified in the contract. Exchange difference on a forward exchange contract is the difference between (a) the foreign currency amount of the contract translated at the exchange rate at the reporting date, or the settlement date where the transaction is settled during the reporting period, and (b) the same foreign currency amount translated at the latter of the date of inception of the forward exchange contract and the last reporting date.

38. A gain or loss on a forward exchange contract to which paragraph 36 does not apply should be computed by multiplying the foreign currency amount of the forward exchange contract by the difference between the forward rate available at the reporting date for the remaining maturity of the contract and the contracted forward rate (or the forward rate last used to measure a gain or loss on that contract for an earlier period). The gain or loss so computed should be recognised in the statement of profit and loss for the period. The premium or discount on the forward exchange contract is not recognised separately.

39. In recording a forward exchange contract intended for trading or speculation purposes, the premium or discount on the contract is ignored and at each balance sheet date, the value of the contract is marked to its current market value and the gain or loss on the contract is recognised.

Disclosure

40. An enterprise should disclose:

(a) the amount of exchange differences included in the net profit or loss for the period; 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.

41. When the reporting currency is different from the currency of the country in which the enterprise is domiciled, the reason for using a different currency should be disclosed. The reason for any change in the reporting currency should also be disclosed.

42. When there is a change in the classification of a significant foreign operation, an enterprise should disclose:

(a) the nature of the change in classification;

(b) the reason for the change;

(c) the impact of the change in classification on shareholders' funds; and

(d) the impact on net profit or loss for each prior period presented had the change in classification occurred at the beginning of the earliest period presented.

43. The effect on foreign currency monetary items or on the financial statements of a foreign operation of a change in exchange rates occurring after the balance sheet date is disclosed in accordance with AS 4, Contingencies and Events Occurring After the Balance Sheet Date.

44. Disclosure is also encouraged of an enterprise's foreign currency risk management policy.

Transitional Provisions

45. On the first time application of this Standard, if a foreign branch is classified as a non-integral foreign operation in accordance with the requirements of this Standard, the accounting treatment prescribed in

paragraphs 33 and 34 of the Standard in respect of change in the classification of a foreign operation should be applied.

Paragraphs 46 and 46A for Companies

46.[7] In respect of accounting periods commencing on or after 7th December, 2006 and ending on or before 31st March, 2011,[8] at the option of the enterprise (such option to be irrevocable and to be excercised retrospectively for such accounting period, from the date this transitional provision comes into force or the first date on which the concerned foreign currency monetary item is acquired, whichever is later, and applied to all such foreign currency monetary items), exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account"[9] in the enterprise's financial statements and amortized over the balance period of such long-term asset/liability but not beyond 31st March, 2011, by recognition as income or expense in each of such periods, with the exception of exchange differences dealt with in accordance with paragraph 15. For the purposes of exercise of this option, an asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of 12 months or more at the date of origination of the asset or liability. Any difference pertaining to accounting periods which commenced on or after 7th December, 2006, previously recognized in the profit and loss account before the exercise of the option shall be reversed in so far as it relates to the acquisition of a depreciable capital asset by addition or deduction from the cost of the asset and in other cases by transfer to "Foreign Currency Monetary Item Translation Difference Account" in both cases, by debit or credit, as the case may be, to the general reserve. If the option stated in this paragraph

[7] Ministry of Corporate Affairs, Government of India, inserted this paragraph by Notification dated 31st March, 2009, which is relevant for companies.

[8] "31st March, 2011" was substituted by "31st March, 2012" by Notification dated 11th May, 2011, published by Ministry of Corporate Affairs, Government of India. Thereafter, "31st March, 2012" was substituted by "31st March, 2020" by Notification dated 29th December, 2011, published by Ministry of Corporate Affairs, Government of India.

[9] The Council has issued an Announcement clarifying presentation of Foreign Currency Monetary Item Translation Difference Account (See Announcement XLIII).

is exercised, disclosure shall be made of the fact of such exercise of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized."

46A.[10] (1) In respect of accounting periods commencing on or after the 1st April, 2011, for an enterprise which had earlier exercised the option under paragraph 46 and at the option of any other enterprise (such option to be irrevocable and to be applied to all such foreign currency monetary items), the exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long term asset or liability, by recognition as income or expense in each of such periods, with the exception of exchange differences dealt with in accordance with the provisions of paragraph 15 of the said rules.

(2) To exercise the option referred to in sub-paragraph (1), an asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of twelve months or more at the date of origination of the asset or the liability:

Provided that the option exercised by the enterprise shall disclose the fact of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized."

[10] Ministry of Corporate Affairs, Government of India, inserted this paragraph by Notification dated 29th December, 2011, which is relevant for companies.

Paragraph 46 for entities other than Companies

46[11] (1) In respect of accounting periods commencing on or after the 7th December 2006, (such option to be irrevocable and to be applied to all such foreign currency monetary items), the exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and should be depreciated over the balance life of the asset, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortised over the balance period of such long term asset or liability, by recognition as income or expense in each of such periods, with the exception of exchange differences dealt with in accordance with the provisions of paragraph 15.

(2) To exercise the option referred to in sub-paragraph (1), an asset or liability should be designated as a long term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of twelve months or more at the date of origination of the asset or the liability:

Provided that the option exercised by the enterprise should disclose the fact of such option and of the amount remaining to be amortised in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortised.

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[11] Paragraph 46 has been inserted for entities other than Companies in accordance with an Announcement issued by the Council of the ICAI (See Announcement XLIV).

Accounting Standard (AS) 12
(issued 1991)

Accounting for Government Grants

Contents

Accounting Standard (AS) 12

(issued 1991)

Accounting for Government Grants

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

Introduction

1. This Standard deals with accounting for government grants. Government grants are sometimes called by other names such as subsidies, cash incentives, duty drawbacks, etc.

2. This Standard does not deal with:

(i) the special problems arising in accounting for government grants in financial statements reflecting the effects of changing prices or in supplementary information of a similar nature;

(ii) government assistance other than in the form of government grants;

(iii) government participation in the ownership of the enterprise.

Definitions

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

3.1 <u>Government</u> refers to government, government agencies and similar bodies whether local, national or international.

[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.

3.2. Government grants are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.

Explanation

4. The receipt of government grants by an enterprise is significant for preparation of the financial statements for two reasons. Firstly, if a government grant has been received, an appropriate method of accounting therefor is necessary. Secondly, it is desirable to give an indication of the extent to which the enterprise has benefited from such grant during the reporting period. This facilitates comparison of an enterprise's financial statements with those of prior periods and with those of other enterprises.

Accounting Treatment of Government Grants

5. Capital Approach versus Income Approach

5.1 Two broad approaches may be followed for the accounting treatment of government grants: the 'capital approach', under which a grant is treated as part of shareholders' funds, and the 'income approach', under which a grant is taken to income over one or more periods.

5.2 Those in support of the 'capital approach' argue as follows:

(i) Many government grants are in the nature of promoters' contribution, i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay and no repayment is ordinarily expected in the case of such grants. These should, therefore, be credited directly to shareholders' funds.

(ii) It is inappropriate to recognise government grants in the profit and loss statement, since they are not earned but represent an incentive provided by government without related costs.

5.3 Arguments in support of the 'income approach' are as follows:

(i) Government grants are rarely gratuitous. The enterprise earns them through compliance with their conditions and meeting the envisaged obligations. They should therefore be taken to income and matched with the associated costs which the grant is intended to compensate.

(ii) As income tax and other taxes are charged against income, it is logical to deal also with government grants, which are an extension of fiscal policies, in the profit and loss statement.

(iii) In case grants are credited to shareholders' funds, no correlation is done between the accounting treatment of the grant and the accounting treatment of the expenditure to which the grant relates.

5.4 It is generally considered appropriate that accounting for government grant should be based on the nature of the relevant grant. Grants which have the characteristics similar to those of promoters' contribution should be treated as part of shareholders' funds. Income approach may be more appropriate in the case of other grants.

5.5 It is fundamental to the 'income approach' that government grants be recognised in the profit and loss statement on a systematic and rational basis over the periods necessary to match them with the related costs. Income recognition of government grants on a receipts basis is not in accordance with the accrual accounting assumption (see Accounting Standard (AS) 1, Disclosure of Accounting Policies).

5.6 In most cases, the periods over which an enterprise recognises the costs or expenses related to a government grant are readily ascertainable and thus grants in recognition of specific expenses are taken to income in the same period as the relevant expenses.

6. Recognition of Government Grants

6.1 Government grants available to the enterprise are considered for inclusion in accounts:

(i) where there is reasonable assurance that the enterprise will comply with the conditions attached to them; and

(ii) where such benefits have been earned by the enterprise and it is reasonably certain that the ultimate collection will be made.

Mere receipt of a grant is not necessarily a conclusive evidence that conditions attaching to the grant have been or will be fulfilled.

6.2 An appropriate amount in respect of such earned benefits, estimated on a prudent basis, is credited to income for the year even though the actual amount of such benefits may be finally settled and received after the end of the relevant accounting period.

6.3 A contingency related to a government grant, arising after the grant has been recognised, is treated in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date.[2]

6.4 In certain circumstances, a government grant is awarded for the purpose of giving immediate financial support to an enterprise rather than as an incentive to undertake specific expenditure. Such grants may be confined to an individual enterprise and may not be available to a whole class of enterprises. These circumstances may warrant taking the grant to income in the period in which the enterprise qualifies to receive it, as an extraordinary item if appropriate (see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies).

6.5 Government grants may become receivable by an enterprise as compensation for expenses or losses incurred in a previous accounting period. Such a grant is recognised in the income statement of the period in which it becomes receivable, as an extraordinary item if appropriate (see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies).

7. Non-monetary Government Grants

7.1 Government grants may take the form of non-monetary assets, such as land or other resources, given at concessional rates. In these circumstances, it is usual to account for such assets at their acquisition cost. Non-monetary assets given free of cost are recorded at a nominal value.

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[2] Pursuant to AS 29, Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory, 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 Accounting Standards.

8. Presentation of Grants Related to Specific Fixed Assets

8.1 Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets. Other conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

8.2 Two methods of presentation in financial statements of grants (or the appropriate portions of grants) related to specific fixed assets are regarded as acceptable alternatives.

8.3 Under one method, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Where the grant equals the whole, or virtually the whole, of the cost of the asset, the asset is shown in the balance sheet at a nominal value.

8.4 Under the other method, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset. Such allocation to income is usually made over the periods and in the proportions in which depreciation on related assets is charged. Grants related to non-depreciable assets are credited to capital reserve under this method, as there is usually no charge to income in respect of such assets. However, if a grant related to a non-depreciable asset requires the fulfillment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income is suitably disclosed in the balance sheet pending its apportionment to profit and loss account. For example, in the case of a company, it is shown after 'Reserves and Surplus' but before 'Secured Loans' with a suitable description, e.g., 'Deferred government grants'.

8.5 The purchase of assets and the receipt of related grants can cause major movements in the cash flow of an enterprise. For this reason and in order to show the gross investment in assets, such movements are often disclosed as separate items in the statement of changes in financial position regardless of whether or not the grant is deducted from the related asset for the purpose of balance sheet presentation.

9. Presentation of Grants Related to Revenue

9.1 Grants related to revenue are sometimes presented as a credit in the profit and loss statement, either separately or under a general heading such as 'Other Income'. Alternatively, they are deducted in reporting the related expense.

9.2 Supporters of the first method claim that it is inappropriate to net income and expense items and that separation of the grant from the expense facilitates comparison with other expenses not affected by a grant. For the second method, it is argued that the expense might well not have been incurred by the enterprise if the grant had not been available and presentation of the expense without offsetting the grant may therefore be misleading.

10. Presentation of Grants of the nature of Promoters' contribution

10.1 Where the government grants are of the nature of promoters' contribution, i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, central investment subsidy scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

11. Refund of Government Grants

11.1 Government grants sometimes become refundable because certain conditions are not fulfilled. A government grant that becomes refundable is treated as an extraordinary item (see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies).

11.2 The amount refundable in respect of a government grant related to revenue is applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement.

11.3 The amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. In the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value is provided prospectively over the residual useful life of the asset.

11.4 Where a grant which is in the nature of promoters' contribution becomes refundable, in part or in full, to the government on non-fulfillment of some specified conditions, the relevant amount recoverable by the government is reduced from the capital reserve.

12. Disclosure

12.1 The following disclosures are appropriate:

(i) the accounting policy adopted for government grants, including the methods of presentation in the financial statements;

(ii) the nature and extent of government grants recognised in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.

Main Principles

13. Government grants should not be recognised until there is reasonable assurance that (i) the enterprise will comply with the conditions attached to them, and (ii) the grants will be received.

14. Government grants related to specific fixed assets should be presented in the balance sheet by showing the grant as a deduction from the gross value of the assets concerned in arriving at their book value. Where the grant related to a specific fixed asset equals the whole, or virtually the whole, of the cost of the asset, the asset should be shown in the balance sheet at a nominal value. Alternatively, government grants related to depreciable fixed assets may be treated as deferred income which should be recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset, i.e., such grants should be allocated to income over the periods and in the proportions in which depreciation on those assets is charged. Grants related to non-depreciable assets should be credited to capital reserve under this method. However, if a grant related to a non-depreciable asset requires the fulfillment of certain obligations, the grant should be credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income balance should be separately disclosed in the financial statements.

15. Government grants related to revenue should be recognised on a systematic basis in the profit and loss statement over the periods necessary to match them with the related costs which they are intended to compensate. Such grants should either be shown separately under 'other income' or deducted in reporting the related expense.

16. Government grants of the nature of promoters' contribution should be credited to capital reserve and treated as a part of shareholders' funds.

17. Government grants in the form of non-monetary assets, given at a concessional rate, should be accounted for on the basis of their acquisition cost. In case a non-monetary asset is given free of cost, it should be recorded at a nominal value.

18. Government grants that are receivable as compensation for expenses or losses incurred in a previous accounting period or for the purpose of giving immediate financial support to the enterprise with no further related costs, should be recognised and disclosed in the profit and loss statement of the period in which they are receivable, as an extraordinary item if appropriate (see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies).

19. A contingency related to a government grant, arising after the grant has been recognised, should be treated in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date.[3]

20. Government grants that become refundable should be accounted for as an extraordinary item (see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies).

21. The amount refundable in respect of a grant related to revenue should be applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount should be charged to profit and loss statement. The amount refundable in respect of a grant related to a specific fixed asset should be recorded by increasing the book value of the asset or by reducing the capital reserve

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[3] See footnote 2.

or the deferred income balance, as appropriate, by the amount refundable. In the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.

22. Government grants in the nature of promoters' contribution that become refundable should be reduced from the capital reserve.

Disclosure

23. The following should be disclosed:

(i) the accounting policy adopted for government grants, including the methods of presentation in the financial statements;

(ii) the nature and extent of government grants recognised in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.

Accounting Standard (AS) 13
(issued 1993)

Accounting for Investments

Contents

Continued../..

Accounting Standard (AS) 13*

(issued 1993)

Accounting for Investments

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

Introduction

1. This Standard deals with accounting for investments in the financial statements of enterprises and related disclosure requirements.[2]

2. This Standard does not deal with:

   (a) the bases for recognition of interest, dividends and rentals earned on investments which are covered by Accounting Standard 9 on Revenue Recognition;

   (b) operating or finance leases;

   (c) investments of retirement benefit plans and life insurance enterprises; and

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* A limited revision to this Standard was made in 2003, pursuant to which paragraph 2 (d) of this Standard has been revised to include 'and venture capital funds'.

[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] Shares, debentures and other securities held as stock-in-trade (i.e., for sale in the ordinary course of business) are not 'investments' as defined in this Standard. However, the manner in which they are accounted for and disclosed in the financial statements is quite similar to that applicable in respect of current investments. Accordingly, the provisions of this Standard, to the extent that they relate to current investments, are also applicable to shares, debentures and other securities held as stock-in-trade, with suitable modifications as specified in this Standard.

(d) mutual funds and venture capital funds and/or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act, 1956.

Definitions

3. The following terms are used in this Standard with the meanings assigned:

3.1 Investments are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. Assets held as stock-in-trade are not 'investments'.

3.2 A current investment is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made.

3.3 A long term investment is an investment other than a current investment.

3.4 An investment property is an investment in land or buildings that are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise.

3.5 Fair value is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction. Under appropriate circumstances, market value or net realisable value provides an evidence of fair value.

3.6 Market value is the amount obtainable from the sale of an investment in an open market, net of expenses necessarily to be incurred on or before disposal.

Explanation

Forms of Investments

4. Enterprises hold investments for diverse reasons. For some enterprises, investment activity is a significant element of operations, and assessment of the performance of the enterprise may largely, or solely, depend on the reported results of this activity.

5. Some investments have no physical existence and are represented merely by certificates or similar documents (e.g., shares) while others exist in a physical form (e.g., buildings). The nature of an investment may be that of a debt, other than a short or long term loan or a trade debt, representing a monetary amount owing to the holder and usually bearing interest; alternatively, it may be a stake in the results and net assets of an enterprise such as an equity share. Most investments represent financial rights, but some are tangible, such as certain investments in land or buildings.

6. For some investments, an active market exists from which a market value can be established. For such investments, market value generally provides the best evidence of fair value. For other investments, an active market does not exist and other means are used to determine fair value.

Classification of Investments

7. Enterprises present financial statements that classify fixed assets, investments and current assets into separate categories. Investments are classified as long term investments and current investments. Current investments are in the nature of current assets, although the common practice may be to include them in investments.[3]

8. Investments other than current investments are classified as long term investments, even though they may be readily marketable.

Cost of Investments

9. The cost of an investment includes acquisition charges such as brokerage, fees and duties.

[3] Shares, debentures and other securities held for sale in the ordinary course of business are disclosed as 'stock-in-trade' under the head 'current assets'.

10. If an investment is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost is the fair value of the securities issued (which, in appropriate cases, may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued.

11. If an investment is acquired in exchange, or part exchange, for another asset, the acquisition cost of the investment is determined by reference to the fair value of the asset given up. It may be appropriate to consider the fair value of the investment acquired if it is more clearly evident.

12. Interest, dividends and rentals receivables in connection with an investment are generally regarded as income, being the return on the investment. However, in some circumstances, such inflows represent a recovery of cost and do not form part of income. For example, when unpaid interest has accrued before the acquisition of an interest-bearing investment and is therefore included in the price paid for the investment, the subsequent receipt of interest is allocated between pre-acquisition and post-acquisition periods; the pre-acquisition portion is deducted from cost. When dividends on equity are declared from pre-acquisition profits, a similar treatment may apply. If it is difficult to make such an allocation except on an arbitrary basis, the cost of investment is normally reduced by dividends receivable only if they clearly represent a recovery of a part of the cost.

13. When right shares offered are subscribed for, the cost of the right shares is added to the carrying amount of the original holding. If rights are not subscribed for but are sold in the market, the sale proceeds are taken to the profit and loss statement. However, where the investments are acquired on cum-right basis and the market value of investments immediately after their becoming ex-right is lower than the cost for which they were acquired, it may be appropriate to apply the sale proceeds of rights to reduce the carrying amount of such investments to the market value.

Carrying Amount of Investments

Current Investments

14. The carrying amount for current investments is the lower of cost and fair value. In respect of investments for which an active market exists, market value generally provides the best evidence of fair value. The

valuation of current investments at lower of cost and fair value provides a prudent method of determining the carrying amount to be stated in the balance sheet.

15. Valuation of current investments on overall (or global) basis is not considered appropriate. Sometimes, the concern of an enterprise may be with the value of a category of related current investments and not with each individual investment, and accordingly the investments may be carried at the lower of cost and fair value computed categorywise (i.e. equity shares, preference shares, convertible debentures, etc.). However, the more prudent and appropriate method is to carry investments individually at the lower of cost and fair value.

16. For current investments, any reduction to fair value and any reversals of such reductions are included in the profit and loss statement.

Long-term Investments

17. Long-term investments are usually carried at cost. However, when there is a decline, other than temporary, in the value of a long term investment, the carrying amount is reduced to recognise the decline. Indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. The type and extent of the investor's stake in the investee are also taken into account. Restrictions on distributions by the investee or on disposal by the investor may affect the value attributed to the investment.

18. Long-term investments are usually of individual importance to the investing enterprise. The carrying amount of long-term investments is therefore determined on an individual investment basis.

19. Where there is a decline, other than temporary, in the carrying amounts of long term investments, the resultant reduction in the carrying amount is charged to the profit and loss statement. The reduction in carrying amount is reversed when there is a rise in the value of the investment, or if the reasons for the reduction no longer exist.

Investment Properties

20. The cost of any shares in a co-operative society or a company, the holding of which is directly related to the right to hold the investment property, is added to the carrying amount of the investment property.

Disposal of Investments

21. On disposal of an investment, the difference between the carrying amount and the disposal proceeds, net of expenses, is recognised in the profit and loss statement.

22. When disposing of a part of the holding of an individual investment, the carrying amount to be allocated to that part is to be determined on the basis of the average carrying amount of the total holding of the investment.[4]

Reclassification of Investments

23. Where long-term investments are reclassified as current investments, transfers are made at the lower of cost and carrying amount at the date of transfer.

24. Where investments are reclassified from current to long-term, transfers are made at the lower of cost and fair value at the date of transfer.

Disclosure

25. The following disclosures in financial statements in relation to investments are appropriate:—

(a) the accounting policies for the determination of carrying amount of investments;

(b) the amounts included in profit and loss statement for:

(i) interest, dividends (showing separately dividends from subsidiary companies), and rentals on investments showing

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[4] In respect of shares, debentures and other securities held as stock-in-trade, the cost of stocks disposed of is determined by applying an appropriate cost formula (e.g. first-in, first-out; average cost, etc.). These cost formulae are the same as those specified in Accounting Standard (AS) 2, in respect of Valuation of Inventories.

separately such income from long term and current investments. Gross income should be stated, the amount of income tax deducted at source being included under Advance Taxes Paid;

(ii) profits and losses on disposal of current investments and changes in carrying amount of such investments;

(iii) profits and losses on disposal of long-term investments and changes in the carrying amount of such investments;

(c) significant restrictions on the right of ownership, realisability of investments or the remittance of income and proceeds of disposal;

(d) the aggregate amount of quoted and unquoted investments, giving the aggregate market value of quoted investments;

(e) other disclosures as specifically required by the relevant statute governing the enterprise.

Main Principles

Classification of Investments

26. An enterprise should disclose current investments and long term investments distinctly in its financial statements.

27. Further classification of current and long-term investments should be as specified in the statute governing the enterprise. In the absence of a statutory requirement, such further classification should disclose, where applicable, investments in:

(a) Government or Trust securities

(b) Shares, debentures or bonds

(c) Investment properties

(d) Others—specifying nature.

Cost of Investments

28. The cost of an investment should include acquisition charges such as brokerage, fees and duties.

29. If an investment is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost should be the fair value of the securities issued (which in appropriate cases may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued. If an investment is acquired in exchange for another asset, the acquisition cost of the investment should be determined by reference to the fair value of the asset given up. Alternatively, the acquisition cost of the investment may be determined with reference to the fair value of the investment acquired if it is more clearly evident.

Investment Properties

30. An enterprise holding investment properties should account for them as long term investments.

Carrying Amount of Investments

31. Investments classified as current investments should be carried in the financial statements at the lower of cost and fair value determined either on an individual investment basis or by category of investment, but not on an overall (or global) basis.

32. Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.

Changes in Carrying Amounts of Investments

33. Any reduction in the carrying amount and any reversals of such reductions should be charged or credited to the profit and loss statement.

Disposal of Investments

34. On disposal of an investment, the difference between the carrying amount and net disposal proceeds should be charged or credited to the profit and loss statement.

Disclosure

35. The following information should be disclosed in the financial statements:

(a) ***the accounting policies for determination of carrying amount of investments;***

(b) ***classification of investments as specified in paragraphs 26 and 27 above;***

(c) ***the amounts included in profit and loss statement for:***

(i) ***interest, dividends (showing separately dividends from subsidiary companies), and rentals on investments showing separately such income from long term and current investments. Gross income should be stated, the amount of income tax deducted at source being included under Advance Taxes Paid;***

(ii) ***profits and losses on disposal of current investments and changes in the carrying amount of such investments; and***

(iii) ***profits and losses on disposal of long term investments and changes in the carrying amount of such investments;***

(d) ***significant restrictions on the right of ownership, realisability of investments or the remittance of income and proceeds of disposal;***

(e) ***the aggregate amount of quoted and unquoted investments, giving the aggregate market value of quoted investments;***

(f) other disclosures as specifically required by the relevant statute governing the enterprise.

Effective Date

36. This Accounting Standard comes into effect for financial statements covering periods commencing on or after April 1, 1995.

Accounting Standard (AS) 14
(issued 1994)

Accounting for Amalgamations

Contents

Continued../..

Accounting Standard (AS) 14*

(issued 1994)

Accounting for Amalgamations

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

Introduction

1. This standard deals with accounting for amalgamations and the treatment of any resultant goodwill or reserves. This Standard is directed principally to companies although some of its requirements also apply to financial statements of other enterprises.

2. This standard does not deal with cases of acquisitions which arise when there is a purchase by one company (referred to as the acquiring company) of the whole or part of the shares, or the whole or part of the assets, of another company (referred to as the acquired company) in consideration for payment in cash or by issue of shares or other securities in the acquiring company or partly in one form and partly in the other. The distinguishing feature of an acquisition is that the acquired company is not dissolved and its separate entity continues to exist.

* A limited revision to this Standard was made in 2004, pursuant to which paragraphs 23 and 42 of this Standard were revised.

[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.

Definitions

3. The following terms are used in this standard with the meanings specified:

(a) Amalgamation means an amalgamation pursuant to the provisions of the Companies Act, 1956 or any other statute which may be applicable to companies.

(b) Transferor company means the company which is amalgamated into another company.

(c) Transferee company means the company into which a transferor company is amalgamated.

(d) Reserve means the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability.

(e) Amalgamation in the nature of merger is an amalgamation which satisfies all the following conditions.

(i) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.

(ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.

(iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company,

except that cash may be paid in respect of any fractional shares.

(iv) *The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.*

(v) *No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.*

(f) ***Amalgamation in the nature of purchase*** *is an amalgamation which does not satisfy any one or more of the conditions specified in sub-paragraph (e) above.*

(g) ***Consideration*** *for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company.*

(h) ***Fair value*** *is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction.*

(i) ***Pooling of interests*** *is a method of accounting for amalgamations the object of which is to account for the amalgamation as if the separate businesses of the amalgamating companies were intended to be continued by the transferee company. Accordingly, only minimal changes are made in aggregating the individual financial statements of the amalgamating companies.*

Explanation

Types of Amalgamations

4. Generally speaking, amalgamations fall into two broad categories. In the first category are those amalgamations where there is a genuine pooling

not merely of the assets and liabilities of the amalgamating companies but also of the shareholders' interests and of the businesses of these companies. Such amalgamations are amalgamations which are in the nature of 'merger' and the accounting treatment of such amalgamations should ensure that the resultant figures of assets, liabilities, capital and reserves more or less represent the sum of the relevant figures of the amalgamating companies. In the second category are those amalgamations which are in effect a mode by which one company acquires another company and, as a consequence, the shareholders of the company which is acquired normally do not continue to have a proportionate share in the equity of the combined company, or the business of the company which is acquired is not intended to be continued. Such amalgamations are amalgamations in the nature of 'purchase'.

5. An amalgamation is classified as an 'amalgamation in the nature of merger' when all the conditions listed in paragraph 3(e) are satisfied. There are, however, differing views regarding the nature of any further conditions that may apply. Some believe that, in addition to an exchange of equity shares, it is necessary that the shareholders of the transferor company obtain a substantial share in the transferee company even to the extent that it should not be possible to identify any one party as dominant therein. This belief is based in part on the view that the exchange of control of one company for an insignificant share in a larger company does not amount to a mutual sharing of risks and benefits.

6. Others believe that the substance of an amalgamation in the nature of merger is evidenced by meeting certain criteria regarding the relationship of the parties, such as the former independence of the amalgamating companies, the manner of their amalgamation, the absence of planned transactions that would undermine the effect of the amalgamation, and the continuing participation by the management of the transferor company in the management of the transferee company after the amalgamation.

Methods of Accounting for Amalgamations

7. There are two main methods of accounting for amalgamations:

   (a) the pooling of interests method; and

   (b) the purchase method.

8. The use of the pooling of interests method is confined to circumstances which meet the criteria referred to in paragraph 3(e) for an amalgamation in the nature of merger.

9. The object of the purchase method is to account for the amalgamation by applying the same principles as are applied in the normal purchase of assets. This method is used in accounting for amalgamations in the nature of purchase.

The Pooling of Interests Method

10. Under the pooling of interests method, the assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts (after making the adjustments required in paragraph 11).

11. If, at the time of the amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting policies is adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies are reported in accordance with Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

The Purchase Method

12. Under the purchase method, the transferee company accounts for the amalgamation either by incorporating the assets and liabilities at their existing carrying amounts or by allocating the consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair values at the date of amalgamation. The identifiable assets and liabilities may include assets and liabilities not recorded in the financial statements of the transferor company.

13. Where assets and liabilities are restated on the basis of their fair values, the determination of fair values may be influenced by the intentions of the transferee company. For example, the transferee company may have a specialised use for an asset, which is not available to other potential buyers. The transferee company may intend to effect changes in the activities of the transferor company which necessitate the creation of specific provisions for the expected costs, e.g. planned employee termination and plant relocation costs.

Consideration

14. The consideration for the amalgamation may consist of securities, cash or other assets. In determining the value of the consideration, an assessment is made of the fair value of its elements. A variety of techniques is applied in arriving at fair value. For example, when the consideration includes securities, the value fixed by the statutory authorities may be taken to be the fair value. In case of other assets, the fair value may be determined by reference to the market value of the assets given up. Where the market value of the assets given up cannot be reliably assessed, such assets may be valued at their respective net book values.

15. Many amalgamations recognise that adjustments may have to be made to the consideration in the light of one or more future events. When the additional payment is probable and can reasonably be estimated at the date of amalgamation, it is included in the calculation of the consideration. In all other cases, the adjustment is recognised as soon as the amount is determinable [see Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date].

Treatment of Reserves on Amalgamation

16. If the amalgamation is an 'amalgamation in the nature of merger', the identity of the reserves is preserved and they appear in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company. Thus, for example, the General Reserve of the transferor company becomes the General Reserve of the transferee company, the Capital Reserve of the transferor company becomes the Capital Reserve of the transferee company and the Revaluation Reserve of the transferor company becomes the Revaluation Reserve of the transferee company. As a result of preserving the identity, reserves which are available for distribution as dividend before the amalgamation would also be available for distribution as dividend after the amalgamation. The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company is adjusted in reserves in the financial statements of the transferee company.

17. If the amalgamation is an 'amalgamation in the nature of purchase', the identity of the reserves, other than the statutory reserves dealt with in paragraph 18, is not preserved. The amount of the consideration is deducted

from the value of the net assets of the transferor company acquired by the transferee company. If the result of the computation is negative, the difference is debited to goodwill arising on amalgamation and dealt with in the manner stated in paragraphs 19-20. If the result of the computation is positive, the difference is credited to Capital Reserve.

18. Certain reserves may have been created by the transferor company pursuant to the requirements of, or to avail of the benefits under, the Income-tax Act, 1961; for example, Development Allowance Reserve, or Investment Allowance Reserve. The Act requires that the identity of the reserves should be preserved for a specified period. Likewise, certain other reserves may have been created in the financial statements of the transferor company in terms of the requirements of other statutes. Though, normally, in an amalgamation in the nature of purchase, the identity of reserves is not preserved, an exception is made in respect of reserves of the aforesaid nature (referred to hereinafter as 'statutory reserves') and such reserves retain their identity in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company, so long as their identity is required to be maintained to comply with the relevant statute. This exception is made only in those amalgamations where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with. In such cases the statutory reserves are recorded in the financial statements of the transferee company by a corresponding debit to a suitable account head (e.g., 'Amalgamation Adjustment Account') which is disclosed as a part of 'miscellaneous expenditure' or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed.

Treatment of Goodwill Arising on Amalgamation

19. Goodwill arising on amalgamation represents a payment made in anticipation of future income and it is appropriate to treat it as an asset to be amortised to income on a systematic basis over its useful life. Due to the nature of goodwill, it is frequently difficult to estimate its useful life with reasonable certainty. Such estimation is, therefore, made on a prudent basis. Accordingly, it is considered appropriate to amortise goodwill over a period not exceeding five years unless a somewhat longer period can be justified.

20. Factors which may be considered in estimating the useful life of goodwill arising on amalgamation include:

(a) the foreseeable life of the business or industry;

(b) the effects of product obsolescence, changes in demand and other economic factors;

(c) the service life expectancies of key individuals or groups of employees;

(d) expected actions by competitors or potential competitors; and

(e) legal, regulatory or contractual provisions affecting the useful life.

Balance of Profit and Loss Account

21. In the case of an 'amalgamation in the nature of merger', the balance of the Profit and Loss Account appearing in the financial statements of the transferor company is aggregated with the corresponding balance appearing in the financial statements of the transferee company. Alternatively, it is transferred to the General Reserve, if any.

22. In the case of an 'amalgamation in the nature of purchase', the balance of the Profit and Loss Account appearing in the financial statements of the transferor company, whether debit or credit, loses its identity.

Treatment of Reserves Specified in A Scheme of Amalgamation

23. The scheme of amalgamation sanctioned under the provisions of the Companies Act, 1956 or any other statute may prescribe the treatment to be given to the reserves of the transferor company after its amalgamation. Where the treatment is so prescribed, the same is followed. In some cases, the scheme of amalgamation sanctioned under a statute may prescribe a different treatment to be given to the reserves of the transferor company after amalgamation as compared to the requirements of this Standard that would have been followed had no treatment been prescribed by the scheme. In such cases, the following disclosures are made in the first financial statements following the amalgamation:

(a) A description of the accounting treatment given to the reserves and the reasons for following the treatment different from that prescribed in this Standard.

(b) Deviations in the accounting treatment given to the reserves as prescribed by the scheme of amalgamation sanctioned under the statute as compared to the requirements of this Standard that would have been followed had no treatment been prescribed by the scheme.

(c) The financial effect, if any, arising due to such deviation.

Disclosure

24. For all amalgamations, the following disclosures are considered appropriate in the first financial statements following the amalgamation:

(a) names and general nature of business of the amalgamating companies;

(b) effective date of amalgamation for accounting purposes;

(c) the method of accounting used to reflect the amalgamation; and

(d) particulars of the scheme sanctioned under a statute.

25. For amalgamations accounted for under the pooling of interests method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:

(a) description and number of shares issued, together with the percentage of each company's equity shares exchanged to effect the amalgamation;

(b) the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.

26. For amalgamations accounted for under the purchase method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:

(a) consideration for the amalgamation and a description of the consideration paid or contingently payable; and

(b) the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof including the period of amortisation of any goodwill arising on amalgamation.

Amalgamation after the Balance Sheet Date

27. When an amalgamation is effected after the balance sheet date but before the issuance of the financial statements of either party to the amalgamation, disclosure is made in accordance with AS 4, 'Contingencies and Events Occurring After the Balance Sheet Date', but the amalgamation is not incorporated in the financial statements. In certain circumstances, the amalgamation may also provide additional information affecting the financial statements themselves, for instance, by allowing the going concern assumption to be maintained.

Main Principles

28. An amalgamation may be either –

(a) an amalgamation in the nature of merger, or

(b) an amalgamation in the nature of purchase.

29. An amalgamation should be considered to be an amalgamation in the nature of merger when all the following conditions are satisfied:

(i) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.

(ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the

equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.

(iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.

(iv) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.

(v) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

30. An amalgamation should be considered to be an amalgamation in the nature of purchase, when any one or more of the conditions specified in paragraph 29 is not satisfied.

31. When an amalgamation is considered to be an amalgamation in the nature of merger, it should be accounted for under the pooling of interests method described in paragraphs 33–35.

32. When an amalgamation is considered to be an amalgamation in the nature of purchase, it should be accounted for under the purchase method described in paragraphs 36–39.

The Pooling of Interests Method

33. In preparing the transferee company's financial statements, the assets, liabilities and reserves (whether capital or revenue or arising on revaluation) of the transferor company should be recorded at their existing carrying amounts and in the same form as at the date of the amalgamation. The balance of the Profit and Loss Account of the transferor company should be aggregated with the corresponding balance of the transferee company or transferred to the General Reserve, if any.

34. If, at the time of the amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting policies should be adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies should be reported in accordance with Accounting Standard (AS) 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

35. The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company should be adjusted in reserves.

The Purchase Method

36. In preparing the transferee company's financial statements, the assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or, alternatively, the consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation. The reserves (whether capital or revenue or arising on revaluation) of the transferor company, other than the statutory reserves, should not be included in the financial statements of the transferee company except as stated in paragraph 39.

37. Any excess of the amount of the consideration over the value of the net assets of the transferor company acquired by the transferee company should be recognised in the transferee company's financial statements as goodwill arising on amalgamation. If the amount of the consideration is lower than the value of the net assets acquired, the difference should be treated as Capital Reserve.

38. The goodwill arising on amalgamation should be amortised to income on a systematic basis over its useful life. The amortisation period should not exceed five years unless a somewhat longer period can be justified.

39. Where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with, statutory reserves of the transferor company should be recorded in the financial statements of the transferee company. The corresponding debit should be given to a suitable account head (e.g., 'Amalgamation

Adjustment Account') which should be disclosed as a part of 'miscellaneous expenditure' or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account should be reversed.

Common Procedures

40. The consideration for the amalgamation should include any non-cash element at fair value. In case of issue of securities, the value fixed by the statutory authorities may be taken to be the fair value. In case of other assets, the fair value may be determined by reference to the market value of the assets given up. Where the market value of the assets given up cannot be reliably assessed, such assets may be valued at their respective net book values.

41. Where the scheme of amalgamation provides for an adjustment to the consideration contingent on one or more future events, the amount of the additional payment should be included in the consideration if payment is probable and a reasonable estimate of the amount can be made. In all other cases, the adjustment should be recognised as soon as the amount is determinable [see Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date].

Treatment of Reserves Specified in A Scheme of Amalgamation

42. Where the scheme of amalgamation sanctioned under a statute prescribes the treatment to be given to the reserves of the transferor company after amalgamation, the same should be followed. Where the scheme of amalgamation sanctioned under a statute prescribes a different treatment to be given to the reserves of the transferor company after amalgamation as compared to the requirements of this Standard that would have been followed had no treatment been prescribed by the scheme, the following disclosures should be made in the first financial statements following the amalgamation:

- *(a) A description of the accounting treatment given to the reserves and reasons for following the treatment different from that prescribed in this Standard.*

(b) Deviations in the accounting treatment given to the reserves as prescribed by the scheme of amalgamation sanctioned under the statute as compared to the requirements of this Standard that would have been followed had no treatment been prescribed by the scheme.

(c) The financial effect, if any, arising due to such deviation.

Disclosure

43. For all amalgamations, the following disclosures should be made in the first financial statements following the amalgamation:

(a) names and general nature of business of the amalgamating companies;

(b) effective date of amalgamation for accounting purposes;

(c) the method of accounting used to reflect the amalgamation; and

(d) particulars of the scheme sanctioned under a statute.

44. For amalgamations accounted for under the pooling of interests method, the following additional disclosures should be made in the first financial statements following the amalgamation:

(a) description and number of shares issued, together with the percentage of each company's equity shares exchanged to effect the amalgamation;

(b) the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.

45. For amalgamations accounted for under the purchase method, the following additional disclosures should be made in the first financial statements following the amalgamation:

(a) consideration for the amalgamation and a description of the consideration paid or contingently payable; and

(b) the amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof including the period of amortisation of any goodwill arising on amalgamation.

Amalgamation after the Balance Sheet Date

46. When an amalgamation is effected after the balance sheet date but before the issuance of the financial statements of either party to the amalgamation, disclosure should be made in accordance with AS 4, 'Contingencies and Events Occurring After the Balance Sheet Date', but the amalgamation should not be incorporated in the financial statements. In certain circumstances, the amalgamation may also provide additional information affecting the financial statements themselves, for instance, by allowing the going concern assumption to be maintained.

Accounting Standard (AS) 15
(revised 2005)

Employee Benefits

Contents

Accounting Standard (AS) 15*

(revised 2005)

Employee Benefits

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

Objective

The objective of this Standard is to prescribe the accounting and disclosure for employee benefits. The Standard requires an enterprise to recognise:

(a) a liability when an employee has provided service in exchange for employee benefits to be paid in the future; and

(b) an expense when the enterprise consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.

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* Originally issued in 1995 and titled as 'Accounting for Retirement Benefits in the Financial Statements of Employers'. AS 15 (revised 2005) was originally published in the March 2005 issue of the Institute's Journal. Subsequently, the Institute, in January 2006, made a Limited Revision to AS 15 (revised 2005) primarily with a view to bring the disclosure requirements of the standard relating to the defined benefit plans in line with the corresponding International Accounting Standard (IAS) 19, *Employee Benefits*; to clarify the application of the transitional provisions; and to provide relaxation/ exemptions to the Small and Medium-sized Enterprises (SMEs). Thereafter, another Limited Revision to AS 15 (revised 2005) was made primaily with a view to provide an option to an entity to charge additional liability arising upon the first application of the standard as an expense over a period up to five years with a disclosure of unrecognised amount. An entity was allowed to exercise this option only during the first accounting year commencing on or after 7th December 2006. These Limited Revisions have been duly incorporated in AS 15 (revised 2005).

[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.

Scope

1. This Standard should be applied by an employer in accounting for all employee benefits, except employee share-based payments[2] .

2. This Standard does not deal with accounting and reporting by employee benefit plans.

3. The employee benefits to which this Standard applies include those provided:

(a) under formal plans or other formal agreements between an enterprise and individual employees, groups of employees or their representatives;

(b) under legislative requirements, or through industry arrangements, whereby enterprises are required to contribute to state, industry or other multi-employer plans; or

(c) by those informal practices that give rise to an obligation. Informal practices give rise to an obligation where the enterprise has no realistic alternative but to pay employee benefits. An example of such an obligation is where a change in the enterprise's informal practices would cause unacceptable damage to its relationship with employees.

4. Employee benefits include:

(a) short-term employee benefits, such as wages, salaries and social security contributions (e.g., contribution to an insurance company by an employer to pay for medical care of its employees), paid annual leave, profit-sharing and bonuses (if payable within twelve months of the end of the period) and non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;

(b) post-employment benefits such as gratuity, pension, other retirement benefits, post-employment life insurance and post-employment medical care;

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[2] The accounting for such benefits is dealt with in the Guidance Note on Accounting for Employee Share-based Payments issued by the Institute of Chartered Accountants of India.

(c) other long-term employee benefits, including long-service leave or sabbatical leave, jubilee or other long-service benefits, long-term disability benefits and, if they are not payable wholly within twelve months after the end of the period, profit-sharing, bonuses and deferred compensation; and

(d) termination benefits.

Because each category identified in (a) to (d) above has different characteristics, this Standard establishes separate requirements for each category.

5. Employee benefits include benefits provided to either employees or their spouses, children or other dependants and may be settled by payments (or the provision of goods or services) made either:

(a) directly to the employees, to their spouses, children or other dependants, or to their legal heirs or nominees; or

(b) to others, such as trusts, insurance companies.

6. An employee may provide services to an enterprise on a full-time, part-time, permanent, casual or temporary basis. For the purpose of this Standard, employees include whole-time directors and other management personnel.

Definitions

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

7.1 <u>Employee benefits</u> are all forms of consideration given by an enterprise in exchange for service rendered by employees.

7.2 <u>Short-term employee benefits</u> are employee benefits (other than termination benefits) which fall due wholly within twelve months after the end of the period in which the employees render the related service.

7.3 <u>Post-employment benefits</u> are employee benefits (other than termination benefits) which are payable after the completion of employment.

7.4 <u>Post-employment benefit plans</u> are formal or informal arrangements under which an enterprise provides post-employment benefits for one or more employees.

7.5 <u>Defined contribution plans</u> are post-employment benefit plans under which an enterprise pays fixed contributions into a separate entity (a fund) and will have no obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

7.6 <u>Defined benefit plans</u> are post-employment benefit plans other than defined contribution plans.

7.7 <u>Multi-employer plans</u> are defined contribution plans (other than state plans) or defined benefit plans (other than state plans) that:

(a) pool the assets contributed by various enterprises that are not under common control; and

(b) use those assets to provide benefits to employees of more than one enterprise, on the basis that contribution and benefit levels are determined without regard to the identity of the enterprise that employs the employees concerned.

7.8 <u>Other long-term employee benefits</u> are employee benefits (other than post-employment benefits and termination benefits) which do not fall due wholly within twelve months after the end of the period in which the employees render the related service.

7.9 <u>Termination benefits</u> are employee benefits payable as a result of either:

(a) an enterprise's decision to terminate an employee's employment before the normal retirement date; or

(b) an employee's decision to accept voluntary redundancy in exchange for those benefits (voluntary retirement).

7.10 <u>Vested employee benefits</u> are employee benefits that are not conditional on future employment.

7.11 The present value of a defined benefit obligation is the present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods.

7.12 Current service cost is the increase in the present value of the defined benefit obligation resulting from employee service in the current period.

7.13 Interest cost is the increase during a period in the present value of a defined benefit obligation which arises because the benefits are one period closer to settlement.

7.14 Plan assets comprise:

(a) assets held by a long-term employee benefit fund; and

(b) qualifying insurance policies.

7.15 Assets held by a long-term employee benefit fund are assets (other than non-transferable financial instruments issued by the reporting enterprise) that:

(a) are held by an entity (a fund) that is legally separate from the reporting enterprise and exists solely to pay or fund employee benefits; and

(b) are available to be used only to pay or fund employee benefits, are not available to the reporting enterprise's own creditors (even in bankruptcy), and cannot be returned to the reporting enterprise, unless either:

(i) the remaining assets of the fund are sufficient to meet all the related employee benefit obligations of the plan or the reporting enterprise; or

(ii) the assets are returned to the reporting enterprise to reimburse it for employee benefits already paid.

7.16 A qualifying insurance policy is an insurance policy issued by an insurer that is not a related party (as defined in AS 18 Related Party Disclosures) of the reporting enterprise, if the proceeds of the policy:

(a) can be used only to pay or fund employee benefits under a defined benefit plan; and

(b) are not available to the reporting enterprise's own creditors (even in bankruptcy) and cannot be paid to the reporting enterprise, unless either:

(i) the proceeds represent surplus assets that are not needed for the policy to meet all the related employee benefit obligations; or

(ii) the proceeds are returned to the reporting enterprise to reimburse it for employee benefits already paid.

7.17 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.

7.18 The return on plan assets is interest, dividends and other revenue derived from the plan assets, together with realised and unrealised gains or losses on the plan assets, less any costs of administering the plan and less any tax payable by the plan itself.

7.19 Actuarial gains and losses comprise:

(a) experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred); and

(b) the effects of changes in actuarial assumptions.

7.20 Past service cost is the change in the present value of the defined benefit obligation for employee service in prior periods, resulting in the current period from the introduction of, or changes to, post-employment benefits or other long-term employee benefits. Past service cost may be either positive (where benefits are introduced or improved) or negative (where existing benefits are reduced).

Short-term Employee Benefits

8. Short-term employee benefits include items such as:

(a) wages, salaries and social security contributions;

(b) short-term compensated absences (such as paid annual leave) where the absences are expected to occur within twelve months after the end of the period in which the employees render the related employee service;

(c) profit-sharing and bonuses payable within twelve months after the end of the period in which the employees render the related service; and

(d) non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees.

9. Accounting for short-term employee benefits is generally straightforward because no actuarial assumptions are required to measure the obligation or the cost and there is no possibility of any actuarial gain or loss. Moreover, short-term employee benefit obligations are measured on an undiscounted basis.

Recognition and Measurement

All Short-term Employee Benefits

10. When an employee has rendered service to an enterprise during an accounting period, the enterprise should recognise the undiscounted amount of short-term employee benefits expected to be paid in exchange for that service:

(a) as a liability (accrued expense), after deducting any amount already paid. If the amount already paid exceeds the undiscounted amount of the benefits, an enterprise should recognise that excess as an asset (prepaid expense) to the extent that the prepayment will lead to, for example, a reduction in future payments or a cash refund; and

(b) as an expense, unless another Accounting Standard requires or

> ***permits the inclusion of the benefits in the cost of an asset (see, for example, AS 10 Accounting for Fixed Assets).***

Paragraphs 11, 14 and 17 explain how an enterprise should apply this requirement to short-term employee benefits in the form of compensated absences and profit-sharing and bonus plans.

Short-term Compensated Absences

11. An enterprise should recognise the expected cost of short-term employee benefits in the form of compensated absences under paragraph 10 as follows:

(a) in the case of accumulating compensated absences, when the employees render service that increases their entitlement to future compensated absences; and

(b) in the case of non-accumulating compensated absences, when the absences occur.

12. An enterprise may compensate employees for absence for various reasons including vacation, sickness and short-term disability, and maternity or paternity. Entitlement to compensated absences falls into two categories:

(a) accumulating; and

(b) non-accumulating.

13. Accumulating compensated absences are those that are carried forward and can be used in future periods if the current period's entitlement is not used in full. Accumulating compensated absences may be either vesting (in other words, employees are entitled to a cash payment for unused entitlement on leaving the enterprise) or non-vesting (when employees are not entitled to a cash payment for unused entitlement on leaving). An obligation arises as employees render service that increases their entitlement to future compensated absences. The obligation exists, and is recognised, even if the compensated absences are non-vesting, although the possibility that employees may leave before they use an accumulated non-vesting entitlement affects the measurement of that obligation.

14. An enterprise should measure the expected cost of accumulating compensated absences as the additional amount that the enterprise expects to pay as a result of the unused entitlement that has accumulated at the balance sheet date.

15. The method specified in the previous paragraph measures the obligation at the amount of the additional payments that are expected to arise solely from the fact that the benefit accumulates. In many cases, an enterprise may not need to make detailed computations to estimate that there is no material obligation for unused compensated absences. For example, a leave obligation is likely to be material only if there is a formal or informal understanding that unused leave may be taken as paid vacation.

Example Illustrating Paragraphs 14 and 15

An enterprise has 100 employees, who are each entitled to five working days of leave for each year. Unused leave may be carried forward for one calendar year. The leave is taken first out of the current year's entitlement and then out of any balance brought forward from the previous year (a LIFO basis). At 31 December 20X4, the average unused entitlement is two days per employee. The enterprise expects, based on past experience which is expected to continue, that 92 employees will take no more than five days of leave in 20X5 and that the remaining eight employees will take an average of six and a half days each.

The enterprise expects that it will pay an additional 12 days of pay as a result of the unused entitlement that has accumulated at 31 December 20X4 (one and a half days each, for eight employees). Therefore, the enterprise recognises a liability, as at 31 December 20X4, equal to 12 days of pay.

16. Non-accumulating compensated absences do not carry forward they lapse if the current period's entitlement is not used in full and do not entitle employees to a cash payment for unused entitlement on leaving the enterprise. This is commonly the case for maternity or paternity leave. An enterprise recognises no liability or expense until the time of the absence, because employee service does not increase the amount of the benefit.

Provided that a Small and Medium-sized Company and Small and Medium-sized Enterprise (Levels II and III non-corporate entities), as defined in Appendix 1 to this Compendium, may not comply with

paragraphs 11 to 16 of the Standard to the extent they deal with recognition and measurement of short-term accumulating compensated absenses which are non-vesting (i.e., short-term accumulating compensated absenses in respect of which employees are not entitled to cash payment of unused entitlement on leaving).

Profit-sharing and Bonus Plans

17. ***An enterprise should recognise the expected cost of profit-sharing and bonus payments under paragraph 10 when, and only when:***

(a) the enterprise has a present obligation to make such payments as a result of past events; and

(b) a reliable estimate of the obligation can be made.

A present obligation exists when, and only when, the enterprise has no realistic alternative but to make the payments.

18. Under some profit-sharing plans, employees receive a share of the profit only if they remain with the enterprise for a specified period. Such plans create an obligation as employees render service that increases the amount to be paid if they remain in service until the end of the specified period. The measurement of such obligations reflects the possibility that some employees may leave without receiving profit-sharing payments.

Example Illustrating Paragraph 18

A profit-sharing plan requires an enterprise to pay a specified proportion of its net profit for the year to employees who serve throughout the year. If no employees leave during the year, the total profit-sharing payments for the year will be 3% of net profit. The enterprise estimates that staff turnover will reduce the payments to 2.5% of net profit.

The enterprise recognises a liability and an expense of 2.5% of net profit.

19. An enterprise may have no legal obligation to pay a bonus. Nevertheless, in some cases, an enterprise has a practice of paying bonuses. In such cases also, the enterprise has an obligation because the enterprise has no realistic alternative but to pay the bonus. The measurement of the

obligation reflects the possibility that some employees may leave without receiving a bonus.

20. An enterprise can make a reliable estimate of its obligation under a profit-sharing or bonus plan when, and only when:

(a) the formal terms of the plan contain a formula for determining the amount of the benefit; or

(b) the enterprise determines the amounts to be paid before the financial statements are approved; or

(c) past practice gives clear evidence of the amount of the enterprise's obligation.

21. An obligation under profit-sharing and bonus plans results from employee service and not from a transaction with the enterprise's owners. Therefore, an enterprise recognises the cost of profit-sharing and bonus plans not as a distribution of net profit but as an expense.

22. If profit-sharing and bonus payments are not due wholly within twelve months after the end of the period in which the employees render the related service, those payments are other long-term employee benefits (see paragraphs 127-132).

Disclosure

23. Although this Standard does not require specific disclosures about short-term employee benefits, other Accounting Standards may require disclosures. For example, where required by AS 18 *Related Party Disclosures* an enterprise discloses information about employee benefits for key management personnel.

Post-employment Benefits: Defined Contribution Plans and Defined Benefit Plans

24. Post-employment benefits include:

(a) retirement benefits, e.g., gratuity and pension; and

(b) other benefits, e.g., post-employment life insurance and post-employment medical care.

Arrangements whereby an enterprise provides post-employment benefits are post-employment benefit plans. An enterprise applies this Standard to all such arrangements whether or not they involve the establishment of a separate entity to receive contributions and to pay benefits.

25. Post-employment benefit plans are classified as either defined contribution plans or defined benefit plans, depending on the economic substance of the plan as derived from its principal terms and conditions. Under defined contribution plans:

(a) the enterprise's obligation is limited to the amount that it agrees to contribute to the fund. Thus, the amount of the post-employment benefits received by the employee is determined by the amount of contributions paid by an enterprise (and also by the employee) to a post-employment benefit plan or to an insurance company, together with investment returns arising from the contributions; and

(b) in consequence, actuarial risk (that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall on the employee.

26. Examples of cases where an enterprise's obligation is not limited to the amount that it agrees to contribute to the fund are when the enterprise has an obligation through:

(a) a plan benefit formula that is not linked solely to the amount of contributions; or

(b) a guarantee, either indirectly through a plan or directly, of a specified return on contributions; or

(c) informal practices that give rise to an obligation, for example, an obligation may arise where an enterprise has a history of increasing benefits for former employees to keep pace with inflation even where there is no legal obligation to do so.

27. Under defined benefit plans:

(a) the enterprise's obligation is to provide the agreed benefits to current and former employees; and

(b) actuarial risk (that benefits will cost more than expected) and investment risk fall, in substance, on the enterprise. If actuarial or investment experience are worse than expected, the enterprise's obligation may be increased.

28. Paragraphs 29 to 43 below deal with defined contribution plans and defined benefit plans in the context of multi-employer plans, state plans and insured benefits.

Multi-employer Plans

29. An enterprise should classify a multi-employer plan as a defined contribution plan or a defined benefit plan under the terms of the plan (including any obligation that goes beyond the formal terms). Where a multi-employer plan is a defined benefit plan, an enterprise should:

(a) account for its proportionate share of the defined benefit obligation, plan assets and cost associated with the plan in the same way as for any other defined benefit plan; and

(b) disclose the information required by paragraph 120.

30. When sufficient information is not available to use defined benefit accounting for a multi-employer plan that is a defined benefit plan, an enterprise should:

(a) account for the plan under paragraphs 45-47 as if it were a defined contribution plan;

(b) disclose:

(i) the fact that the plan is a defined benefit plan; and

(ii) the reason why sufficient information is not available to enable the enterprise to account for the plan as a defined benefit plan; and

(c) to the extent that a surplus or deficit in the plan may affect the amount of future contributions, disclose in addition:

(i) any available information about that surplus or deficit;

(ii) the basis used to determine that surplus or deficit; and

(iii) the implications, if any, for the enterprise.

31. One example of a defined benefit multi-employer plan is one where:

(a) the plan is financed in a manner such that contributions are set at a level that is expected to be sufficient to pay the benefits falling due in the same period; and future benefits earned during the current period will be paid out of future contributions; and

(b) employees' benefits are determined by the length of their service and the participating enterprises have no realistic means of withdrawing from the plan without paying a contribution for the benefits earned by employees up to the date of withdrawal. Such a plan creates actuarial risk for the enterprise; if the ultimate cost of benefits already earned at the balance sheet date is more than expected, the enterprise will have to either increase its contributions or persuade employees to accept a reduction in benefits. Therefore, such a plan is a defined benefit plan.

32. Where sufficient information is available about a multi-employer plan which is a defined benefit plan, an enterprise accounts for its proportionate share of the defined benefit obligation, plan assets and post-employment benefit cost associated with the plan in the same way as for any other defined benefit plan. However, in some cases, an enterprise may not be able to identify its share of the underlying financial position and performance of the plan with sufficient reliability for accounting purposes. This may occur if:

(a) the enterprise does not have access to information about the plan that satisfies the requirements of this Standard; or

(b) the plan exposes the participating enterprises to actuarial risks associated with the current and former employees of other enterprises, with the result that there is no consistent and reliable basis for allocating the obligation, plan assets and cost to individual enterprises participating in the plan.

In those cases, an enterprise accounts for the plan as if it were a defined contribution plan and discloses the additional information required by paragraph 30.

33. Multi-employer plans are distinct from group administration plans. A group administration plan is merely an aggregation of single employer plans combined to allow participating employers to pool their assets for investment purposes and reduce investment management and administration costs, but the claims of different employers are segregated for the sole benefit of their own employees. Group administration plans pose no particular accounting problems because information is readily available to treat them in the same way as any other single employer plan and because such plans do not expose the participating enterprises to actuarial risks associated with the current and former employees of other enterprises. The definitions in this Standard require an enterprise to classify a group administration plan as a defined contribution plan or a defined benefit plan in accordance with the terms of the plan (including any obligation that goes beyond the formal terms).

34. Defined benefit plans that share risks between various enterprises under common control, for example, a parent and its subsidiaries, are not multi-employer plans.

35. In respect of such a plan, if there is a contractual agreement or stated policy for charging the net defined benefit cost for the plan as a whole to individual group enterprises, the enterprise recognises, in its separate financial statements, the net defined benefit cost so charged. If there is no such agreement or policy, the net defined benefit cost is recognised in the separate financial statements of the group enterprise that is legally the sponsoring employer for the plan. The other group enterprises recognise, in their separate financial statements, a cost equal to their contribution payable for the period.

36. AS 29 *Provisions, Contingent Liabilities and Contingent Assets* requires an enterprise to recognise, or disclose information about, certain contingent liabilities. In the context of a multi-employer plan, a contingent liability may arise from, for example:

(a) actuarial losses relating to other participating enterprises because each enterprise that participates in a multi-employer plan shares in the actuarial risks of every other participating enterprise; or

(b) any responsibility under the terms of a plan to finance any shortfall in the plan if other enterprises cease to participate.

State Plans

37. An enterprise should account for a state plan in the same way as for a multi-employer plan (see paragraphs 29 and 30).

38. State plans are established by legislation to cover all enterprises (or all enterprises in a particular category, for example, a specific industry) and are operated by national or local government or by another body (for example, an autonomous agency created specifically for this purpose) which is not subject to control or influence by the reporting enterprise. Some plans established by an enterprise provide both compulsory benefits which substitute for benefits that would otherwise be covered under a state plan and additional voluntary benefits. Such plans are not state plans.

39. State plans are characterised as defined benefit or defined contribution in nature based on the enterprise's obligation under the plan. Many state plans are funded in a manner such that contributions are set at a level that is expected to be sufficient to pay the required benefits falling due in the same period; future benefits earned during the current period will be paid out of future contributions. Nevertheless, in most state plans, the enterprise has no obligation to pay those future benefits: its only obligation is to pay the contributions as they fall due and if the enterprise ceases to employ members of the state plan, it will have no obligation to pay the benefits earned by such employees in previous years. For this reason, state plans are normally defined contribution plans. However, in the rare cases when a state plan is a defined benefit plan, an enterprise applies the treatment prescribed in paragraphs 29 and 30.

Insured Benefits

40. An enterprise may pay insurance premiums to fund a post-employment benefit plan. The enterprise should treat such a plan as a

defined contribution plan unless the enterprise will have (either directly, or indirectly through the plan) an obligation to either:

(a) pay the employee benefits directly when they fall due; or

(b) pay further amounts if the insurer does not pay all future employee benefits relating to employee service in the current and prior periods.

If the enterprise retains such an obligation, the enterprise should treat the plan as a defined benefit plan.

41. The benefits insured by an insurance contract need not have a direct or automatic relationship with the enterprise's obligation for employee benefits. Post-employment benefit plans involving insurance contracts are subject to the same distinction between accounting and funding as other funded plans.

42. Where an enterprise funds a post-employment benefit obligation by contributing to an insurance policy under which the enterprise (either directly, indirectly through the plan, through the mechanism for setting future premiums or through a related party relationship with the insurer) retains an obligation, the payment of the premiums does not amount to a defined contribution arrangement. It follows that the enterprise:

(a) accounts for a qualifying insurance policy as a plan asset (see paragraph 7); and

(b) recognises other insurance policies as reimbursement rights (if the policies satisfy the criteria in paragraph 103).

43. Where an insurance policy is in the name of a specified plan participant or a group of plan participants and the enterprise does not have any obligation to cover any loss on the policy, the enterprise has no obligation to pay benefits to the employees and the insurer has sole responsibility for paying the benefits. The payment of fixed premiums under such contracts is, in substance, the settlement of the employee benefit obligation, rather than an investment to meet the obligation. Consequently, the enterprise no longer has an asset or a liability. Therefore, an enterprise treats such payments as contributions to a defined contribution plan.

Post-employment Benefits: Defined Contribution Plans

44. Accounting for defined contribution plans is straightforward because the reporting enterprise's obligation for each period is determined by the amounts to be contributed for that period. Consequently, no actuarial assumptions are required to measure the obligation or the expense and there is no possibility of any actuarial gain or loss. Moreover, the obligations are measured on an undiscounted basis, except where they do not fall due wholly within twelve months after the end of the period in which the employees render the related service.

Recognition and Measurement

45. When an employee has rendered service to an enterprise during a period, the enterprise should recognise the contribution payable to a defined contribution plan in exchange for that service:

(a) as a liability (accrued expense), after deducting any contribution already paid. If the contribution already paid exceeds the contribution due for service before the balance sheet date, an enterprise should recognise that excess as an asset (prepaid expense) to the extent that the prepayment will lead to, for example, a reduction in future payments or a cash refund; and

(b) as an expense, unless another Accounting Standard requires or permits the inclusion of the contribution in the cost of an asset (see, for example, AS 10, Accounting for Fixed Assets).

46. Where contributions to a defined contribution plan do not fall due wholly within twelve months after the end of the period in which the employees render the related service, they should be discounted using the discount rate specified in paragraph 78.

Provided that a Small and Medium-sized Company and Small and Medium-sized Enterprise (Levels II and III non-corporate entities), as defined in Appendix 1 to this Compandium, may not discount contributions that fall due more than 12 months after the balance sheet date.

Disclosure

47. An enterprise should disclose the amount recognised as an expense for defined contribution plans.

48. Where required by AS 18 *Related Party Disclosures* an enterprise discloses information about contributions to defined contribution plans for key management personnel.

Post-employment Benefits: Defined Benefit Plans

49. Accounting for defined benefit plans is complex because actuarial assumptions are required to measure the obligation and the expense and there is a possibility of actuarial gains and losses. Moreover, the obligations are measured on a discounted basis because they may be settled many years after the employees render the related service. While the Standard requires that it is the responsibility of the reporting enterprise to measure the obligations under the defined benefit plans, it is recognised that for doing so the enterprise would normally use the services of a qualified actuary.

Recognition and Measurement[3]

50. Defined benefit plans may be unfunded, or they may be wholly or partly funded by contributions by an enterprise, and sometimes its employees, into an entity, or fund, that is legally separate from the reporting enterprise and from which the employee benefits are paid. The payment of funded benefits when they fall due depends not only on the financial position and the investment performance of the fund but also on an enterprise's ability to make good any shortfall in the fund's assets. Therefore, the enterprise is, in substance, underwriting the actuarial and investment risks associated with the plan. Consequently, the expense recognised for a defined benefit plan is not necessarily the amount of the contribution due for the period.

[3] For applicability of paragraphs 50 to 116 to Small and Medium-sized Companies and Small and Medium-sized Enterprises, refer to the provisos appearing after paragraph 116.

51. Accounting by an enterprise for defined benefit plans involves the following steps:

(a) using actuarial techniques to make a reliable estimate of the amount of benefit that employees have earned in return for their service in the current and prior periods. This requires an enterprise to determine how much benefit is attributable to the current and prior periods (see paragraphs 68-72) and to make estimates (actuarial assumptions) about demographic variables (such as employee turnover and mortality) and financial variables (such as future increases in salaries and medical costs) that will influence the cost of the benefit (see paragraphs 73-91);

(b) discounting that benefit using the Projected Unit Credit Method in order to determine the present value of the defined benefit obligation and the current service cost (see paragraphs 65-67);

(c) determining the fair value of any plan assets (see paragraphs 100-102);

(d) determining the total amount of actuarial gains and losses (see paragraphs 92-93);

(e) where a plan has been introduced or changed, determining the resulting past service cost (see paragraphs 94-99); and

(f) where a plan has been curtailed or settled, determining the resulting gain or loss (see paragraphs 110-116).

Where an enterprise has more than one defined benefit plan, the enterprise applies these procedures for each material plan separately.

52. For measuring the amounts under paragraph 51, in some cases, estimates, averages and simplified computations may provide a reliable approximation of the detailed computations.

Accounting for the Obligation under a Defined Benefit Plan

53. An enterprise should account not only for its legal obligation under the formal terms of a defined benefit plan, but also for any other obligation that arises from the enterprise's informal practices. Informal

practices give rise to an obligation where the enterprise has no realistic alternative but to pay employee benefits. An example of such an obligation is where a change in the enterprise's informal practices would cause unacceptable damage to its relationship with employees.

54. The formal terms of a defined benefit plan may permit an enterprise to terminate its obligation under the plan. Nevertheless, it is usually difficult for an enterprise to cancel a plan if employees are to be retained. Therefore, in the absence of evidence to the contrary, accounting for post-employment benefits assumes that an enterprise which is currently promising such benefits will continue to do so over the remaining working lives of employees.

Balance Sheet

55. The amount recognised as a defined benefit liability should be the net total of the following amounts:

(a) the present value of the defined benefit obligation at the balance sheet date (see paragraph 65);

(b) minus any past service cost not yet recognised (see paragraph 94);

(c) minus the fair value at the balance sheet date of plan assets (if any) out of which the obligations are to be settled directly (see paragraphs 100-102).

56. The present value of the defined benefit obligation is the gross obligation, before deducting the fair value of any plan assets.

57. An enterprise should determine the present value of defined benefit obligations and the fair value of any plan assets with sufficient regularity that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the balance sheet date.

58. The detailed actuarial valuation of the present value of defined benefit obligations may be made at intervals not exceeding three years. However, with a view that the amounts recognised in the financial statements do not

PREVIOUS HOME NEXT

differ materially from the amounts that would be determined at the balance sheet date, the most recent valuation is reviewed at the balance sheet date and updated to reflect any material transactions and other material changes in circumstances (including changes in interest rates) between the date of valuation and the balance sheet date. The fair value of any plan assets is determined at each balance sheet date.

59. The amount determined under paragraph 55 may be negative (an asset). An enterprise should measure the resulting asset at the lower of:

(a) the amount determined under paragraph 55; and

(b) the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan. The present value of these economic benefits should be determined using the discount rate specified in paragraph 78.

60. An asset may arise where a defined benefit plan has been overfunded or in certain cases where actuarial gains are recognised. An enterprise recognises an asset in such cases because:

(a) the enterprise controls a resource, which is the ability to use the surplus to generate future benefits;

(b) that control is a result of past events (contributions paid by the enterprise and service rendered by the employee); and

(c) future economic benefits are available to the enterprise in the form of a reduction in future contributions or a cash refund, either directly to the enterprise or indirectly to another plan in deficit.

Example Illustrating Paragraph 59

	(Amount in Rs.)
A defined benefit plan has the following characteristics:	
Present value of the obligation	1,100
Fair value of plan assets	(1,190)
	(90)
Unrecognised past service cost	(70)
Negative amount determined under paragraph 55	(160)
Present value of available future refunds and	

reductions in future contributions	90
Limit under paragraph 59 (b)	90

Rs. 90 is less than Rs. 160. Therefore, the enterprise recognises an asset of Rs. 90 and discloses that the limit reduced the carrying amount of the asset by Rs. 70 (see paragraph 120(f)(ii)).

Statement of Profit and Loss

61. An enterprise should recognise the net total of the following amounts in the statement of profit and loss, except to the extent that another Accounting Standard requires or permits their inclusion in the cost of an asset:

(a) current service cost (see paragraphs 64-91);

(b) interest cost (see paragraph 82);

(c) the expected return on any plan assets (see paragraphs 107-109) and on any reimbursement rights (see paragraph 103);

(d) actuarial gains and losses (see paragraphs 92-93);

(e) past service cost to the extent that paragraph 94 requires an enterprise to recognise it;

(f) the effect of any curtailments or settlements (see paragraphs 110 and 111); and

(g) the effect of the limit in paragraph 59 (b), i.e., the extent to which the amount determined under paragraph 55 (if negative) exceeds the amount determined under paragraph 59 (b).

62. Other Accounting Standards require the inclusion of certain employee benefit costs within the cost of assets such as tangible fixed assets (see AS 10 *Accounting for Fixed Assets*). Any post-employment benefit costs included in the cost of such assets include the appropriate proportion of the components listed in paragraph 61.

Illustration

63. Illustration I attached to the Standard illustrates describing the components of the amounts recognised in the balance sheet and statement of profit and loss in respect of defined benefit plans.

Recognition and Measurement: Present Value of Defined Benefit Obligations and Current Service Cost

64. The ultimate cost of a defined benefit plan may be influenced by many variables, such as final salaries, employee turnover and mortality, medical cost trends and, for a funded plan, the investment earnings on the plan assets. The ultimate cost of the plan is uncertain and this uncertainty is likely to persist over a long period of time. In order to measure the present value of the post-employment benefit obligations and the related current service cost, it is necessary to:

(a) apply an actuarial valuation method (see paragraphs 65-67);

(b) attribute benefit to periods of service (see paragraphs 68-72); and

(c) make actuarial assumptions (see paragraphs 73-91).

Actuarial Valuation Method

65. An enterprise should use the Projected Unit Credit Method to determine the present value of its defined benefit obligations and the related current service cost and, where applicable, past service cost.

66. The Projected Unit Credit Method (sometimes known as the accrued benefit method pro-rated on service or as the benefit/years of service method) considers each period of service as giving rise to an additional unit of benefit entitlement (see paragraphs 68-72) and measures each unit separately to build up the final obligation (see paragraphs 73-91).

67. An enterprise discounts the whole of a post-employment benefit obligation, even if part of the obligation falls due within twelve months of the balance sheet date.

Example Illustrating Paragraph 66

A lump sum benefit, equal to 1% of final salary for each year of service, is payable on termination of service. The salary in year 1 is Rs. 10,000 and is assumed to increase at 7% (compound) each year resulting in Rs. 13,100 at the end of year 5. The discount rate used is 10% per annum. The following table shows how the obligation builds up for an employee who is expected to leave at the end of year 5, assuming that there are no changes in actuarial assumptions. For simplicity, this example ignores the additional adjustment needed to reflect the probability that the employee may leave the enterprise at an earlier or later date.

(Amount in Rs.)

Year	*1*	*2*	*3*	*4*	*5*
Benefit attributed to:					
- prior years	*0*	*131*	*262*	*393*	*524*
- current year (1% of final salary)	*131*	*131*	*131*	*131*	*131*
- current and prior years	*131*	*262*	*393*	*524*	*655*
Opening Obligation (see note 1)	*-*	*89*	*196*	*324*	*476*
Interest at 10%	*-*	*9*	*20*	*33*	*48*
Current Service Cost (see note 2)	*89*	*98*	*108*	*119*	*131*
Closing Obligation (see note 3)	*89*	*196*	*324*	*476*	*655*

Notes:

1. *The Opening Obligation is the present value of benefit attributed to prior years.*
2. *The Current Service Cost is the present value of benefit attributed to the current year.*
3. *The Closing Obligation is the present value of benefit attributed to current and prior years.*

Attributing Benefit to Periods of Service

68. In determining the present value of its defined benefit obligations and the related current service cost and, where applicable, past service cost, an enterprise should attribute benefit to periods of service under the plan's benefit formula. However, if an employee's service in later

PREVIOUS HOME NEXT

years will lead to a materially higher level of benefit than in earlier years, an enterprise should attribute benefit on a straight-line basis from:

(a) the date when service by the employee first leads to benefits under the plan (whether or not the benefits are conditional on further service); until

(b) the date when further service by the employee will lead to no material amount of further benefits under the plan, other than from further salary increases.

69. The Projected Unit Credit Method requires an enterprise to attribute benefit to the current period (in order to determine current service cost) and the current and prior periods (in order to determine the present value of defined benefit obligations). An enterprise attributes benefit to periods in which the obligation to provide post-employment benefits arises. That obligation arises as employees render services in return for post-employment benefits which an enterprise expects to pay in future reporting periods. Actuarial techniques allow an enterprise to measure that obligation with sufficient reliability to justify recognition of a liability.

Examples Illustrating Paragraph 69

1. A defined benefit plan provides a lump-sum benefit of Rs. 100 payable on retirement for each year of service.

   A benefit of Rs. 100 is attributed to each year. The current service cost is the present value of Rs. 100. The present value of the defined benefit obligation is the present value of Rs. 100, multiplied by the number of years of service up to the balance sheet date.

   If the benefit is payable immediately when the employee leaves the enterprise, the current service cost and the present value of the defined benefit obligation reflect the date at which the employee is expected to leave. Thus, because of the effect of discounting, they are less than the amounts that would be determined if the employee left at the balance sheet date.

2. A plan provides a monthly pension of 0.2% of final salary for each year of service. The pension is payable from the age of 60.

> *Benefit equal to the present value, at the expected retirement date, of a monthly pension of 0.2% of the estimated final salary payable from the expected retirement date until the expected date of death is attributed to each year of service. The current service cost is the present value of that benefit. The present value of the defined benefit obligation is the present value of monthly pension payments of 0.2% of final salary, multiplied by the number of years of service up to the balance sheet date. The current service cost and the present value of the defined benefit obligation are discounted because pension payments begin at the age of 60.*

70. Employee service gives rise to an obligation under a defined benefit plan even if the benefits are conditional on future employment (in other words they are not vested). Employee service before the vesting date gives rise to an obligation because, at each successive balance sheet date, the amount of future service that an employee will have to render before becoming entitled to the benefit is reduced. In measuring its defined benefit obligation, an enterprise considers the probability that some employees may not satisfy any vesting requirements. Similarly, although certain post-employment benefits, for example, post-employment medical benefits, become payable only if a specified event occurs when an employee is no longer employed, an obligation is created when the employee renders service that will provide entitlement to the benefit if the specified event occurs. The probability that the specified event will occur affects the measurement of the obligation, but does not determine whether the obligation exists.

Examples Illustrating Paragraph 70

1. A plan pays a benefit of Rs. 100 for each year of service. The benefits vest after ten years of service.

   A benefit of Rs. 100 is attributed to each year. In each of the first ten years, the current service cost and the present value of the obligation reflect the probability that the employee may not complete ten years of service.

2. A plan pays a benefit of Rs. 100 for each year of service, excluding service before the age of 25. The benefits vest immediately.

No benefit is attributed to service before the age of 25 because service before that date does not lead to benefits (conditional or unconditional). A benefit of Rs. 100 is attributed to each subsequent year.

71. The obligation increases until the date when further service by the employee will lead to no material amount of further benefits. Therefore, all benefit is attributed to periods ending on or before that date. Benefit is attributed to individual accounting periods under the plan's benefit formula. However, if an employee's service in later years will lead to a materially higher level of benefit than in earlier years, an enterprise attributes benefit on a straight-line basis until the date when further service by the employee will lead to no material amount of further benefits. That is because the employee's service throughout the entire period will ultimately lead to benefit at that higher level.

Examples Illustrating Paragraph 71

1. A plan pays a lump-sum benefit of Rs. 1,000 that vests after ten years of service. The plan provides no further benefit for subsequent service.

   A benefit of Rs. 100 (Rs. 1,000 divided by ten) is attributed to each of the first ten years. The current service cost in each of the first ten years reflects the probability that the employee may not complete ten years of service. No benefit is attributed to subsequent years.

2. A plan pays a lump-sum retirement benefit of Rs. 2,000 to all employees who are still employed at the age of 50 after twenty years of service, or who are still employed at the age of 60, regardless of their length of service.

   For employees who join before the age of 30, service first leads to benefits under the plan at the age of 30 (an employee could leave at the age of 25 and return at the age of 28, with no effect on the amount or timing of benefits). Those benefits are conditional on further service. Also, service beyond the age of 50 will lead to no material amount of further benefits. For these employees, the enterprise attributes benefit of Rs. 100 (Rs. 2,000 divided by 20) to each year from the age of 30 to the age of 50.

For employees who join between the ages of 30 and 40, service beyond twenty years will lead to no material amount of further benefits. For these employees, the enterprise attributes benefit of Rs. 100 (Rs. 2,000 divided by 20) to each of the first twenty years.

For an employee who joins at the age of 50, service beyond ten years will lead to no material amount of further benefits. For this employee, the enterprise attributes benefit of Rs. 200 (Rs. 2,000 divided by 10) to each of the first ten years.

For all employees, the current service cost and the present value of the obligation reflect the probability that the employee may not complete the necessary period of service.

3. A post-employment medical plan reimburses 40% of an employee's post-employment medical costs if the employee leaves after more than ten and less than twenty years of service and 50% of those costs if the employee leaves after twenty or more years of service.

   Under the plan's benefit formula, the enterprise attributes 4% of the present value of the expected medical costs (40% divided by ten) to each of the first ten years and 1% (10% divided by ten) to each of the second ten years. The current service cost in each year reflects the probability that the employee may not complete the necessary period of service to earn part or all of the benefits. For employees expected to leave within ten years, no benefit is attributed.

4. A post-employment medical plan reimburses 10% of an employee's post-employment medical costs if the employee leaves after more than ten and less than twenty years of service and 50% of those costs if the employee leaves after twenty or more years of service.

   Service in later years will lead to a materially higher level of benefit than in earlier years. Therefore, for employees expected to leave after twenty or more years, the enterprise attributes benefit on a straight-line basis under paragraph 69. Service beyond twenty years will lead to no material amount of further benefits. Therefore, the benefit attributed to each of the first twenty years is 2.5% of *the present value of the expected medical costs (50% divided by twenty).*

For employees expected to leave between ten and twenty years, the benefit attributed to each of the first ten years is 1% of the present value of the expected medical costs. For these employees, no benefit is attributed to service between the end of the tenth year and the estimated date of leaving.

For employees expected to leave within ten years, no benefit is attributed.

72. Where the amount of a benefit is a constant proportion of final salary for each year of service, future salary increases will affect the amount required to settle the obligation that exists for service before the balance sheet date, but do not create an additional obligation. Therefore:

(a) for the purpose of paragraph 68(b), salary increases do not lead to further benefits, even though the amount of the benefits is dependent on final salary; and

(b) the amount of benefit attributed to each period is a constant proportion of the salary to which the benefit is linked.

Example Illustrating Paragraph 72

Employees are entitled to a benefit of 3% of final salary for each year of service before the age of 55.

Benefit of 3% of estimated final salary is attributed to each year up to the age of 55. This is the date when further service by the employee will lead to no material amount of further benefits under the plan. No benefit is attributed to service after that age.

Actuarial Assumptions

73. Actuarial assumptions comprising demographic assumptions and financial assumptions should be unbiased and mutually compatible. Financial assumptions should be based on market expectations, at the

balance sheet date, for the period over which the obligations are to be settled.

74. Actuarial assumptions are an enterprise's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits. Actuarial assumptions comprise:

(a) demographic assumptions about the future characteristics of current and former employees (and their dependants) who are eligible for benefits. Demographic assumptions deal with matters such as:

(i) mortality, both during and after employment;

(ii) rates of employee turnover, disability and early retirement;

(iii) the proportion of plan members with dependants who will be eligible for benefits; and

(iv) claim rates under medical plans; and

(b) financial assumptions, dealing with items such as:

(i) the discount rate (see paragraphs 78-82);

(ii) future salary and benefit levels (see paragraphs 83-87);

(iii) in the case of medical benefits, future medical costs, including, where material, the cost of administering claims and benefit payments (see paragraphs 88-91); and

(iv) the expected rate of return on plan assets (see paragraphs 107-109).

75. Actuarial assumptions are unbiased if they are neither imprudent nor excessively conservative.

76. Actuarial assumptions are mutually compatible if they reflect the economic relationships between factors such as inflation, rates of salary increase, the return on plan assets and discount rates. For example, all assumptions which depend on a particular inflation level (such as assumptions about interest rates and salary and benefit increases) in any given future period assume the same inflation level in that period.

77. An enterprise determines the discount rate and other financial assumptions in nominal (stated) terms, unless estimates in real (inflation-adjusted) terms are more reliable, for example, where the benefit is index-linked and there is a deep market in index-linked bonds of the same currency and term.

Actuarial Assumptions: Discount Rate

78. The rate used to discount post-employment benefit obligations (both funded and unfunded) should be determined by reference to market yields at the balance sheet date on government bonds. The currency and term of the government bonds should be consistent with the currency and estimated term of the post-employment benefit obligations.

79. One actuarial assumption which has a material effect is the discount rate. The discount rate reflects the time value of money but not the actuarial or investment risk. Furthermore, the discount rate does not reflect the enterprise-specific credit risk borne by the enterprise's creditors, nor does it reflect the risk that future experience may differ from actuarial assumptions.

80. The discount rate reflects the estimated timing of benefit payments. In practice, an enterprise often achieves this by applying a single weighted average discount rate that reflects the estimated timing and amount of benefit payments and the currency in which the benefits are to be paid.

81. In some cases, there may be no government bonds with a sufficiently long maturity to match the estimated maturity of all the benefit payments. In such cases, an enterprise uses current market rates of the appropriate term to discount shorter term payments, and estimates the discount rate for longer maturities by extrapolating current market rates along the yield curve. The total present value of a defined benefit obligation is unlikely to be particularly sensitive to the discount rate applied to the portion of benefits that is payable beyond the final maturity of the available government bonds.

82. Interest cost is computed by multiplying the discount rate as determined at the start of the period by the present value of the defined benefit obligation throughout that period, taking account of any material changes in the obligation. The present value of the obligation will differ from the liability recognised in the balance sheet because the liability is

recognised after deducting the fair value of any plan assets and because some past service cost are not recognised immediately. [Illustration I attached to the Standard illustrates the computation of interest cost, among other things]

Actuarial Assumptions: Salaries, Benefits and Medical Costs

83. Post-employment benefit obligations should be measured on a basis that reflects:

(a) estimated future salary increases;

(b) the benefits set out in the terms of the plan (or resulting from any obligation that goes beyond those terms) at the balance sheet date; and

(c) estimated future changes in the level of any state benefits that affect the benefits payable under a defined benefit plan, if, and only if, either:

(i) those changes were enacted before the balance sheet date; or

(ii) past history, or other reliable evidence, indicates that those state benefits will change in some predictable manner, for example, in line with future changes in general price levels or general salary levels.

84. Estimates of future salary increases take account of inflation, seniority, promotion and other relevant factors, such as supply and demand in the employment market.

85. If the formal terms of a plan (or an obligation that goes beyond those terms) require an enterprise to change benefits in future periods, the measurement of the obligation reflects those changes. This is the case when, for example:

(a) the enterprise has a past history of increasing benefits, for example, to mitigate the effects of inflation, and there is no indication that this practice will change in the future; or

(b) actuarial gains have already been recognised in the financial statements and the enterprise is obliged, by either the formal terms of a plan (or an obligation that goes beyond those terms) or legislation, to use any surplus in the plan for the benefit of plan participants (see paragraph 96(c)).

86. Actuarial assumptions do not reflect future benefit changes that are not set out in the formal terms of the plan (or an obligation that goes beyond those terms) at the balance sheet date. Such changes will result in:

(a) past service cost, to the extent that they change benefits for service before the change; and

(b) current service cost for periods after the change, to the extent that they change benefits for service after the change.

87. Some post-employment benefits are linked to variables such as the level of state retirement benefits or state medical care. The measurement of such benefits reflects expected changes in such variables, based on past history and other reliable evidence.

88. Assumptions about medical costs should take account of estimated future changes in the cost of medical services, resulting from both inflation and specific changes in medical costs.

89. Measurement of post-employment medical benefits requires assumptions about the level and frequency of future claims and the cost of meeting those claims. An enterprise estimates future medical costs on the basis of historical data about the enterprise's own experience, supplemented where necessary by historical data from other enterprises, insurance companies, medical providers or other sources. Estimates of future medical costs consider the effect of technological advances, changes in health care utilisation or delivery patterns and changes in the health status of plan participants.

90. The level and frequency of claims is particularly sensitive to the age, health status and sex of employees (and their dependants) and may be sensitive to other factors such as geographical location. Therefore, historical data is adjusted to the extent that the demographic mix of the population differs from that of the population used as a basis for the historical data. It

is also adjusted where there is reliable evidence that historical trends will not continue.

91. Some post-employment health care plans require employees to contribute to the medical costs covered by the plan. Estimates of future medical costs take account of any such contributions, based on the terms of the plan at the balance sheet date (or based on any obligation that goes beyond those terms). Changes in those employee contributions result in past service cost or, where applicable, curtailments. The cost of meeting claims may be reduced by benefits from state or other medical providers (see paragraphs 83(c) and 87).

Actuarial Gains and Losses

92. Actuarial gains and losses should be recognised immediately in the statement of profit and loss as income or expense (see paragraph 61).

92A. Paragraph 145(b)(iii) explains the need to consider any unrecognised part of the transitional liability in accounting for subsequent actuarial gains.

93. Actuarial gains and losses may result from increases or decreases in either the present value of a defined benefit obligation or the fair value of any related plan assets. Causes of actuarial gains and losses include, for example:

(a) unexpectedly high or low rates of employee turnover, early retirement or mortality or of increases in salaries, benefits (if the terms of a plan provide for inflationary benefit increases) or medical costs;

(b) the effect of changes in estimates of future employee turnover, early retirement or mortality or of increases in salaries, benefits (if the terms of a plan provide for inflationary benefit increases) or medical costs;

(c) the effect of changes in the discount rate; and

(d) differences between the actual return on plan assets and the expected return on plan assets (see paragraphs 107-109).

Past Service Cost

94. In measuring its defined benefit liability under paragraph 55, an enterprise should recognise past service cost as an expense on a straight-line basis over the average period until the benefits become vested. To the extent that the benefits are already vested immediately following the introduction of, or changes to, a defined benefit plan, an enterprise should recognise past service cost immediately.

95. Past service cost arises when an enterprise introduces a defined benefit plan or changes the benefits payable under an existing defined benefit plan. Such changes are in return for employee service over the period until the benefits concerned are vested. Therefore, past service cost is recognised over that period, regardless of the fact that the cost refers to employee service in previous periods. Past service cost is measured as the change in the liability resulting from the amendment (see paragraph 65).

Example Illustrating Paragraph 95

An enterprise operates a pension plan that provides a pension of 2% of final salary for each year of service. The benefits become vested after five years of service. On 1 January 20X5 the enterprise improves the pension to 2.5% of final salary for each year of service starting from 1 January 20X1. At the date of the improvement, the present value of the additional benefits for service from 1 January 20X1 to 1 January 20X5 is as follows:

Employees with more than five years' service at 1/1/X5	Rs.150
Employees with less than five years' service at 1/1/X5 (average period until vesting: three years)	Rs. 120
	Rs. 270

The enterprise recognises Rs. 150 immediately because those benefits are already vested. The enterprise recognises Rs. 120 on a straight-line basis over three years from 1 January 20X5.

96. Past service cost excludes:

(a) the effect of differences between actual and previously assumed salary increases on the obligation to pay benefits for service in prior years (there is no past service cost because actuarial assumptions allow for projected salaries);

(b) under and over estimates of discretionary pension increases where an enterprise has an obligation to grant such increases (there is no past service cost because actuarial assumptions allow for such increases);

(c) estimates of benefit improvements that result from actuarial gains that have already been recognised in the financial statements if the enterprise is obliged, by either the formal terms of a plan (or an obligation that goes beyond those terms) or legislation, to use any surplus in the plan for the benefit of plan participants, even if the benefit increase has not yet been formally awarded (the resulting increase in the obligation is an actuarial loss and not past service cost, see paragraph 85(b));

(d) the increase in vested benefits (not on account of new or improved benefits) when employees complete vesting requirements (there is no past service cost because the estimated cost of benefits was recognised as current service cost as the service was rendered); and

(e) the effect of plan amendments that reduce benefits for future service (a curtailment).

97. An enterprise establishes the amortisation schedule for past service cost when the benefits are introduced or changed. It would be impracticable to maintain the detailed records needed to identify and implement subsequent changes in that amortisation schedule. Moreover, the effect is likely to be material only where there is a curtailment or settlement. Therefore, an enterprise amends the amortisation schedule for past service cost only if there is a curtailment or settlement.

98. Where an enterprise reduces benefits payable under an existing defined benefit plan, the resulting reduction in the defined benefit liability is recognised as (negative) past service cost over the average period until the reduced portion of the benefits becomes vested.

99. Where an enterprise reduces certain benefits payable under an existing defined benefit plan and, at the same time, increases other benefits payable

under the plan for the same employees, the enterprise treats the change as a single net change.

Recognition and Measurement: Plan Assets

Fair Value of Plan Assets

100. The fair value of any plan assets is deducted in determining the amount recognised in the balance sheet under paragraph 55. When no market price is available, the fair value of plan assets is estimated; for example, by discounting expected future cash flows using a discount rate that reflects both the risk associated with the plan assets and the maturity or expected disposal date of those assets (or, if they have no maturity, the expected period until the settlement of the related obligation).

101. Plan assets exclude unpaid contributions due from the reporting enterprise to the fund, as well as any non-transferable financial instruments issued by the enterprise and held by the fund. Plan assets are reduced by any liabilities of the fund that do not relate to employee benefits, for example, trade and other payables and liabilities resulting from derivative financial instruments.

102. Where plan assets include qualifying insurance policies that exactly match the amount and timing of some or all of the benefits payable under the plan, the fair value of those insurance policies is deemed to be the present value of the related obligations, as described in paragraph 55 (subject to any reduction required if the amounts receivable under the insurance policies are not recoverable in full).

Reimbursements

103. When, and only when, it is virtually certain that another party will reimburse some or all of the expenditure required to settle a defined benefit obligation, an enterprise should recognise its right to reimbursement as a separate asset. The enterprise should measure the asset at fair value. In all other respects, an enterprise should treat that asset in the same way as plan assets. In the statement of profit and loss, the expense relating to a defined benefit plan may be presented net of the amount recognised for a reimbursement.

104. Sometimes, an enterprise is able to look to another party, such as an insurer, to pay part or all of the expenditure required to settle a defined benefit obligation. Qualifying insurance policies, as defined in paragraph 7, are plan assets. An enterprise accounts for qualifying insurance policies in the same way as for all other plan assets and paragraph 103 does not apply (see paragraphs 40-43 and 102).

105. When an insurance policy is not a qualifying insurance policy, that insurance policy is not a plan asset. Paragraph 103 deals with such cases: the enterprise recognises its right to reimbursement under the insurance policy as a separate asset, rather than as a deduction in determining the defined benefit liability recognised under paragraph 55; in all other respects, including for determination of the fair value, the enterprise treats that asset in the same way as plan assets. Paragraph 120(f)(iii) requires the enterprise to disclose a brief description of the link between the reimbursement right and the related obligation.

Example Illustrating Paragraphs 103-105

	(Amount in Rs.)
Liability recognised in balance sheet being the present value of obligation	1,258
Rights under insurance policies that exactly match the amount and timing of some of the benefits payable under the plan.	
Those benefits have a present value of Rs. 1,092	1,092

106. If the right to reimbursement arises under an insurance policy that exactly matches the amount and timing of some or all of the benefits payable under a defined benefit plan, the fair value of the reimbursement right is deemed to be the present value of the related obligation, as described in paragraph 55 (subject to any reduction required if the reimbursement is not recoverable in full).

Return on Plan Assets

107. The expected return on plan assets is a component of the expense recognised in the statement of profit and loss. The difference between the expected return on plan assets and the actual return on plan assets is an actuarial gain or loss.

108. The expected return on plan assets is based on market expectations, at the beginning of the period, for returns over the entire life of the related obligation. The expected return on plan assets reflects changes in the fair value of plan assets held during the period as a result of actual contributions paid into the fund and actual benefits paid out of the fund.

109. In determining the expected and actual return on plan assets, an enterprise deducts expected administration costs, other than those included in the actuarial assumptions used to measure the obligation.

Example Illustrating Paragraph 108

At 1 January 20X1, the fair value of plan assets was Rs. 10,000. On 30 June 20X1, the plan paid benefits of Rs. 1,900 and received contributions of Rs. 4,900. At 31 December 20X1, the fair value of plan assets was Rs. 15,000 and the present value of the defined benefit obligation was Rs. 14,792. Actuarial losses on the obligation for 20X1 were Rs. 60.

At 1 January 20X1, the reporting enterprise made the following estimates, based on market prices at that date:

	%
Interest and dividend income, after tax payable by the fund	9.25
Realised and unrealised gains on plan assets (after tax)	2.00
Administration costs	(1.00)
Expected rate of return	10.25

For 20X1, the expected and actual return on plan assets are as follows:

	(Amount in Rs.)
Return on Rs. 10,000 held for 12 months at 10.25%	*1,025*
Return on Rs. 3,000 held for six months at 5% (equivalent to 10.25% annually, compounded every six months)	*150*
Expected return on plan assets for 20X1	*1,175*
Fair value of plan assets at 31 December 20X1	*15,000*
Less fair value of plan assets at 1 January 20X1	*(10,000)*
Less contributions received	*(4,900)*
Add benefits paid	*1,900*
Actual return on plan assets	*2,000*

The difference between the expected return on plan assets (Rs. 1,175) and the actual return on plan assets (Rs. 2,000) is an actuarial gain of Rs. 825. Therefore, the net actuarial gain of Rs. 765 (Rs. 825 – Rs. 60 (actuarial loss on the obligation)) would be recognised in the statement of profit and loss.

The expected return on plan assets for 20X2 will be based on market expectations at 1/1/X2 for returns over the entire life of the obligation.

Curtailments and Settlements

110. An enterprise should recognise gains or losses on the curtailment or settlement of a defined benefit plan when the curtailment or settlement occurs. The gain or loss on a curtailment or settlement should comprise:

- ***(a) any resulting change in the present value of the defined benefit obligation;***
- ***(b) any resulting change in the fair value of the plan assets;***
- ***(c) any related past service cost that, under paragraph 94, had not previously been recognised.***

111. Before determining the effect of a curtailment or settlement, an enterprise should remeasure the obligation (and the related plan assets, if any) using current actuarial assumptions (including current market interest rates and other current market prices).

112. A curtailment occurs when an enterprise either:

- (a) has a present obligation, arising from the requirement of a statute/ regulator or otherwise, to make a material reduction in the number of employees covered by a plan; or
- (b) amends the terms of a defined benefit plan such that a material element of future service by current employees will no longer qualify for benefits, or will qualify only for reduced benefits.

A curtailment may arise from an isolated event, such as the closing of a plant, discontinuance of an operation or termination or suspension of a plan. An event is material enough to qualify as a curtailment if the recognition of a curtailment gain or loss would have a material effect on the financial statements. Curtailments are often linked with a restructuring. Therefore, an enterprise accounts for a curtailment at the same time as for a related restructuring.

113. A settlement occurs when an enterprise enters into a transaction that eliminates all further obligations for part or all of the benefits provided under a defined benefit plan, for example, when a lump-sum cash payment is made to, or on behalf of, plan participants in exchange for their rights to receive specified post-employment benefits.

114. In some cases, an enterprise acquires an insurance policy to fund some or all of the employee benefits relating to employee service in the current and prior periods. The acquisition of such a policy is not a settlement if the enterprise retains an obligation (see paragraph 40) to pay further amounts if the insurer does not pay the employee benefits specified in the insurance policy. Paragraphs 103-106 deal with the recognition and measurement of reimbursement rights under insurance policies that are not plan assets.

115. A settlement occurs together with a curtailment if a plan is terminated such that the obligation is settled and the plan ceases to exist. However, the termination of a plan is not a curtailment or settlement if the plan is replaced by a new plan that offers benefits that are, in substance, identical.

116. Where a curtailment relates to only some of the employees covered by a plan, or where only part of an obligation is settled, the gain or loss includes a proportionate share of the previously unrecognised past service cost (and of transitional amounts remaining unrecognised under paragraph 145(b)). The proportionate share is determined on the basis of the present value of the obligations before and after the curtailment or settlement, unless another basis is more rational in the circumstances.

Example Illustrating Paragraph 116

An enterprise discontinues a business segment and employees of the discontinued segment will earn no further benefits. This is a curtailment without a settlement. Using current actuarial assumptions (including current market interest rates and other current market prices) immediately before the curtailment, the enterprise has a defined benefit obligation with a net present value of Rs. 1,000 and plan assets with a fair value of Rs. 820 and unrecognised past service cost of Rs. 50. The enterprise had first adopted this Standard one year before. This increased the net liability by Rs. 100, which the enterprise chose to recognise over five years (see paragraph 145(b)). The curtailment reduces the net present value of the obligation by Rs. 100 to Rs. 900.

Of the previously unrecognised past service cost and transitional amounts, 10% (Rs. 100/Rs. 1000) relates to the part of the obligation that was eliminated through the curtailment. Therefore, the effect of the curtailment is as follows:

(Amount in Rs.)

	Before curtailment	*Curtailment gain*	*After curtailment*
Net present value of obligation	*1,000*	*(100)*	*900*
Fair value of plan assets	*(820)*	*-*	*(820)*
	180	*(100)*	*80*
Unrecognised past service cost	*(50)*	*5*	*(45)*
Unrecognised transitional amount (100x4/5)	*(80)*	*8*	*(72)*
Net liability recognised in balance sheet	*(50)*	*(87)*	*(37)*

An asset of Rs. 37 will be recognised (it is assumed that the amount under paragraph 59(b) is higher than Rs. 37).

Provided that a Small and Medium-sized Company as defined in Appendix I to this Compendium and a Small and Medium-sized Enterprise (Levels II and III non-corporate entities), as defined in Appendix I to this Compendium, whose average number of persons employed during the year is 50 or more, may not apply the recognition and measurement principles laid down in paragraphs 50 to 116 in respect of accounting for defined benefit plans. However, such companies/enterprises should actuarially determine and provide for accrued liability in respect of defined benefit plans as follows:

- ***The method used for acturial valuation should be the Projected Unit Credit Method; and***

- ***The discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standards.***

Provided further that a Small and Medium-sized Enterprise (Levels II and III non-corporate entities), as defined in Appendix 1 to this Compendium, whose average number of persons employed during the year is less than 50 may not apply the recognition and measurement principles as laid down in paragraphs 50 to 116 in respect of accounting for defined benefit plans. However, such enterprises may calculate and account for the accrued liability under the defined benefit plans by reference to some other rational method, e.g., a method based on the assumption that such benefits are payable to all employees at the end of the accounting year.

Presentation

Offset

117. An enterprise should offset an asset relating to one plan against a liability relating to another plan when, and only when, the enterprise:

(a) has a legally enforceable right to use a surplus in one plan to settle obligations under the other plan; and

(b) intends either to settle the obligations on a net basis, or to realise the surplus in one plan and settle its obligation under the other plan simultaneously.

Financial Components of Post-employment Benefit Costs

118. This Standard does not specify whether an enterprise should present current service cost, interest cost and the expected return on plan assets as components of a single item of income or expense on the face of the statement of profit and loss.

Provided that a Small and Medium-sized company and Small and Medium-sized Enterprise (Levels II and III non-corporate entities), as defined in Appendix 1 to this Compendium, may not apply the pesentation requirements laid down in paragraphs 117 to 118 of the Standard in respect of accounting for defined benefit plans.

Disclosure

119. An enterprise should disclose information that enables users of financial statements to evaluate the nature of its defined benefit plans and the financial effects of changes in those plans during the period.

120. An enterprise should disclose the following information about defined benefit plans:

(a) the enterprise's accounting policy for recognising actuarial gains and losses.

(b) a general description of the type of plan.

(c) a reconciliation of opening and closing balances of the present value of the defined benefit obligation showing separately, if applicable, the effects during the period attributable to each of the following:

(i) current service cost,

(ii) interest cost,

(iii) contributions by plan participants,

(iv) actuarial gains and losses,

(v) foreign currency exchange rate changes on plans measured in a currency different from the enterprise's reporting currency,

(vi) benefits paid,

(vii) past service cost,

(viii) amalgamations,

(ix) curtailments, and

(x) settlements.

(d) an analysis of the defined benefit obligation into amounts arising from plans that are wholly unfunded and amounts arising from plans that are wholly or partly funded.

(e) a reconciliation of the opening and closing balances of the fair value of plan assets and of the opening and closing balances of any reimbursement right recognised as an asset in accordance with paragraph 103 showing separately, if applicable, the effects during the period attributable to each of the following:

(i) expected return on plan assets,

(ii) actuarial gains and losses,

(iii) foreign currency exchange rate changes on plans measured in a currency different from the enterprise's reporting currency,

(iv) contributions by the employer,

(v) contributions by plan participants,

(vi) benefits paid,

(vii) amalgamations, and

(viii) settlements.

(f) a reconciliation of the present value of the defined benefit obligation in (c) and the fair value of the plan assets in (e) to the assets and liabilities recognised in the balance sheet, showing at least:

(i) the past service cost not yet recognised in the balance sheet (see paragraph 94);

(ii) any amount not recognised as an asset, because of the limit in paragraph 59(b);

(iii) the fair value at the balance sheet date of any reimbursement right recognised as an asset in accordance with paragraph

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103 (with a brief description of the link between the reimbursement right and the related obligation); and

(iv) the other amounts recognised in the balance sheet.

(g) the total expense recognised in the statement of profit and loss for each of the following, and the line item(s) of the statement of profit and loss in which they are included:

(i) current service cost;

(ii) interest cost;

(iii) expected return on plan assets;

(iv) expected return on any reimbursement right recognised as an asset in accordance with paragraph 103;

(v) actuarial gains and losses;

(vi) past service cost;

(vii) the effect of any curtailment or settlement; and

(viii) the effect of the limit in paragraph 59 (b), i.e., the extent to which the amount determined in accordance with paragraph 55 (if negative) exceeds the amount determined in accordance with paragraph 59 (b).

(h) for each major category of plan assets, which should include, but is not limited to, equity instruments, debt instruments, property, and all other assets, the percentage or amount that each major category constitutes of the fair value of the total plan assets.

(i) the amounts included in the fair value of plan assets for:

(i) each category of the enterprise's own financial instruments; and

(ii) any property occupied by, or other assets used by, the enterprise.

(j) a narrative description of the basis used to determine the overall expected rate of return on assets, including the effect of the major categories of plan assets.

(k) the actual return on plan assets, as well as the actual return on any reimbursement right recognised as an asset in accordance with paragraph 103.

(l) the principal actuarial assumptions used at the balance sheet date, including, where applicable:

(i) the discount rates;

(ii) the expected rates of return on any plan assets for the periods presented in the financial statements;

(iii) the expected rates of return for the periods presented in the financial statements on any reimbursement right recognised as an asset in accordance with paragraph 103;

(iv) medical cost trend rates; and

(v) any other material actuarial assumptions used.

An enterprise should disclose each actuarial assumption in absolute terms (for example, as an absolute percentage) and not just as a margin between different percentages or other variables.

Apart from the above actuarial assumptions, an enterprise should include an assertion under the actuarial assumptions to the effect that estimates of future salary increases, considered in actuarial valuation, take account of inflation, seniority, promotion and other relevant factors, such as supply and demand in the employment market.

(m) the effect of an increase of one percentage point and the effect of a decrease of one percentage point in the assumed medical cost trend rates on:

***(i)** the aggregate of the current service cost and interest cost components of net periodic post-employment medical costs; and*

***(ii)** the accumulated post-employment benefit obligation for medical costs.*

For the purposes of this disclosure, all other assumptions should be held constant. For plans operating in a high inflation environment, the disclosure should be the effect of a percentage increase or decrease in the assumed medical cost trend rate of a significance similar to one percentage point in a low inflation environment.

(n) the amounts for the current annual period and previous four annual periods of:

(i) the present value of the defined benefit obligation, the fair value of the plan assets and the surplus or deficit in the plan; and

(ii) the experience adjustments arising on:

(A) the plan liabilities expressed either as (1) an amount or (2) a percentage of the plan liabilities at the balance sheet date, and

(B) the plan assets expressed either as (1) an amount or (2) a percentage of the plan assets at the balance sheet date.

(o) the employer's best estimate, as soon as it can reasonably be determined, of contributions expected to be paid to the plan during the annual period beginning after the balance sheet date.

121. Paragraph 120(b) requires a general description of the type of plan. Such a description distinguishes, for example, flat salary pension plans from final salary pension plans and from post-employment medical plans. The description of the plan should include informal practices that give rise to other obligations included in the measurement of the defined benefit obligation in accordance with paragraph 53. Further detail is not required.

122. When an enterprise has more than one defined benefit plan, disclosures may be made in total, separately for each plan, or in such groupings as are considered to be the most useful. It may be useful to distinguish groupings by criteria such as the following:

(a) the geographical location of the plans, for example, by distinguishing domestic plans from foreign plans; or

(b) whether plans are subject to materially different risks, for example, by distinguishing flat salary pension plans from final salary pension plans and from post-employment medical plans.

When an enterprise provides disclosures in total for a grouping of plans, such disclosures are provided in the form of weighted averages or of relatively narrow ranges.

123. Paragraph 30 requires additional disclosures about multi-employer defined benefit plans that are treated as if they were defined contribution plans.

124. Where required by AS 18 *Related Party Disclosures* an enterprise discloses information about:

(a) related party transactions with post-employment benefit plans; and

(b) post-employment benefits for key management personnel.

125. Where required by AS 29 *Provisions, Contingent Liabilities and Contingent Assets* an enterprise discloses information about contingent liabilities arising from post-employment benefit obligations.

Illustrative Disclosures

126. Illustration II attached to the Standard contains illustrative disclosures.

Provided that a Small and Medium-sized Company and Small and Medium-sized Enterprise (Levels II and III non-corporate entities), as defined in Appendix 1 to this Compendium, may not apply the disclosure requirements laid down in paragraphs 119 to 123 of the Standard in respect of accounting for defined benefit plans. However, such company/

PREVIOUS HOME NEXT

enteprise, except a Small and Medium-sized Enterprise (Levels II and III non-corporate entities) whose average number of persons employed during the year are less than 50, should disclose actuarial assumptions as per paragraph 120(1) of the Standard.

Other Long-term Employee Benefits

127. Other long-term employee benefits include, for example:

(a) long-term compensated absences such as long-service or sabbatical leave;

(b) jubilee or other long-service benefits;

(c) long-term disability benefits;

(d) profit-sharing and bonuses payable twelve months or more after the end of the period in which the employees render the related service; and

(e) deferred compensation paid twelve months or more after the end of the period in which it is earned.

128. In case of other long-term employee benefits, the introduction of, or changes to, other long-term employee benefits rarely causes a material amount of past service cost. For this reason, this Standard requires a simplified method of accounting for other long-term employee benefits. This method differs from the accounting required for post-employment benefits insofar as that all past service cost is recognised immediately.

Recognition and Measurement

129. The amount recognised as a liability for other long-term employee benefits should be the net total of the following amounts:

(a) the present value of the defined benefit obligation at the balance sheet date (see paragraph 65);

(b) minus the fair value at the balance sheet date of plan assets (if any) out of which the obligations are to be settled directly (see paragraphs 100-102).

In measuring the liability, an enterprise should apply paragraphs 49-91, excluding paragraphs 55 and 61. An enterprise should apply paragraph 103 in recognising and measuring any reimbursement right.

130. For other long-term employee benefits, an enterprise should recognise the net total of the following amounts as expense or (subject to paragraph 59) income, except to the extent that another Accounting Standard requires or permits their inclusion in the cost of an asset:

(a) current service cost (see paragraphs 64-91);

(b) interest cost (see paragraph 82);

(c) the expected return on any plan assets (see paragraphs 107-109) and on any reimbursement right recognised as an asset (see paragraph 103);

(d) actuarial gains and losses, which should all be recognised immediately;

(e) past service cost, which should all be recognised immediately; and

(f) the effect of any curtailments or settlements (see paragraphs 110 and 111).

131. One form of other long-term employee benefit is long-term disability benefit. If the level of benefit depends on the length of service, an obligation arises when the service is rendered. Measurement of that obligation reflects the probability that payment will be required and the length of time for which payment is expected to be made. If the level of benefit is the same for any disabled employee regardless of years of service, the expected cost of those benefits is recognised when an event occurs that causes a long-term disability.

Provided that a Small and Medium-sized Company as defined in Appendix I to this Compendium and a Small and Medium-sized Enterprise (Levels II and III non-corporate entities), as defined in Appendix I to this Compendium, whose average number of persons employed during the

year is 50 or more, may not apply the recognition and measurement principles laid down in paragraphs 129 to 131 in respect of accounting for other long-term employee benefits. However, such companies/ enterprises should actuarially determine and provide for accrued liability in respect of other long-term employee benefits as follows:

- ***The method used for acturial valuation should be the Projected Unit Credit Method; and***
- ***The discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard.***

Provided further that a Small and Medium-sized Enterprise (Levels II and III non-corporate entities), as defined in Appendix I to this Compendium, whose average number of persons employed during the year is less than 50 may not apply the recognition and measurement principles as laid down in paragraphs 129 to 131 in respect of accounting for other long-term employee benefits. However, such enterprises may calculate and account for the accrued liability under the other long-term employee benefits by reference to some other rational method, e.g., a method based on the assumption that such benefits are payable to all employees at the end of the accounting year.

Disclosure

132. Although this Standard does not require specific disclosures about other long-term employee benefits, other Accounting Standards may require disclosures, for example, where the expense resulting from such benefits is of such size, nature or incidence that its disclosure is relevant to explain the performance of the enterprise for the period (see AS 5 *Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies*). Where required by AS 18 *Related Party Disclosures* an enterprise discloses information about other long-term employee benefits for key management personnel.

Termination Benefits

133. This Standard deals with termination benefits separately from other employee benefits because the event which gives rise to an obligation is the termination rather than employee service.

Recognition

134. An enterprise should recognise termination benefits as a liability and an expense when, and only when:

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

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

(c) a reliable estimate can be made of the amount of the obligation.

135. An enterprise may be committed, by legislation, by contractual or other agreements with employees or their representatives or by an obligation based on business practice, custom or a desire to act equitably, to make payments (or provide other benefits) to employees when it terminates their employment. Such payments are termination benefits. Termination benefits are typically lump-sum payments, but sometimes also include:

(a) enhancement of retirement benefits or of other post-employment benefits, either indirectly through an employee benefit plan or directly; and

(b) salary until the end of a specified notice period if the employee renders no further service that provides economic benefits to the enterprise.

136. Some employee benefits are payable regardless of the reason for the employee's departure. The payment of such benefits is certain (subject to any vesting or minimum service requirements) but the timing of their payment is uncertain. Although such benefits may be described as termination indemnities, or termination gratuities, they are post-employment benefits, rather than termination benefits and an enterprise accounts for them as post-employment benefits. Some enterprises provide a lower level of benefit for voluntary termination at the request of the employee (in substance, a post-employment benefit) than for involuntary termination at the request of the enterprise. The additional benefit payable on involuntary termination is a termination benefit.

137. Termination benefits are recognised as an expense immediately.

138. Where an enterprise recognises termination benefits, the enterprise may also have to account for a curtailment of retirement benefits or other employee benefits (see paragraph 110).

Measurement

139. Where termination benefits fall due more than 12 months after the balance sheet date, they should be discounted using the discount rate specified in paragraph 78.

Provided that a Small and Medium-sized Company and a Small and Medium-sized Enterprise (Levels II and III non-corporate entities), as defined in Appendix I to this Compendium, may not discount amounts that fall due more than 12 months after the balance sheet date.

Disclosure

140. Where there is uncertainty about the number of employees who will accept an offer of termination benefits, a contingent liability exists. As required by AS 29, *Provisions, Contingent Liabilities and Contingent Assets* an enterprise discloses information about the contingent liability unless the possibility of an outflow in settlement is remote.

141. As required by AS 5, *Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies* an enterprise discloses the nature and amount of an expense if it is of such size, nature or incidence that its disclosure is relevant to explain the performance of the enterprise for the period. Termination benefits may result in an expense needing disclosure in order to comply with this requirement.

142. Where required by AS 18, *Related Party Disclosures* an enterprise discloses information about termination benefits for key management personnel.

Transitional Provisions

142 A. An enterprise may disclose the amounts required by paragraph 120(n) as the amounts are determined for each accounting period prospectively from the date the enterprise first adopts this Standard.

Employee Benefits other than Defined Benefit Plans and Termination Benefits

143. Where an enterprise first adopts this Standard for employee benefits, the difference (as adjusted by any related tax expense) between the liability in respect of employee benefits other than defined benefit plans and termination benefits, as per this Standard, existing on the date of adopting this Standard and the liability that would have been recognised at the same date, as per the pre-revised AS 15, should be adjusted against opening balance of revenue reserves and surplus.

Defined Benefit Plans

144. On first adopting this Standard, an enterprise should determine its transitional liability for defined benefit plans at that date as:

(a) the present value of the obligation (see paragraph 65) at the date of adoption;

(b) minus the fair value, at the date of adoption, of plan assets (if any) out of which the obligations are to be settled directly (see paragraphs 100-102);

(c) minus any past service cost that, under paragraph 94, should be recognised in later periods.

145. If the transitional liability is more than the liability that would have been recognised at the same date as per the pre-revised AS 15, the enterprise should make an irrevocable choice to recognise that increase as part of its defined benefit liability under paragraph 55:

(a) immediately as an adjustment against the opening balance of revenue reserves and surplus (as adjusted by any related tax expense), or

(b) as an expense on a straight-line basis over up to five years from the date of adoption.

If an enterprise chooses (b), the enterprise should:

***(i)** apply the limit described in paragraph 59(b) in measuring any asset recognised in the balance sheet;*

***(ii)** disclose at each balance sheet date (1) the amount of the increase that remains unrecognised; and (2) the amount recognised in the current period;*

***(iii)** limit the recognition of subsequent actuarial gains (but not negative past service cost) only to the extent that the net cumulative unrecognised actuarial gains (before recognition of that actuarial gain) exceed the unrecognised part of the transitional liability; and*

***(iv)** include the related part of the unrecognised transitional liability in determining any subsequent gain or loss on settlement or curtailment.*

If the transitional liability is less than the liability that would have been recognised at the same date as per the pre-revised AS 15, the enterprise should recognise that decrease immediately as an adjustment against the opening balance of revenue reserves and surplus.

Example Illustrating Paragraphs 144 and 145

At 31 March 20X7, an enterprise's balance sheet includes a pension liability of Rs. 100, recognised as per the pre-revised AS 15. The enterprise adopts the Standard as of 1 April 20X7, when the present value of the obligation under the Standard is Rs. 1,300 and the fair value of plan assets is Rs. 1,000. On 1 April 20X1, the enterprise had improved pensions (cost for non-vested benefits: Rs. 160; and average remaining period at that date until vesting: 10 years).

	(Amount in Rs.)
The transitional effect is as follows:	
Present value of the obligation	*1,300*
Fair value of plan assets	*(1,000)*
Less: past service cost to be recognised in later periods (160 x 4/10)	*(64)*
Transitional liability	*236*
Liability already recognised	*100*
Increase in liability	*136*

PREVIOUS HOME NEXT

An enterprise may choose to recognise the increase in liability (as adjusted by any related tax expense) *either immediately as an adjustment against the opening balance of revenue reserves and surplus as on 1 April 20X7 or as an expense on straight line basis over up to five years from that date. The choice is irrevocable.*

At 31 March 20X8, the present value of the obligation under the Standard is Rs. 1,400 and the fair value of plan assets is Rs. 1,050. Net cumulative unrecognised actuarial gains since the date of adopting the Standard are Rs. 120. The enterprise is required, as per paragraph 92, to recognise all actuarial gains and losses immediately.

The effect of the limit in paragraph 145 (b) (iii) is as follows :

	(Amount in Rs.)
Net unrecognised actuarial gain	*120*
Unrecognised part of the transitional liability (136 × 4/5) *(If the enterprise adopts the policy of recognising it over 5 years)*	*109*
Maximum gain to be recognised	*11*

Termination Benefits

146. This Standard requires immediate expensing of expenditure on termination benefits (including expenditure incurred on voluntary retirement scheme (VRS)). However, where an enterprise incurs expenditure on termination benefits on or before 31st March, 2009, the enterprise may choose to follow the accounting policy of deferring such expenditure over its pay-back period. However, the expenditure so deferred cannot be carried forward to accounting periods commencing on or after 1st April, 2010.

Illustration I

Illustration

This illustration is illustrative only and does not form part of the Standard. The purpose of this illustration is to illustrate the application of the Standard to assist in clarifying its meaning. Extracts from statements of profit and loss and balance sheets are provided to show the effects of the transactions described below. These extracts do not necessarily conform with all the disclosure and presentation requirements of other Accounting Standards.

Background Information

The following information is given about a funded defined benefit plan. To keep interest computations simple, all transactions are assumed to occur at the year end. The present value of the obligation and the fair value of the plan assets were both Rs. 1,000 at 1 April, 20X4.

(Amount in Rs.)

	20X4-X5	20X5-X6	20X6-X7
Discount rate at start of year	10.0%	9.0%	8.0%
Expected rate of return on plan assets at start of year	12.0%	11.1%	10.3%
Current service cost	130	140	150
Benefits paid	150	180	190
Contributions paid	90	100	110
Present value of obligation at 31 March	1,141	1,197	1,295
Fair value of plan assets at 31 March	1,092	1,109	1,093
Expected average remaining working lives of employees (years)	10	10	10

In 20X5-X6, the plan was amended to provide additional benefits with effect from 1 April 20X5. The present value as at 1 April 20X5 of additional benefits for employee service before 1 April 20X5 was Rs. 50 for vested benefits and Rs. 30 for non-vested benefits. As at 1 April 20X5, the enterprise estimated that the average period until the non-vested benefits would become vested was three years; the past service cost arising from additional non-vested benefits is therefore recognised on a straight-line basis over three years. The past service cost arising from additional vested benefits is recognised immediately (paragraph 94 of the Standard).

Changes in the Present Value of the Obligation and in the Fair Value of the Plan Assets

The first step is to summarise the changes in the present value of the obligation and in the fair value of the plan assets and use this to determine the amount of the actuarial gains or losses for the period. These are as follows:

(Amount in Rs.)

	20X4-X5	20X5-X6	20X6-X7
Present value of obligation, 1 April	1,000	1,141	1,197
Interest cost	100	103	96
Current service cost	130	140	150
Past service cost – (non vested benefits)	-	30	-
Past service cost – (vested benefits)	-	50	-
Benefits paid	(150)	(180)	(190)
Actuarial (gain) loss on obligation (balancing figure)	61	(87)	42
Present value of obligation, 31 March	1,141	1,197	1,295
Fair value of plan assets, 1 April	1,000	1,092	1,109
Expected return on plan assets	120	121	114
Contributions	90	100	110
Benefits paid	(150)	(180)	(190)
Actuarial gain (loss) on plan assets (balancing figure)	32	(24)	(50)
Fair value of plan assets, 31 March	1,092	1,109	1,093
Total actuarial gain (loss) to be recognised immediately as per the Standard	(29)	63	(92)

Amounts Recognised in the Balance Sheet and Statements of Profit and Loss, and Related Analyses

The final step is to determine the amounts to be recognised in the balance sheet and statement of profit and loss, and the related analyses to be disclosed in accordance with paragraphs 120 (f), (g) and (j) of the Standard (the analyses required to be disclosed in accordance with paragraph 120(c) and (e) are given in the section of this illustration 'Changes in the Present Value of the Obligation and in the Fair Value of the Plan Assets'). These are as follows:

(Amount in Rs.)

	20X4-X5	20X5-X6	20X6-X7
Present value of the obligation	1,141	1,197	1,295
Fair value of plan assets	(1,092)	(1,109)	(1,093)
	49	88	202
Unrecognised past service cost – non vested benefits	-	(20)	(10)
Liability recognised in balance sheet	**49**	**68**	**192**
Current service cost	130	140	150
Interest cost	100	103	96
Expected return on plan assets	(120)	(121)	(114)
Net actuarial (gain) loss recognised in year	29	(63)	92
Past service cost - non-vested benefits	-	10	10
Past service cost - vested benefits	-	50	-
Expense recognised in the statement of profit and loss	**139**	**119**	**234**
Actual return on plan assets:			
Expected return on plan assets	120	121	114
Actuarial gain (loss) on plan assets	32	(24)	(50)
Actual return on plan assets	152	97	64

Note: see example illustrating paragraphs 103-105 for presentation of reimbursements.

Illustration II

Illustrative Disclosures

This illustration is illustrative only and does not form part of the Standard. The purpose of this illustration is to illustrate the application of the Standard to assist in clarifying its meaning. Extracts from notes to the financial statements show how the required disclosures may be aggregated in the case of a large multi-national group that provides a variety of employee benefits. These extracts do not necessarily provide all the information required under the disclosure and presentation requirements of AS 15 (2005) and other Accounting Standards. In particular, they do not illustrate the disclosure of:

(a) accounting policies for employee benefits (see AS 1 Disclosure of Accounting Policies). Paragraph 120(a) of the Standard requires this disclosure to include the enterprise's accounting policy for recognising actuarial gains and losses.

(b) a general description of the type of plan (paragraph 120(b)).

(c) a narrative description of the basis used to determine the overall expected rate of return on assets (paragraph 120(j)).

(d) employee benefits granted to directors and key management personnel (see AS 18 Related Party Disclosures).

Employee Benefit Obligations

The amounts (in Rs.) recognised in the balance sheet are as follows:

	Defined benefit pension plans		Post-employment medical benefits	
	20X5-X6	20X4-X5	20X5-X6	20X4-X5
Present value of funded obligations	20,300	17,400	-	-
Fair value of plan assets	18,420	17,280	-	-
	1,880	120	-	-

Present value of unfunded obligations	2,000	1,000	7,337	6,405
Unrecognised past service cost	(450)	(650)	-	-
Net liability	3,430	470	7,337	6,405
Amounts in the balance sheet:				
Liabilities	3,430	560	7,337	6,405
Assets	-	(90)	-	-
Net liability	3,430	470	7,337	6,405

The pension plan assets include equity shares issued by [name of reporting enterprise] with a fair value of Rs. 317 (20X4-X5: Rs. 281). Plan assets also include property occupied by [name of reporting enterprise] with a fair value of Rs. 200 (20X4-X5: Rs. 185).

The amounts (in Rs.) recognised in the statement of profit and loss are as follows:

	Defined benefit pension plans		Post-employment medical benefits	
	20X5-X6	20X4-X5	20X5-X6	20X4-X5
Current service cost	850	750	479	411
Interest on obligation	950	1,000	803	705
Expected return on plan assets	(900)	(650)		
Net actuarial losses (gains) recognised in year	2,650	(650)	250	400
Past service cost	200	200	-	-
Losses (gains) on curtailments and settlements	175	(390)	-	-
Total, included in 'employee benefit expense'	3,925	260	1,532	1,516
Actual return on plan assets	600	2,250	-	-

Changes in the present value of the defined benefit obligation representing reconciliation of opening and closing balances thereof are as follows:

	Defined benefit pension plans 20X5-X6	Defined benefit pension plans 20X4-X5	Post-employment medical benefits 20X5-X6	Post-employment medical benefits 20X4-X5
Opening defined benefit obligation	18,400	11,600	6,405	5,439
Service cost	850	750	479	411
Interest cost	950	1,000	803	705
Actuarial losses (gains)	2,350	950	250	400
Losses (gains) on curtailments	(500)	-		
Liabilities extinguished on settlements	-	(350)		
Liabilities assumed in an amalgamation in the nature of purchase	-	5,000		
Exchange differences on foreign plans	900	(150)		
Benefits paid	(650)	(400)	(600)	(550)
Closing defined benefit obligation	22,300	18,400	7,337	6,405

Changes in the fair value of plan assets representing reconciliation of the opening and closing balances thereof are as follows:

	Defined benefit pension plans 20X5-X6	Defined benefit pension plans 20X4-X5
Opening fair value of plan assets	17,280	9,200
Expected return	900	650
Actuarial gains and (losses)	(300)	1,600
Assets distributed on settlements	(400)	-
Contributions by employer	700	350
Assets acquired in an amalgamation in the nature of purchase	-	6,000
Exchange differences on foreign plans	890	(120)
Benefits paid	(650)	(400)
	18,420	17,280

The Group expects to contribute Rs. 900 to its defined benefit pension plans in 20X6-X7.

The major categories of plan assets as a percentage of total plan assets are as follows:

	Defined benefit pension plans		Post-employment medical benefits	
	20X5-X6	20X4-X5	20X5-X6	20X4-X5
Government of India Securities	80%	82%	78%	81%
High quality corporate bonds	11%	10%	12%	12%
Equity shares of listed companies	4%	3%	10%	7%
Property	5%	5%	-	-

Principal actuarial assumptions at the balance sheet date (expressed as weighted averages):

	20X5-X6	20X4-X5
Discount rate at 31 March	5.0%	6.5%
Expected return on plan assets at 31 March	5.4%	7.0%
Proportion of employees opting for early retirement	30%	30%
Annual increase in healthcare costs	8%	8%
Future changes in maximum state health care benefits	3%	2%

The estimates of future salary increases, considered in actuarial valuation, take account of inflation, seniority, promotion and other relevant factors, such as supply and demand in the employment market.

Assumed healthcare cost trend rates have a significant effect on the amounts recognised in the statement of profit and loss. At present, healthcare costs, as indicated in the principal actuarial assumption given above, are expected to increase at 8% p.a. A one percentage point change in assumed healthcare cost trend rates would have the following effects on the aggregate of the service cost and interest cost and defined benefit obligation:

	One percentage point increase	One percentage point decrease
Effect on the aggregate of the service cost and interest cost	190	(150)
Effect on defined benefit obligation	1,000	(900)

Amounts for the current and previous four periods are as follows:

Defined benefit pension plans

	20X5-X6	20X4-X5	20X3-X4	20X2-X3	20X1-X2
Defined benefit obligation	(22,300)	(18,400)	(11,600)	(10,582)	(9,144)
Plan assets	18,420	17,280	9,200	8,502	10,000
Surplus/(deficit)	(3,880)	(1,120)	(2,400)	(2,080)	856
Experience adjustments on plan liabilities	(1,111)	(768)	(69)	543	(642)
Experience adjustments on plan assets	(300)	1,600	(1,078)	(2,890)	2,777

Post-employment medical benefits

	20X5-X6	20X4-X5	20X3-X4	20X2-X3	20X1-X2
Defined benefit obligation	7,337	6,405	5,439	4,923	4,221
Experience adjustments on plan liabilities	(232)	829	490	(174)	(103)

The group also participates in an industry-wide defined benefit plan which provides pensions linked to final salaries and is funded in a manner such that contributions are set at a level that is expected to be sufficient to pay the benefits falling due in the same period. It is not practicable to determine the present value of the group's obligation or the related current service cost as the plan computes its obligations on a basis that differs materially from the basis used in [name of reporting enterprise]'s financial statements. [describe basis] On that basis, the plan's financial statements to 30 September 20X3 show an unfunded liability of Rs. 27,525. The unfunded liability will result in future payments by participating employers. The plan has approximately 75,000 members, of whom approximately 5,000 are current or former employees of [name of reporting enterprise] or their dependants. The expense recognised in the statement of profit and loss, which is equal to contributions due for the year, and is not included in the above amounts, was Rs. 230 (20X4-X5: Rs. 215). The group's future contributions may be increased substantially if other enterprises withdraw from the plan.

Accounting Standard (AS) 16
(issued 2000)

Borrowing Costs

Contents

Accounting Standard (AS) 16

(issued 2000)

Borrowing Costs

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

Objective

The objective of this Standard is to prescribe the accounting treatment for borrowing costs.

Scope

1. This Standard should be applied in accounting for borrowing costs.

2. This Standard does not deal with the actual or imputed cost of owners' equity, including preference share capital not classified as a liability.

Definitions

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

3.1 <u>Borrowing costs</u> are interest and other costs incurred by an enterprise in connection with the borrowing of funds.

3.2 A <u>qualifying asset</u> is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

[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.

Explanation:

What constitutes a substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. In estimating the period, time which an asset takes, technologically and commercially, to get it ready for its intended use or sale is considered.

4. Borrowing costs may include:

   (a) interest and commitment charges on bank borrowings and other short-term and long-term borrowings;

   (b) amortisation of discounts or premiums relating to borrowings;

   (c) amortisation of ancillary costs incurred in connection with the arrangement of borrowings;

   (d) finance charges in respect of assets acquired under finance leases or under other similar arrangements; and

   (e) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

Explanation:

Exchange differences arising from foreign currency borrowing and considered as borrowing costs are those exchange differences which arise on the amount of principal of the foreign currency borrowings to the extent of the difference between interest on local currency borrowings and interest on foreign currency borrowings. Thus, the amount of exchange difference not exceeding the difference between interest on local currency borrowings and interest on foreign currency borrowings is considered as borrowings cost to be accounted for under this Standard and the remaining exchange difference, if any, is accounted for under AS 11, The Effect of Changes in Foreign Exchange Rates. For this purpose, the interest rate for the local currency borrowings is considered as that rate at which the enterprise would have raised the borrowings locally had the enterprise not decided to raise the foreign currency borrowings.

The application of this explanation is illustrated in the Illustration attached to the Standard.

5. Examples of qualifying assets are manufacturing plants, power generation facilities, inventories that require a substantial period of time to bring them to a saleable condition, and investment properties. Other investments, and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired also are not qualifying assets.

Recognition

6. Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Standard. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

7. Borrowing costs are capitalised as part of the cost of a qualifying asset when it is probable that they will result in future economic benefits to the enterprise and the costs can be measured reliably. Other borrowing costs are recognised as an expense in the period in which they are incurred.

Borrowing Costs Eligible for Capitalisation

8. The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. When an enterprise borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified.

9. It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided. Such a difficulty occurs, for example, when the financing activity of an enterprise is co-ordinated centrally or when a

range of debt instruments are used to borrow funds at varying rates of interest and such borrowings are not readily identifiable with a specific qualifying asset. As a result, the determination of the amount of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset is often difficult and the exercise of judgement is required.

10. To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

11. The financing arrangements for a qualifying asset may result in an enterprise obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditure on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any income earned on the temporary investment of those borrowings is deducted from the borrowing costs incurred.

12. To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined by applying a capitalisation rate to the expenditure on that asset. The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period.

Excess of the Carrying Amount of the Qualifying Asset over Recoverable Amount

13. When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realisable value, the carrying amount is written down or written off in accordance with the requirements of other Accounting Standards. In certain circumstances, the amount of the write-down or write-off is written back in accordance with those other Accounting Standards.

Commencement of Capitalisation

14. The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when all the following conditions are satisfied:

(a) expenditure for the acquisition, construction or production of a qualifying asset is being incurred;

(b) borrowing costs are being incurred; and

(c) activities that are necessary to prepare the asset for its intended use or sale are in progress.

15. Expenditure on a qualifying asset includes only such expenditure that has resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities. Expenditure is reduced by any progress payments received and grants received in connection with the asset (see Accounting Standard 12, Accounting for Government Grants). The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditure to which the capitalisation rate is applied in that period.

16. The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction, such as the activities associated with obtaining permits prior to the commencement of the physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place. For example, borrowing costs incurred while land is under development are capitalised during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalisation.

Suspension of Capitalisation

17. Capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted.

18. Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Capitalisation of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example, capitalisation continues during the extended period needed for inventories to mature or the extended period during which high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographic region involved.

Cessation of Capitalisation

19. Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

20. An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.

21. When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete.

22. A business park comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being used while construction continues for the other parts. An example of a qualifying asset that needs to be complete before any part can be used is an industrial plant involving several processes which are carried out in sequence at different parts of the plant within the same site, such as a steel mill.

Disclosure

23. The financial statements should disclose:

(a) the accounting policy adopted for borrowing costs; and

(b) the amount of borrowing costs capitalised during the period.

Illustration

Note: This illustration does not form part of the Accounting Standard. Its purpose is to assist in clarifying the meaning of paragraph 4(e) of the Standard.

Facts:

XYZ Ltd. has taken a loan of USD 10,000 on April 1, 20X3, for a specific project at an interest rate of 5% p.a., payable annually. On April 1, 20X3, the exchange rate between the currencies was Rs. 45 per USD. The exchange rate, as at March 31, 20X4, is Rs. 48 per USD. The corresponding amount could have been borrowed by XYZ Ltd. in local currency at an interest rate of 11 per cent annum as on April 1, 20X3.

The following computation would be made to determine the amount of borrowing costs for the purposes of paragraph 4(e) of AS 16:

(i) Interest for the period = USD 10,000 × 5% × Rs. 48/USD = Rs. 24,000.

(ii) Increase in the liability towards the principal amount = USD 10,000 × (48–45) = Rs. 30,000.

(iii) Interest that would have resulted if the loan was taken in Indian currency = USD 10,000 × 45 × 11% = Rs. 49,500.

(iv) Difference between interest on local currency borrowing and foreign currency borrowing = Rs. 49,500 – Rs. 24,000 = Rs. 25,500.

Therefore, out of Rs. 30,000 increase in the liability towards principal amount, only Rs. 25,500 will be considered as the borrowing cost. Thus, total borrowing cost would be Rs. 49,500 being the aggregate of interest of Rs. 24,000 on foreign currency borrowings [covered by paragraph 4(a) of AS 16] plus the exchange difference to the extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of Rs. 25,500. Thus, Rs. 49,500 would be considered as the borrowing cost to be accounted for as per AS 16 and the remaining Rs. 4,500 would be considered as the exchange difference to be accounted for as per Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates.

In the above example, if the interest rate on local currency borrowings is assumed to be 13% instead of 11%, the entire exchange difference of Rs. 30,000 would be considered as borrowing costs, since in that case the difference between the interest on local currency borrowings and foreign currency borrowings [i.e. Rs. 34,500 (Rs. 58,500 – Rs. 24,000)] is more than the exchange difference of Rs. 30,000. Therefore, in such a case, the total borrowing cost would be Rs. 54,000 (Rs. 24,000 + Rs. 30,000) which would be accounted for under AS 16 and there would be no exchange difference to be accounted for under AS 11, The Effects of Changes in Foreign Exchange Rates.

Accounting Standard (AS) 17
(issued 2000)

Segment Reporting

Contents

Accounting Standard (AS) 17
(issued 2000)

Segment Reporting

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

This Accounting Standard is not mandatory for Small and Medium Sized Companies and Small and Medium Sized non-corporate entities falling in Level II and Level III, as defined in Appendix 1 to this Compendium 'Applicability of Accounting Standards to Various Entities'. Such Entities are however encourged to comply with this Standard.

Objective

The objective of this Standard is to establish principles for reporting financial information, about the different types of products and services an enterprise produces and the different geographical areas in which it operates. Such information helps users of financial statements:

(a) better understand the performance of the enterprise;

(b) better assess the risks and returns of the enterprise; and

(c) make more informed judgements about the enterprise as a whole.

Many enterprises provide groups of products and services or operate in geographical areas that are subject to differing rates of profitability, opportunities for growth, future prospects, and risks. Information about different types of products and services of an enterprise and its operations in different geographical areas - often called segment information - is relevant to assessing the risks and returns of a diversified or multi-locational enterprise

[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.

but may not be determinable from the aggregated data. Therefore, reporting of segment information is widely regarded as necessary for meeting the needs of users of financial statements.

Scope

1. This Standard should be applied in presenting general purpose financial statements.

2. The requirements of this Standard are also applicable in case of consolidated financial statements.

3. An enterprise should comply with the requirements of this Standard fully and not selectively.

4. If a single financial report contains both consolidated financial statements and the separate financial statements of the parent, segment information need be presented only on the basis of the consolidated financial statements. In the context of reporting of segment information in consolidated financial statements, the references in this Standard to any financial statement items should construed to be the relevant item as appearing in the consolidated financial statements.

Definitions

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

5.1 A <u>business segment</u> is a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different from those of other business segments. Factors that should be considered in determining whether products or services are related include:

(a) the nature of the products or services;

(b) the nature of the production processes;

(c) the type or class of customers for the products or services;

(d) ***the methods used to distribute the products or provide the services; and***

(e) ***if applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.***

5.2 A <u>geographical segment</u> is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments. Factors that should be considered in identifying geographical segments include:

(a) ***similarity of economic and political conditions;***

(b) ***relationships between operations in different geographical areas;***

(c) ***proximity of operations;***

(d) ***special risks associated with operations in a particular area;***

(e) ***exchange control regulations; and***

(f) ***the underlying currency risks.***

5.3 A <u>reportable segment</u> is a business segment or a geographical segment identified on the basis of foregoing definitions for which segment information is required to be disclosed by this Standard.

5.4 <u>Enterprise revenue</u> is revenue from sales to external customers as reported in the statement of profit and loss.

5.5 <u>Segment revenue</u> is the aggregate of

(i) ***the portion of enterprise revenue that is directly attributable to a segment,***

(ii) ***the relevant portion of enterprise revenue that can be allocated on a reasonable basis to a segment, and***

(iii) ***revenue from transactions with other segments of the enterprise.***

Segment revenue does not include:

(a) extraordinary items as defined in AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies;

(b) interest or dividend income, including interest earned on advances or loans to other segments unless the operations of the segment are primarily of a financial nature; and

(c) gains on sales of investments or on extinguishment of debt unless the operations of the segment are primarily of a financial nature.

5.6 Segment expense is the aggregate of

(i) the expense resulting from the operating activities of a segment that is directly attributable to the segment, and

(ii) the relevant portion of enterprise expense that can be allocated on a reasonable basis to the segment, including expense relating to transactions with other segments of the enterprise.

Segment expense does not include:

(a) extraordinary items as defined in AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies;

(b) interest expense, including interest incurred on advances or loans from other segments, unless the operations of the segment are primarily of a financial nature;

Explanation:

The interest expense relating to overdrafts and other operating liabilities identified to a particular segment are not included as a part of the segment expense unless the operations of the segment are primarily of a financial nature or unless the interest is included as a part of the cost of inventories. In case interest

is included as a part of the cost of inventories where it is so required as per AS 16, Borrowing Costs, read with AS 2, Valuation of Inventories, and those inventories are part of segment assets of a particular segment, such interest is considered as a segment expense. In this case, the amount of such interest and the fact that the segment result has been arrived at after considering such interest is disclosed by way of a note to the segment result.

(c) losses on sales of investments or losses on extinguishment of debt unless the operations of the segment are primarily of a financial nature;

(d) income tax expense; and

(e) general administrative expenses, head-office expenses, and other expenses that arise at the enterprise level and relate to the enterprise as a whole. However, costs are sometimes incurred at the enterprise level on behalf of a segment. Such costs are part of segment expense if they relate to the operating activities of the segment and if they can be directly attributed or allocated to the segment on a reasonable basis.

5.7 Segment result is segment revenue less segment expense.

5.8 Segment assets are those operating assets that are employed by a segment in its operating activities and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis.

If the segment result of a segment includes interest or dividend income, its segment assets include the related receivables, loans, investments, or other interest or dividend generating assets.

Segment assets do not include income tax assets.

Segment assets are determined after deducting related allowances/ provisions that are reported as direct offsets in the balance sheet of the enterprise.

5.9 Segment liabilities are those operating liabilities that result from the

operating activities of a segment and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis.

If the segment result of a segment includes interest expense, its segment liabilities include the related interest-bearing liabilities.

Segment liabilities do not include income tax liabilities.

5.10 Segment accounting policies are the accounting policies adopted for preparing and presenting the financial statements of the enterprise as well as those accounting policies that relate specifically to segment reporting.

6. The factors in paragraph 5 for identifying business segments and geographical segments are not listed in any particular order.

7. A single business segment does not include products and services with significantly differing risks and returns. While there may be dissimilarities with respect to one or several of the factors listed in the definition of business segment, the products and services included in a single business segment are expected to be similar with respect to a majority of the factors.

8. Similarly, a single geographical segment does not include operations in economic environments with significantly differing risks and returns. A geographical segment may be a single country, a group of two or more countries, or a region within a country.

9. The risks and returns of an enterprise are influenced both by the geographical location of its operations (where its products are produced or where its service rendering activities are based) and also by the location of its customers (where its products are sold or services are rendered). The definition allows geographical segments to be based on either:

(a) the location of production or service facilities and other assets of an enterprise; or

(b) the location of its customers.

10. The organisational and internal reporting structure of an enterprise will normally provide evidence of whether its dominant source of geographical risks results from the location of its assets (the origin of its

sales) or the location of its customers (the destination of its sales). Accordingly, an enterprise looks to this structure to determine whether its geographical segments should be based on the location of its assets or on the location of its customers.

11. Determining the composition of a business or geographical segment involves a certain amount of judgement. In making that judgement, enterprise management takes into account the objective of reporting financial information by segment as set forth in this Standard and the qualitative characteristics of financial statements as identified in the Framework for the Preparation and Presentation of Financial Statements issued by the Institute of Chartered Accountants of India. The qualitative characteristics include the relevance, reliability, and comparability over time of financial information that is reported about the different groups of products and services of an enterprise and about its operations in particular geographical areas, and the usefulness of that information for assessing the risks and returns of the enterprise as a whole.

12. The predominant sources of risks affect how most enterprises are organised and managed. Therefore, the organisational structure of an enterprise and its internal financial reporting system are normally the basis for identifying its segments.

13. The definitions of segment revenue, segment expense, segment assets and segment liabilities include amounts of such items that are directly attributable to a segment and amounts of such items that can be allocated to a segment on a reasonable basis. An enterprise looks to its internal financial reporting system as the starting point for identifying those items that can be directly attributed, or reasonably allocated, to segments. There is thus a presumption that amounts that have been identified with segments for internal financial reporting purposes are directly attributable or reasonably allocable to segments for the purpose of measuring the segment revenue, segment expense, segment assets, and segment liabilities of reportable segments.

14. In some cases, however, a revenue, expense, asset or liability may have been allocated to segments for internal financial reporting purposes on a basis that is understood by enterprise management but that could be deemed arbitrary in the perception of external users of financial statements. Such an allocation would not constitute a reasonable basis under the definitions of segment revenue, segment expense, segment assets, and segment liabilities

in this Standard. Conversely, an enterprise may choose not to allocate some item of revenue, expense, asset or liability for internal financial reporting purposes, even though a reasonable basis for doing so exists. Such an item is allocated pursuant to the definitions of segment revenue, segment expense, segment assets, and segment liabilities in this Standard.

15. Examples of segment assets include current assets that are used in the operating activities of the segment and tangible and intangible fixed assets. If a particular item of depreciation or amortisation is included in segment expense, the related asset is also included in segment assets. Segment assets do not include assets used for general enterprise or head-office purposes. Segment assets include operating assets shared by two or more segments if a reasonable basis for allocation exists. Segment assets include goodwill that is directly attributable to a segment or that can be allocated to a segment on a reasonable basis, and segment expense includes related amortisation of goodwill. If segment assets have been revalued subsequent to acquisition, then the measurement of segment assets reflects those revaluations.

16. Examples of segment liabilities include trade and other payables, accrued liabilities, customer advances, product warranty provisions, and other claims relating to the provision of goods and services. Segment liabilities do not include borrowings and other liabilities that are incurred for financing rather than operating purposes. The liabilities of segments whose operations are not primarily of a financial nature do not include borrowings and similar liabilities because segment result represents an operating, rather than a net-of-financing, profit or loss. Further, because debt is often issued at the head-office level on an enterprise-wide basis, it is often not possible to directly attribute, or reasonably allocate, the interest-bearing liabilities to segments.

17. Segment revenue, segment expense, segment assets and segment liabilities are determined before intra-enterprise balances and intra-enterprise transactions are eliminated as part of the process of preparation of enterprise financial statements, except to the extent that such intra-enterprise balances and transactions are within a single segment.

18. While the accounting policies used in preparing and presenting the financial statements of the enterprise as a whole are also the fundamental segment accounting policies, segment accounting policies include, in addition, policies that relate specifically to segment reporting, such as

identification of segments, method of pricing inter-segment transfers, and basis for allocating revenues and expenses to segments.

Identifying Reportable Segments

Primary and Secondary Segment Reporting Formats

19. The dominant source and nature of risks and returns of an enterprise should govern whether its primary segment reporting format will be business segments or geographical segments. If the risks and returns of an enterprise are affected predominantly by differences in the products and services it produces, its primary format for reporting segment information should be business segments, with secondary information reported geographically. Similarly, if the risks and returns of the enterprise are affected predominantly by the fact that it operates in different countries or other geographical areas, its primary format for reporting segment information should be geographical segments, with secondary information reported for groups of related products and services.

20. Internal organisation and management structure of an enterprise and its system of internal financial reporting to the board of directors and the chief executive officer should normally be the basis for identifying the predominant source and nature of risks and differing rates of return facing the enterprise and, therefore, for determining which reporting format is primary and which is secondary, except as provided in sub-paragraphs (a) and (b) below:

(a) if risks and returns of an enterprise are strongly affected both by differences in the products and services it produces and by differences in the geographical areas in which it operates, as evidenced by a 'matrix approach' to managing the company and to reporting internally to the board of directors and the chief executive officer, then the enterprise should use business segments as its primary segment reporting format and geographical segments as its secondary reporting format; and

(b) if internal organisational and management structure of an enterprise and its system of internal financial reporting to the board of directors and the chief executive officer are based neither on individual products or services or groups of related

products/services nor on geographical areas, the directors and management of the enterprise should determine whether the risks and returns of the enterprise are related more to the products and services it produces or to the geographical areas in which it operates and should, accordingly, choose business segments or geographical segments as the primary segment reporting format of the enterprise, with the other as its secondary reporting format.

21. For most enterprises, the predominant source of risks and returns determines how the enterprise is organised and managed. Organisational and management structure of an enterprise and its internal financial reporting system normally provide the best evidence of the predominant source of risks and returns of the enterprise for the purpose of its segment reporting. Therefore, except in rare circumstances, an enterprise will report segment information in its financial statements on the same basis as it reports internally to top management. Its predominant source of risks and returns becomes its primary segment reporting format. Its secondary source of risks and returns becomes its secondary segment reporting format.

22. A 'matrix presentation' — both business segments and geographical segments as primary segment reporting formats with full segment disclosures on each basis -- will often provide useful information if risks and returns of an enterprise are strongly affected both by differences in the products and services it produces and by differences in the geographical areas in which it operates. This Standard does not require, but does not prohibit, a 'matrix presentation'.

23. In some cases, organisation and internal reporting of an enterprise may have developed along lines unrelated to both the types of products and services it produces, and the geographical areas in which it operates. In such cases, the internally reported segment data will not meet the objective of this Standard. Accordingly, paragraph 20(b) requires the directors and management of the enterprise to determine whether the risks and returns of the enterprise are more product/service driven or geographically driven and to accordingly choose business segments or geographical segments as the primary basis of segment reporting. The objective is to achieve a reasonable degree of comparability with other enterprises, enhance understandability of the resulting information, and meet the needs of investors, creditors, and others for information about product/service-related and geographically-related risks and returns.

Business and Geographical Segments

24. Business and geographical segments of an enterprise for external reporting purposes should be those organisational units for which information is reported to the board of directors and to the chief executive officer for the purpose of evaluating the unit's performance and for making decisions about future allocations of resources, except as provided in paragraph 25.

25. If internal organisational and management structure of an enterprise and its system of internal financial reporting to the board of directors and the chief executive officer are based neither on individual products or services or groups of related products/services nor on geographical areas, paragraph 20(b) requires that the directors and management of the enterprise should choose either business segments or geographical segments as the primary segment reporting format of the enterprise based on their assessment of which reflects the primary source of the risks and returns of the enterprise, with the other as its secondary reporting format. In that case, the directors and management of the enterprise should determine its business segments and geographical segments for external reporting purposes based on the factors in the definitions in paragraph 5 of this Standard, rather than on the basis of its system of internal financial reporting to the board of directors and chief executive officer, consistent with the following:

(a) if one or more of the segments reported internally to the directors and management is a business segment or a geographical segment based on the factors in the definitions in paragraph 5 but others are not, sub-paragraph (b) below should be applied only to those internal segments that do not meet the definitions in paragraph 5 (that is, an internally reported segment that meets the definition should not be further segmented);

(b) for those segments reported internally to the directors and management that do not satisfy the definitions in paragraph 5, management of the enterprise should look to the next lower level of internal segmentation that reports information along product and service lines or geographical lines, as appropriate under the definitions in paragraph 5; and

> *(c)* ***if such an internally reported lower-level segment meets the definition of business segment or geographical segment based on the factors in paragraph 5, the criteria in paragraph 27 for identifying reportable segments should be applied to that segment.***

26. Under this Standard, most enterprises will identify their business and geographical segments as the organisational units for which information is reported to the board of the directors (particularly the non-executive directors, if any) and to the chief executive officer (the senior operating decision maker, which in some cases may be a group of several people) for the purpose of evaluating each unit's performance and for making decisions about future allocations of resources. Even if an enterprise must apply paragraph 25 because its internal segments are not along product/service or geographical lines, it will consider the next lower level of internal segmentation that reports information along product and service lines or geographical lines rather than construct segments solely for external reporting purposes. This approach of looking to organisational and management structure of an enterprise and its internal financial reporting system to identify the business and geographical segments of the enterprise for external reporting purposes is sometimes called the 'management approach', and the organisational components for which information is reported internally are sometimes called 'operating segments'.

Reportable Segments

27. A business segment or geographical segment should be identified as a reportable segment if:

> *(a)* ***its revenue from sales to external customers and from transactions with other segments is 10 per cent or more of the total revenue, external and internal, of all segments; or***
>
> *(b)* ***its segment result, whether profit or loss, is 10 per cent or more of -***
>
> ***(i) the combined result of all segments in profit, or***
>
> ***(ii) the combined result of all segments in loss,***

whichever is greater in absolute amount; or

(c) its segment assets are 10 per cent or more of the total assets of all segments.

28. A business segment or a geographical segment which is not a reportable segment as per paragraph 27, may be designated as a reportable segment despite its size at the discretion of the management of the enterprise. If that segment is not designated as a reportable segment, it should be included as an unallocated reconciling item.

29. If total external revenue attributable to reportable segments constitutes less than 75 per cent of the total enterprise revenue, additional segments should be identified as reportable segments, even if they do not meet the 10 per cent thresholds in paragraph 27, until at least 75 per cent of total enterprise revenue is included in reportable segments.

30. The 10 per cent thresholds in this Standard are not intended to be a guide for determining materiality for any aspect of financial reporting other than identifying reportable business and geographical segments.

Illustration II attached to this Standard presents an illustration of the determination of reportable segments as per paragraphs 27-29.

31. A segment identified as a reportable segment in the immediately preceding period because it satisfied the relevant 10 per cent thresholds should continue to be a reportable segment for the current period notwithstanding that its revenue, result, and assets all no longer meet the 10 per cent thresholds.

32. If a segment is identified as a reportable segment in the current period because it satisfies the relevant 10 per cent thresholds, preceding-period segment data that is presented for comparative purposes should, unless it is impracticable to do so, be restated to reflect the newly reportable segment as a separate segment, even if that segment did not satisfy the 10 per cent thresholds in the preceding period.

Segment Accounting Policies

33. Segment information should be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole.

34. There is a presumption that the accounting policies that the directors and management of an enterprise have chosen to use in preparing the financial statements of the enterprise as a whole are those that the directors and management believe are the most appropriate for external reporting purposes. Since the purpose of segment information is to help users of financial statements better understand and make more informed judgements about the enterprise as a whole, this Standard requires the use, in preparing segment information, of the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole. That does not mean, however, that the enterprise accounting policies are to be applied to reportable segments as if the segments were separate stand-alone reporting entities. A detailed calculation done in applying a particular accounting policy at the enterprise-wide level may be allocated to segments if there is a reasonable basis for doing so. Pension calculations, for example, often are done for an enterprise as a whole, but the enterprise-wide figures may be allocated to segments based on salary and demographic data for the segments.

35. This Standard does not prohibit the disclosure of additional segment information that is prepared on a basis other than the accounting policies adopted for the enterprise financial statements provided that (a) the information is reported internally to the board of directors and the chief executive officer for purposes of making decisions about allocating resources to the segment and assessing its performance and (b) the basis of measurement for this additional information is clearly described.

36. Assets and liabilities that relate jointly to two or more segments should be allocated to segments if, and only if, their related revenues and expenses also are allocated to those segments.

37. The way in which asset, liability, revenue, and expense items are allocated to segments depends on such factors as the nature of those items, the activities conducted by the segment, and the relative autonomy of that segment. It is not possible or appropriate to specify a single basis of allocation that should be adopted by all enterprises; nor is it appropriate to force allocation of enterprise asset, liability, revenue,

and expense items that relate jointly to two or more segments, if the only basis for making those allocations is arbitrary. At the same time, the definitions of segment revenue, segment expense, segment assets, and segment liabilities are interrelated, and the resulting allocations should be consistent. Therefore, jointly used assets and liabilities are allocated to segments if, and only if, their related revenues and expenses also are allocated to those segments. For example, an asset is included in segment assets if, and only if, the related depreciation or amortisation is included in segment expense.

Disclosure

38. Paragraphs 39-46 specify the disclosures required for reportable segments for primary segment reporting format of an enterprise. Paragraphs 47-51 identify the disclosures required for secondary reporting format of an enterprise. Enterprises are encouraged to make all of the primary-segment disclosures identified in paragraphs 39-46 for each reportable secondary segment although paragraphs 47-51 require considerably less disclosure on the secondary basis. Paragraphs 53-59 address several other segment disclosure matters. Illustration III attached to this Standard illustrates the application of these disclosure standards.

Explanation:

In case, by applying the definitions of 'business segment' and 'geographical segment', it is concluded that there is neither more than one business segment nor more than one geographical segment, segment information as per this Standard is not required to be disclosed. However, the fact that there is only one 'business segment' and 'geographical segment' is disclosed by way of a note.

Primary Reporting Format

39. The disclosure requirements in paragraphs 40-46 should be applied to each reportable segment based on primary reporting format of an enterprise.

40. An enterprise should disclose the following for each reportable segment:

(a) ***segment revenue, classified into segment revenue from sales to external customers and segment revenue from transactions with other segments;***

(b) ***segment result;***

(c) ***total carrying amount of segment assets;***

(d) ***total amount of segment liabilities;***

(e) ***total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets);***

(f) ***total amount of expense included in the segment result for depreciation and amortisation in respect of segment assets for the period; and***

(g) ***total amount of significant non-cash expenses, other than depreciation and amortisation in respect of segment assets, that were included in segment expense and, therefore, deducted in measuring segment result.***

41. Paragraph 40 (b) requires an enterprise to report segment result. If an enterprise can compute segment net profit or loss or some other measure of segment profitability other than segment result, without arbitrary allocations, reporting of such amount(s) in addition to segment result is encouraged. If that measure is prepared on a basis other than the accounting policies adopted for the financial statements of the enterprise, the enterprise will include in its financial statements a clear description of the basis of measurement.

42. An example of a measure of segment performance above segment result in the statement of profit and loss is gross margin on sales. Examples of measures of segment performance below segment result in the statement of profit and loss are profit or loss from ordinary activities (either before or after income taxes) and net profit or loss.

43. Accounting Standard 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies' requires that "when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the

performance of the enterprise for the period, the nature and amount of such items should be disclosed separately". Examples of such items include write-downs of inventories, provisions for restructuring, disposals of fixed assets and long-term investments, legislative changes having retrospective application, litigation settlements, and reversal of provisions. An enterprise is encouraged, but not required, to disclose the nature and amount of any items of segment revenue and segment expense that are of such size, nature, or incidence that their disclosure is relevant to explain the performance of the segment for the period. Such disclosure is not intended to change the classification of any such items of revenue or expense from ordinary to extraordinary or to change the measurement of such items. The disclosure, however, does change the level at which the significance of such items is evaluated for disclosure purposes from the enterprise level to the segment level.

44. An enterprise that reports the amount of cash flows arising from operating, investing and financing activities of a segment need not disclose depreciation and amortisation expense and non-cash expenses of such segment pursuant to sub-paragraphs (f) and (g) of paragraph 40.

45. AS 3, Cash Flow Statements, recommends that an enterprise present a cash flow statement that separately reports cash flows from operating, investing and financing activities. Disclosure of information regarding operating, investing and financing cash flows of each reportable segment is relevant to understanding the enterprise's overall financial position, liquidity, and cash flows. Disclosure of segment cash flow is, therefore, encouraged, though not required. An enterprise that provides segment cash flow disclosures need not disclose depreciation and amortisation expense and non-cash expenses pursuant to sub-paragraphs (f) and (g) of paragraph 40.

46. An enterprise should present a reconciliation between the information disclosed for reportable segments and the aggregated information in the enterprise financial statements. In presenting the reconciliation, segment revenue should be reconciled to enterprise revenue; segment result should be reconciled to enterprise net profit or loss; segment assets should be reconciled to enterprise assets; and segment liabilities should be reconciled to enterprise liabilities.

Secondary Segment Information

47. Paragraphs 39-46 identify the disclosure requirements to be applied to

each reportable segment based on primary reporting format of an enterprise. Paragraphs 48-51 identify the disclosure requirements to be applied to each reportable segment based on secondary reporting format of an enterprise, as follows:

(a) if primary format of an enterprise is business segments, the required secondary-format disclosures are identified in paragraph 48;

(b) if primary format of an enterprise is geographical segments based on location of assets (where the products of the enterprise are produced or where its service rendering operations are based), the required secondary-format disclosures are identified in paragraphs 49 and 50;

(c) if primary format of an enterprise is geographical segments based on the location of its customers (where its products are sold or services are rendered), the required secondary-format disclosures are identified in paragraphs 49 and 51.

48. If primary format of an enterprise for reporting segment information is business segments, it should also report the following information:

(a) segment revenue from external customers by geographical area based on the geographical location of its customers, for each geographical segment whose revenue from sales to external customers is 10 per cent or more of enterprise revenue;

(b) the total carrying amount of segment assets by geographical location of assets, for each geographical segment whose segment assets are 10 per cent or more of the total assets of all geographical segments; and

(c) the total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets) by geographical location of assets, for each geographical segment whose segment assets are 10 per cent or more of the total assets of all geographical segments.

49. If primary format of an enterprise for reporting segment information is geographical segments (whether based on location of assets or location of

customers), it should also report the following segment information for each business segment whose revenue from sales to external customers is 10 per cent or more of enterprise revenue or whose segment assets are 10 per cent or more of the total assets of all business segments:

(a) segment revenue from external customers;

(b) the total carrying amount of segment assets; and

(c) the total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets).

50. If primary format of an enterprise for reporting segment information is geographical segments that are based on location of assets, and if the location of its customers is different from the location of its assets, then the enterprise should also report revenue from sales to external customers for each customer-based geographical segment whose revenue from sales to external customers is 10 per cent or more of enterprise revenue.

51. If primary format of an enterprise for reporting segment information is geographical segments that are based on location of customers, and if the assets of the enterprise are located in different geographical areas from its customers, then the enterprise should also report the following segment information for each asset-based geographical segment whose revenue from sales to external customers or segment assets are 10 per cent or more of total enterprise amounts:

(a) the total carrying amount of segment assets by geographical location of the assets; and

(b) the total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets) by location of the assets.

Illustrative Segment Disclosures

52. Illustration III attached to this Standard Illustrates the disclosures for primary and secondary formats that are required by this Standard.

Other Disclosures

53. In measuring and reporting segment revenue from transactions with other segments, inter-segment transfers should be measured on the basis that the enterprise actually used to price those transfers. The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements.

54. Changes in accounting policies adopted for segment reporting that have a material effect on segment information should be disclosed. Such disclosure should include a description of the nature of the change, and the financial effect of the change if it is reasonably determinable.

55. AS 5 requires that changes in accounting policies adopted by the enterprise should be made only if required by statute, or for compliance with an accounting standard, or if it is considered that the change would result in a more appropriate presentation of events or transactions in the financial statements of the enterprise.

56. Changes in accounting policies adopted at the enterprise level that affect segment information are dealt with in accordance with AS 5. AS 5 requires that any change in an accounting policy which has a material effect should be disclosed. The impact of, and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

57. Some changes in accounting policies relate specifically to segment reporting. Examples include changes in identification of segments and changes in the basis for allocating revenues and expenses to segments. Such changes can have a significant impact on the segment information reported but will not change aggregate financial information reported for the enterprise. To enable users to understand the impact of such changes, this Standard requires the disclosure of the nature of the change and the financial effect of the change, if reasonably determinable.

58. An enterprise should indicate the types of products and services included in each reported business segment and indicate the composition of each reported geographical segment, both primary and secondary, if not otherwise disclosed in the financial statements.

59. To assess the impact of such matters as shifts in demand, changes in the prices of inputs or other factors of production, and the development of alternative products and processes on a business segment, it is necessary to know the activities encompassed by that segment. Similarly, to assess the impact of changes in the economic and political environment on the risks and returns of a geographical segment, it is important to know the composition of that geographical segment.

Illustration I

Segment Definition Decision Tree

The purpose of this illustration is to illustrate the application of paragraphs 24-32 of the Accounting Standard.

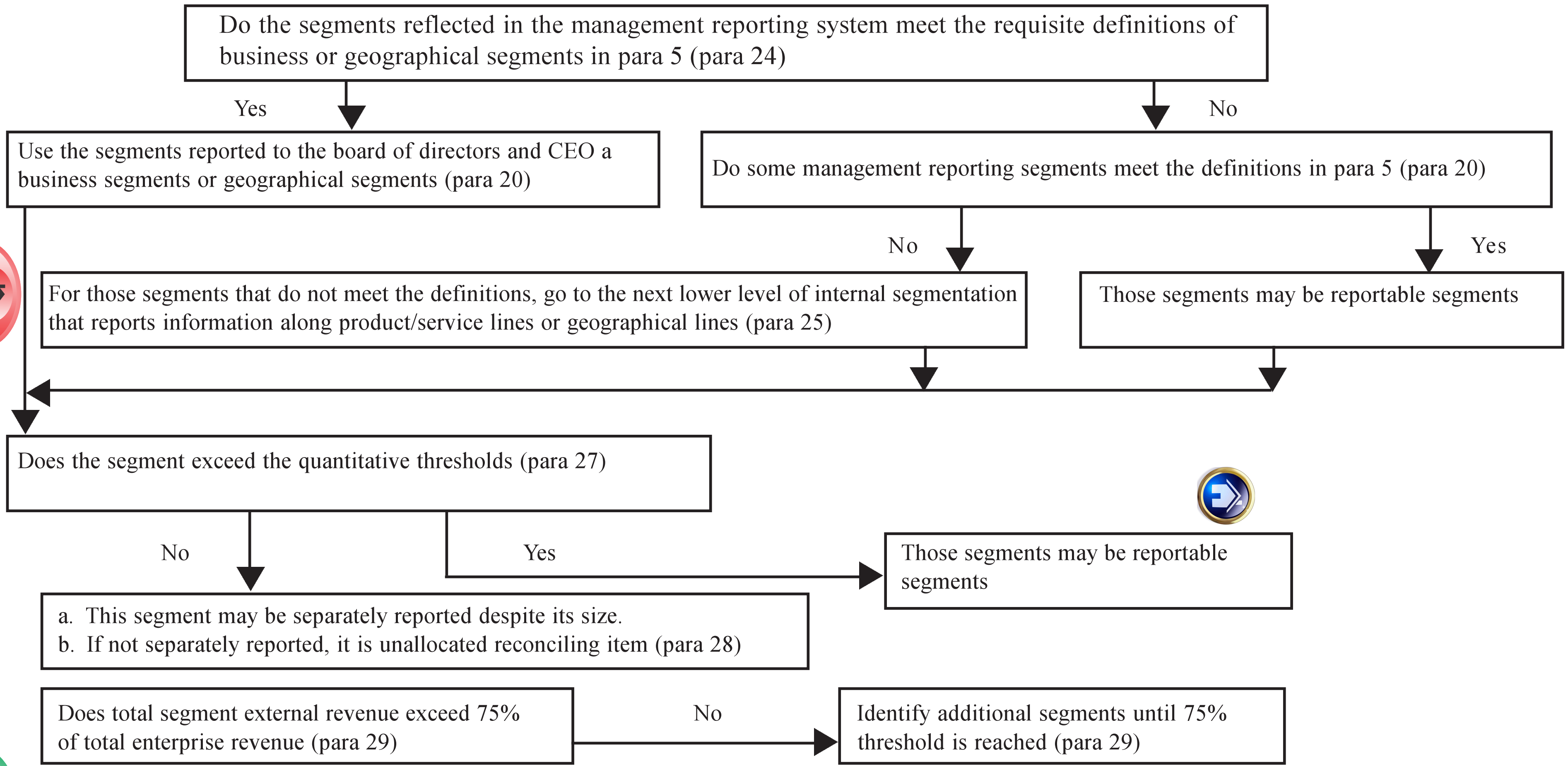

Illustration II

Illustration on Determination of Reportable Segments [Paragraphs 27-29]

This illustration does not form part of the Accounting Standard. Its purpose is to illustrate the application of paragraphs 27-29 of the Accounting Standard.

An enterprise operates through eight segments, namely, A, B, C, D, E, F, G and H. The relevant information about these segments is given in the following table (amounts in Rs.'000):

	A	B	C	D	E	F	G	H	Total (Segments)	Total (Enterprise)
1. SEGMENT REVENUE										
(a) External Sales	-	255	15	10	15	50	20	35	400	
(b) Inter-segment Sales	100	60	30	5	-	-	5	-	200	
(c) Total Revenue	100	315	45	15	15	50	25	35	600	400
2. Total Revenue of each segment as a percentage of total revenue of all segments	16.7	52.5	7.5	2.5	2.5	8.3	4.2	5.8		

	A	B	C	D	E	F	G	H	Total (Segments)	Total (Enterprise)
3. SEGMENT RESULT [Profit/(Loss)]	5	(90)	15	(5)	8	(5)	5	7		
4. Combined Result of all Segments in profits	5		15		8		5	7	40	
5. Combined Result of all Segments in loss		(90)		(5)		(5)			(100)	
6. Segment Result as a percentage of the greater of the totals arrived at 4 and 5 above in absolute amount (i.e., 100)	5	90	15	5	8	5	5	7		
7. SEGMENT ASSETS	15	47	5	11	3	5	5	9	100	
8. Segment assets as a percentage of total assets of all segments	15	47	5	11	3	5	5	9		

The reportable segments of the enterprise will be identified as below:

(a) In accordance with paragraph 27(a), segments whose total revenue from external sales and inter-segment sales is 10% or more of the total revenue of all segments, external and internal, should be identified as reportable segments. Therefore, Segments A and B are reportable segments.

(b) As per the requirements of paragraph 27(b), it is to be first identified whether the combined result of all segments in profit or the combined result of all segments in loss is greater in absolute amount. From the table, it is evident that combined result in loss (i.e., Rs.100,000) is greater. Therefore, the individual segment result as a percentage of Rs.100,000 needs to be examined. In accordance with paragraph 27(b), Segments B and C are reportable segments as their segment result is more than the threshold limit of 10%.

(c) Segments A, B and D are reportable segments as per paragraph 27(c), as their segment assets are more than 10% of the total segment assets.

Thus, Segments A, B, C and D are reportable segments in terms of the criteria laid down in paragraph 27.

Paragraph 28 of the Standard gives an option to the management of the enterprise to designate any segment as a reportable segment. In the given case, it is presumed that the management decides to designate Segment E as a reportable segment.

Paragraph 29 requires that if total external revenue attributable to reportable segments identified as aforesaid constitutes less than 75% of the total enterprise revenue, additional segments should be identified as reportable segments even if they do not meet the 10% thresholds in paragraph 27, until at least 75% of total enterprise revenue is included in reportable segments.

The total external revenue of Segments A, B, C, D and E, identified above as reportable segments, is Rs.295,000. This is less than 75% of total enterprise revenue of Rs.400,000. The management of the enterprise is required to designate any one or more of the remaining segments as reportable segment(s) so that the external revenue of reportable segments is at least 75% of the total enterprise revenue. Suppose, the management designates Segment H for this purpose. Now the external revenue of reportable segments is more than 75% of the total enterprise revenue.

Segments A, B, C, D, E and H are reportable segments. Segments F and G will be shown as reconciling items.

Illustration III

Illustrative Segment Disclosures

This illustration does not form part of the Accounting Standard. Its purpose is to illustrate the application of paragraphs 38-59 of the Accounting Standard.

This illustration illustrates the segment disclosures that this Standard would require for a diversified multi-locational business enterprise. This example is intentionally complex to illustrate most of the provisions of this Standard.

INFORMATION ABOUT BUSINESS SEGMENTS (NOTE xx)
(All amounts in Rs. lakhs)

	Paper Products		Office Products		Publishing		Other Operations		Eliminations		Consolidated Total	
	Current Year	*Previous Year*	*Current Year*	*Previous Year*	*Current Year*	*Previous Year*	*Current Year*	*Previous Year*	*Current Year*	*Previous Year*	*Current Year*	*Previous Year*
REVENUE												
External sales	55	50	20	17	19	16	7	7				
Inter-segment sales	15	10	10	14	2	4	2	2	(29)	(30)		
Total Revenue	70	60	30	31	21	20	9	9	(29)	(30)	101	90

	Paper Products		Office Products		Publishing		Other Operations		Eliminations		Consolidated Total	
	Current Year	*Previous Year*	*Current Year*	*Previous Year*	*Current Year*	*Previous Year*	*Current Year*	*Previous Year*	*Current Year*	*Previous Year*	*Current Year*	*Previous Year*
RESULT												
Segment result	20	17	9	7	2	1	0	0	(1)	(1)	30	24
Unallocated corporate expenses											(7)	(9)
Operating profit											23	15
Interest expense											(4)	(4)
Interest income											2	3
Income taxes											(7)	(4)
Profit from ordinary activities											14	10

	Paper Products		**Office Products**		**Publishing**		**Other Operations**		**Eliminations**		**Consolidated Total**	
	Current Year	*Previous Year*	*Current Year*	*Previous Year*	*Current Year*	*Previous Year*	*Current Year*	*Previous Year*	*Current Year*	*Previous Year*	*Current Year*	*Previous Year*
Extraordinary loss: uninsured earthquake damage to factory		(3)										(3)
Net profit											14	7
OTHER INFORMATION												
Segment assets	54	50	34	30	10	10	10	9			108	99
Unallocated corporate assets											67	56
Total assets											175	155
Segment liabilities	25	15	8	11	8	8	1	1			42	35

	Paper Products		Office Products		Publishing		Other Operations		Eliminations		Consolidated Total	
	Current Year	*Previous Year*	*Current Year*	*Previous Year*	*Current Year*	*Previous Year*	*Current Year*	*Previous Year*	*Current Year*	*Previous Year*	*Current Year*	*Previous Year*
Unallocated corporate liabilities											40	55
Total liabilities											82	90
Capital expenditure	12	10	3	5	5		4	3				
Depre-ciation	9	7	9	7	5	3	3	4				
Non-cash expenses other than depre-ciation	8	2	7	3	2	2	2	1				

Note xx-Business and Geographical Segments (amounts in Rs. lakhs)

Business segments: For management purposes, the Company is organised on a worldwide basis into three major operating divisions-paper products, office products and publishing — each headed by a senior vice president. The divisions are the basis on which the company reports its primary segment information. The paper products segment produces a broad range of writing and publishing papers and newsprint. The office products segment manufactures labels, binders, pens, and markers and also distributes office products made by others. The publishing segment develops and sells books in the fields of taxation, law and accounting. Other operations include development of computer software for standard and specialised business applications. Financial information about business segments is presented in the above table (from page 314 to page 317).

Geographical segments: Although the Company's major operating divisions are managed on a worldwide basis, they operate in four principal geographical areas of the world. In India, its home country, the Company produces and sells a broad range of papers and office products. Additionally, all of the Company's publishing and computer software development operations are conducted in India. In the European Union, the Company operates paper and office products manufacturing facilities and sales offices in the following countries: France, Belgium, Germany and the U.K. Operations in Canada and the United States are essentially similar and consist of manufacturing papers and newsprint that are sold entirely within those two countries. Operations in Indonesia include the production of paper pulp and the manufacture of writing and publishing papers and office products, almost all of which is sold outside Indonesia, both to other segments of the company and to external customers.

Sales by market: The following table shows the distribution of the Company's consolidated sales by geographical market, regardless of where the goods were produced:

	Sales Revenue by *Geographical Market*	
	Current Year	Previous Year
India	19	22
European Union	30	31

Canada and the United States	28	21
Mexico and South America	6	2
Southeast Asia (principally Japan and Taiwan)	18	14
	101	90

Assets and additions to tangible and intangible fixed assets by geographical area: The following table shows the carrying amount of segment assets and additions to tangible and intangible fixed assets by geographical area in which the assets are located:

	Carrying Amount of Segment Assets		Additions to Fixed Assets and Intangible Assets	
	Current Year	Previous Year	Current Year	Previous Year
India	72	78	8	5
European Union	47	37	5	4
Canada and the United States	34	20	4	3
Indonesia	22	20	7	6
	175	155	24	18

Segment revenue and expense: In India, paper and office products are manufactured in combined facilities and are sold by a combined sales force. Joint revenues and expenses are allocated to the two business segments on a reasonable basis. All other segment revenue and expense are directly attributable to the segments.

Segment assets and liabilities: Segment assets include all operating assets used by a segment and consist principally of operating cash, debtors, inventories and fixed assets, net of allowances and provisions which are reported as direct offsets in the balance sheet. While most such assets can be directly attributed to individual segments, the carrying amount of certain assets used jointly by two or more segments is allocated to the segments on a reasonable basis. Segment liabilities include all operating liabilities and consist principally of creditors and accrued liabilities. Segment assets and liabilities do not include deferred income taxes.

Inter-segment transfers: Segment revenue, segment expenses and segment result include transfers between business segments and between geographical segments. Such transfers are accounted for at competitive market prices charged to unaffiliated customers for similar goods. Those transfers are eliminated in consolidation.

Unusual item: Sales of office products to external customers in the current year were adversely affected by a lengthy strike of transportation workers in India, which interrupted product shipments for approximately four months. The Company estimates that sales of office products during the four-month period were approximately half of what they would otherwise have been.

Extraordinary loss: As more fully discussed in Note x, the Company incurred an uninsured loss of Rs.3,00,000 caused by earthquake damage to a paper mill in India during the previous year.

PREVIOUS
HOME
NEXT

Illustration IV

Summary of Required Disclosure

This illustration does not form part of the Accounting Standard. Its purpose is to summarise the disclosures required by paragraphs 38-59 for each of the three possible primary segment reporting formats.

Figures in parentheses refer to paragraph numbers of the relevant paragraphs in the text.

PRIMARY FORMAT IS BUSINESS SEGMENTS	PRIMARY FORMAT IS GEOGRAPHICAL SEGMENTS BY LOCATION OF ASSETS	PRIMARY FORMAT IS GEOGRAPHICAL SEGMENTS BY LOCATION OF CUSTOMERS
Required Primary Disclosures	***Required Primary Disclosures***	***Required Primary Disclosures***
Revenue from external customers by business segment [40(a)]	Revenue from external customers by location of assets [40(a)]	Revenue from external customers by location of customers [40(a)]
Revenue from transactions with other segments by business segment [40(a)]	Revenue from transactions with other segments by location of assets [40(a)]	Revenue from transactions with other segments by location of customers [40(a)]
Segment result by business segment [40(b)]	Segment result by location of assets [40(b)]	Segment result by location of customers [40(b)]
Carrying amount of segment assets by business segment [40(c)]	Carrying amount of segment assets by location of assets [40(c)]	Carrying amount of segment assets by location of customers [40(c)]
Segment liabilities by business segment [40(d)]	Segment liabilities by location of assets [40(d)]	Segment liabilities by location of customers [40(d)]
Cost to acquire tangible and intangible fixed assets by business segment [40(e)]	Cost to acquire tangible and intangible fixed assets by location of assets [40(e)]	Cost to acquire tangible and intangible fixed assets by location of customers [40(e)]

PRIMARY FORMAT IS BUSINESS SEGMENTS	PRIMARY FORMAT IS GEOGRAPHICAL SEGMENTS BY LOCATION OF ASSETS	PRIMARY FORMAT IS GEOGRAPHICAL SEGMENTS BY LOCATION OF CUSTOMERS
Required Primary Disclosures	***Required Primary Disclosures***	***Required Primary Disclosures***
Depreciation and amortisation expense by business segment [40(f)]	Depreciation and amortisation expense by location of assets[40(f)]	Depreciation and amortisation expense by location of customers[40(f)]
Non-cash expenses other than depreciation and amortisation by business segment [40(g)]	Non-cash expenses other than depreciation and amortisation by location of assets [40(g)]	Non-cash expenses other than depreciation and amortisation by location of customers [40(g)]
Reconciliation of revenue, result, assets, and liabilities by business segment [46]	Reconciliation of revenue, result, assets, and liabilities [46]	Reconciliation of revenue, result, assets, and liabilities [46]
Required Secondary Disclosures	***Required Secondary Disclosures***	***Required Secondary Disclosures***
Revenue from external customers by location of customers [48]	Revenue from external customers by business segment [49]	Revenue from external customers by business segment [49]
Carrying amount of segment assets by location of assets [48]	Carrying amount of segment assets by business segment [49]	Carrying amount of segment assets by business segment [49]
Cost to acquire tangible and intangible fixed assets by location of assets [48]	Cost to acquire tangible and intangible fixed assets by business segment [49]	Cost to acquire tangible and intangible fixed assets by business segment [49]
	Revenue from external customers by geographical customers if different from location of assets [50]	

PRIMARY FORMAT IS BUSINESS SEGMENTS	PRIMARY FORMAT IS GEOGRAPHICAL SEGMENTS BY LOCATION OF ASSETS	PRIMARY FORMAT IS GEOGRAPHICAL SEGMENTS BY LOCATION OF CUSTOMERS
Required Secondary Disclosures	***Required Secondary Disclosures***	***Required Secondary Disclosures***
		Carrying amount of segment assets by location of assets if different from location of customers [51]
		Cost to acquire tangible and intangible fixed assets by location of assets if different from location of customers [51]
Other Required Disclosures	***Other Required Disclosures***	***Other Required Disclosures***
Basis of pricing inter-segment transfers and any change therein [53]	Basis of pricing inter-segment transfers and any change therein [53]	Basis of pricing inter-segment transfers and any change therein [53]
Changes in segment accounting policies [54]	Changes in segment accounting policies [54]	Changes in segment accounting policies [54]
Types of products and services in each business segment [58]	Types of products and services in each business segment [58]	Types of products and services in each business segment [58]
Composition of each geographical segment [58]	Composition of each geographical segment [58]	Composition of each geographical segment [58]

Accounting Standard (AS) 18
(issued 2000)

Related Party Disclosures

Contents

Accounting Standard (AS) 18*
(issued 2000)

Related Party Disclosures

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

This Accounting Standard is not Mandatory for non-corporate entities falling in Level III, as defined in Appendix 1 to this Compendium 'Applicability of Accounting Standards to Various Entities'.

Objective

The objective of this Standard is to establish requirements for disclosure of:

(a) related party relationships; and

(b) transactions between a reporting enterprise and its related parties.

Scope

1. This Standard should be applied in reporting related party relationships and transactions between a reporting enterprise and its related parties. The requirements of this Standard apply to the financial statements of each reporting enterprise as also to consolidated financial statements presented by a holding company.

2. This Standard applies only to related party relationships described in paragraph 3.

* A limited revision to this Standard was made in 2003, pursuant to which paragraph 26 of this Standard was revised and paragraph 27 was added to this Standard.

[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.

3. This Standard deals only with related party relationships described in (a) to (e) below:

(a) enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries);

(b) associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture;

(c) individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual;

(d) key management personnel and relatives of such personnel; and

(e) enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

4. In the context of this Standard, the following are deemed not to be related parties:

(a) two companies simply because they have a director in common, notwithstanding paragraph 3(d) or (e) above (unless the director is able to affect the policies of both companies in their mutual dealings);

(b) a single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence; and

(c) the parties listed below, in the course of their normal dealings with an enterprise by virtue only of those dealings (although they may circumscribe the freedom of action of the enterprise or participate in its decision-making process):

(i) providers of finance;

(ii) trade unions;

(iii) public utilities;

(iv) government departments and government agencies including government sponsored bodies.

5. Related party disclosure requirements as laid down in this Standard do not apply in circumstances where providing such disclosures would conflict with the reporting enterprise's duties of confidentiality as specifically required in terms of a statute or by any regulator or similar competent authority.

6. In case a statute or a regulator or a similar competent authority governing an enterprise prohibit the enterprise to disclose certain information which is required to be disclosed as per this Standard, disclosure of such information is not warranted. For example, banks are obliged by law to maintain confidentiality in respect of their customers' transactions and this Standard would not override the obligation to preserve the confidentiality of customers' dealings.

7. No disclosure is required in consolidated financial statements in respect of intra-group transactions.

8. Disclosure of transactions between members of a group is unnecessary in consolidated financial statements because consolidated financial statements present information about the holding and its subsidiaries as a single reporting enterprise.

9. No disclosure is required in the financial statements of state-controlled enterprises as regards related party relationships with other state-controlled enterprises and transactions with such enterprises.

Definitions

10. For the purpose of this Standard, the following terms are used with the meanings specified:

10.1 Related party - parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

10.2 Related party transaction - a transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

10.3 Control – (a) ownership, directly or indirectly, of more than one half of the voting power of an enterprise, or

(b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise, or

(c) a substantial interest in voting power and the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise.

10.4 Significant influence - participation in the financial and/or operating policy decisions of an enterprise, but not control of those policies.

10.5 An Associate - an enterprise in which an investing reporting party has significant influence and which is neither a subsidiary nor a joint venture of that party.

10.6 A Joint venture - a contractual arrangement whereby two or more parties undertake an economic activity which is subject to joint control.

10.7 Joint control - the contractually agreed sharing of power to govern the financial and operating policies of an economic activity so as to obtain benefits from it.

10.8 Key management personnel - those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

10.9 <u>Relative</u> – in relation to an individual, means the spouse, son, daughter, brother, sister, father and mother who may be expected to influence, or be influenced by, that individual in his/her dealings with the reporting enterprise.

10.10 <u>Holding company</u> - a company having one or more subsidiaries.

10.11 <u>Subsidiary</u> - a company:

(a) in which another company (the holding company) holds, either by itself and/or through one or more subsidiaries, more than one-half in nominal value of its equity share capital; or

(b) of which another company (the holding company) controls, either by itself and/or through one or more subsidiaries, the composition of its board of directors.

10.12 <u>Fellow subsidiary</u> - a company is considered to be a fellow subsidiary of another company if both are subsidiaries of the same holding company.

10.13 <u>State-controlled enterprise</u> - an enterprise which is under the control of the Central Government and/or any State Government(s).

11. For the purpose of this Standard, an enterprise is considered to control the composition of

(i) the board of directors of a company, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors of that company. An enterprise is deemed to have the power to appoint a director if any of the following conditions is satisfied:

(a) a person cannot be appointed as director without the exercise in his favour by that enterprise of such a power as aforesaid; or

(b) a person's appointment as director follows necessarily from his appointment to a position held by him in that enterprise; or

(c) the director is nominated by that enterprise; in case that enterprise is a company, the director is nominated by that company/subsidiary thereof.

(ii) the governing body of an enterprise that is not a company, if it has the power, without the consent or the concurrence of any other person, to appoint or remove all or a majority of members of the governing body of that other enterprise. An enterprise is deemed to have the power to appoint a member if any of the following conditions is satisfied:

(a) a person cannot be appointed as member of the governing body without the exercise in his favour by that other enterprise of such a power as aforesaid; or

(b) a person's appointment as member of the governing body follows necessarily from his appointment to a position held by him in that other enterprise; or

(c) the member of the governing body is nominated by that other enterprise.

12. An enterprise is considered to have a substantial interest in another enterprise if that enterprise owns, directly or indirectly, 20 per cent or more interest in the voting power of the other enterprise. Similarly, an individual is considered to have a substantial interest in an enterprise, if that individual owns, directly or indirectly, 20 per cent or more interest in the voting power of the enterprise.

13. Significant influence may be exercised in several ways, for example, by representation on the board of directors, participation in the policy making process, material inter-company transactions, interchange of managerial personnel, or dependence on technical information. Significant influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investing party holds, directly or indirectly through intermediaries, 20 per cent or more of the voting power of the enterprise, it is presumed that the investing party does have significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investing party holds, directly or indirectly through intermediaries, less than 20 per cent of the voting power of the enterprise, it is presumed that the investing party does not have significant influence, unless such influence

can be clearly demonstrated. A substantial or majority ownership by another investing party does not necessarily preclude an investing party from having significant influence.

Explanation

An intermediary means a subsidiary as defined in AS 21, Consolidated Financial Statements.

14. Key management personnel are those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise. For example, in the case of a company, the managing director(s), whole time director(s), manager and any person in accordance with whose directions or instructions the board of directors of the company is accustomed to act, are usually considered key management personnel.

Explanation

A non-executive director of a company is not considered as a key management person under this Standard by virtue of merely his being a director unless he has the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise. The requirements of this Standard are not applied in respect of a non-executive director even enterprise, unless he falls in any of the categories in paragraph 3 of this Standard.

The Related Party Issue

15. Related party relationships are a normal feature of commerce and business. For example, enterprises frequently carry on separate parts of their activities through subsidiaries or associates and acquire interests in other enterprises - for investment purposes or for trading reasons - that are of sufficient proportions for the investing enterprise to be able to control or exercise significant influence on the financial and/or operating decisions of its investee.

16. Without related party disclosures, there is a general presumption that transactions reflected in financial statements are consummated on an arm's-length basis between independent parties. However, that presumption may not be valid when related party relationships exist because related parties may enter into transactions which unrelated parties would not enter into. Also, transactions between related parties may not be effected at the same terms and conditions as between unrelated parties. Sometimes, no price is

charged in related party transactions, for example, free provision of management services and the extension of free credit on a debt. In view of the aforesaid, the resulting accounting measures may not represent what they usually would be expected to represent. Thus, a related party relationship could have an effect on the financial position and operating results of the reporting enterprise.

17. The operating results and financial position of an enterprise may be affected by a related party relationship even if related party transactions do not occur. The mere existence of the relationship may be sufficient to affect the transactions of the reporting enterprise with other parties. For example, a subsidiary may terminate relations with a trading partner on acquisition by the holding company of a fellow subsidiary engaged in the same trade as the former partner. Alternatively, one party may refrain from acting because of the control or significant influence of another - for example, a subsidiary may be instructed by its holding company not to engage in research and development.

18. Because there is an inherent difficulty for management to determine the effect of influences which do not lead to transactions, disclosure of such effects is not required by this Standard.

19. Sometimes, transactions would not have taken place if the related party relationship had not existed. For example, a company that sold a large proportion of its production to its holding company at cost might not have found an alternative customer if the holding company had not purchased the goods.

Disclosure

20. The statutes governing an enterprise often require disclosure in financial statements of transactions with certain categories of related parties. In particular, attention is focussed on transactions with the directors or similar key management personnel of an enterprise, especially their remuneration and borrowings, because of the fiduciary nature of their relationship with the enterprise.

21. Name of the related party and nature of the related party relationship where control exists should be disclosed irrespective of whether or not there have been transactions between the related parties.

22. Where the reporting enterprise controls, or is controlled by, another party, this information is relevant to the users of financial statements irrespective of whether or not transactions have taken place with that party. This is because the existence of control relationship may prevent the reporting enterprise from being independent in making its financial and/or operating decisions. The disclosure of the name of the related party and the nature of the related party relationship where control exists may sometimes be at least as relevant in appraising an enterprise's prospects as are the operating results and the financial position presented in its financial statements. Such a related party may establish the enterprise's credit standing, determine the source and price of its raw materials, and determine to whom and at what price the product is sold.

23. If there have been transactions between related parties, during the existence of a related party relationship, the reporting enterprise should disclose the following:

(i) the name of the transacting related party;

(ii) a description of the relationship between the parties;

(iii) a description of the nature of transactions;

(iv) volume of the transactions either as an amount or as an appropriate proportion;

(v) any other elements of the related party transactions necessary for an understanding of the financial statements;

(vi) the amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and

(vii) amounts written off or written back in the period in respect of debts due from or to related parties.

24. The following are examples of the related party transactions in respect of which disclosures may be made by a reporting enterprise:

(a) purchases or sales of goods (finished or unfinished);

(b) purchases or sales of fixed assets;

(c) rendering or receiving of services;

(d) agency arrangements;

(e) leasing or hire purchase arrangements;

(f) transfer of research and development;

(g) licence agreements;

(h) finance (including loans and equity contributions in cash or in kind);

(i) guarantees and collaterals; and

(j) management contracts including for deputation of employees.

25. Paragraph 23 (v) requires disclosure of 'any other elements of the related party transactions necessary for an understanding of the financial statements'. An example of such a disclosure would be an indication that the transfer of a major asset had taken place at an amount materially different from that obtainable on normal commercial terms.

26. Items of a similar nature may be disclosed in aggregate by type of related party except when seperate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the reporting enterprise.

Explanation:

Type of related party means each related party relationship described in paragraph 3 above.

27. Disclosure of details of particular transactions with individual related parties would frequently be too voluminous to be easily understood. Accordingly, items of a similar nature may be disclosed in aggregate by type of related party. However, this is not done in such a way as to obscure the importance of significant transactions. Hence, purchases or sales of goods are not aggregated with purchases or sales of fixed assets. Nor a material related party transaction with an individual party is clubbed in an aggregated disclosure.

Explanation:

(a) Materiality primarily depends on the facts and circumstances of each case. In deciding whether an item or an aggregate of items is material, the nature and the size of the item(s) are evaluated together. Depending on the circumstances, either the nature or the size of the item could be the determining factor. As regards size, for the purpose of applying the test of materiality as per this paragraph, ordinarily a related party transaction, the amount of which is in excess of 10% of the total related party transactions of the same type (such as purchase of goods), is considered material, unless on the basis of facts and circumstances of the case it can be concluded that even a transaction of less than 10% is material. As regards nature, ordinarily the related party transactions which are not entered into in the normal course of the business of the reporting enterprise are considered material subject to the facts and circumstances of the case.

(b) The manner of disclosure required by paragraph 23, read with paragraph 26, is illustrated in the Illustration attached to the Standard.

Illustration

<u>Note:</u> This illustration does not form part of the Accounting Standard. Its purpose is to assist in clarifying the meaning of the Accounting Standard.

The manner or disclosures required by paragraphs 23 and 26 of AS 18 is illustrated as below. It may be noted that the format given below is merely illustrative in nature and is not exhaustive.

	Holding Company	Subs-diaries	Fellow Subsi-diaries	Assoc-iates	Key Manag-ement Personnel	Relatives of Key Manage-Ment Personnel	Total
Purchases of goods							
Sale of goods							
Purchase of fixed assets							
Sale of fixed assets							
Rendering of services							

Receiving of services

Agency arrangements

Leasing or hire purchase arrangements

Transter of research and development

Licence agreements Finance (including loans and equity contributions in cash or in kind)

Guarantees and collaterals

Management contracts including for deputation of employees

Note:

Name of related parties and description of relationship:

1.	Holding Company	A Ltd.
2.	Subsidiaries	B Ltd. and C (P) Ltd.
3.	Fellow Subsidiaries	D Ltd. and Q Ltd.
4.	Associates	X Ltd., Y Ltd. and Z (P) Ltd.
5.	Key Management Personnel	Mr. Y and Mr. Z
6.	Relatives of Key Management Personnel	Mrs. Y (wife of Mr. Y), Mr. F (father of Mr. Z)

Accounting Standard (AS) 19
(issued 2001)

Leases

Contents

Accounting Standard (AS) 19
(issued 2001)

Leases

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

Objective

The objective of this Standard is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures in relation to finance leases and operating leases.

Scope

1. This Standard should be applied in accounting for all leases other than:

> ***(a) lease agreements to explore for or use natural resources, such as oil, gas, timber, metals and other mineral rights; and***
>
> ***(b) licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights; and***
>
> ***(c) lease agreements to use lands.***

2. This Standard applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. On the other

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[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.

hand, this Standard does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.

Definitions

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

3.1 A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

3.2 A finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset.

3.3 An operating lease is a lease other than a finance lease.

3.4 A non-cancellable lease is a lease that is cancellable only:

(a) upon the occurrence of some remote contingency; or

(b) with the permission of the lessor; or

(c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or

(d) upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.

3.5 The inception of the lease is the earlier of the date of the lease agreement and the date of a commitment by the parties to the principal provisions of the lease.

3.6 The lease term is the non-cancellable period for which the lessee has agreed to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise.

3.7 Minimum lease payments are the payments over the lease term that

the lessee is, or can be required, to make excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:

(a) in the case of the lessee, any residual value guaranteed by or on behalf of the lessee; or

(b) in the case of the lessor, any residual value guaranteed to the lessor:

(i) by or on behalf of the lessee; or

(ii) by an independent third party financially capable of meeting this guarantee.

However, if the lessee has an option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable that, at the inception of the lease, is reasonably certain to be exercised, the minimum lease payments comprise minimum payments payable over the lease term and the payment required to exercise this purchase option.

3.8 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.

3.9 Economic life is either:

(a) the period over which an asset is expected to be economically usable by one or more users; or

(b) the number of production or similar units expected to be obtained from the asset by one or more users.

3.10 Useful life of a leased asset is either:

(a) the period over which the leased asset is expected to be used by the lessee; or

(b) the number of production or similar units expected to be obtained from the use of the asset by the lessee.

3.11 Residual value of a leased asset is the estimated fair value of the *asset at the end of the lease term.*

3.12 Guaranteed residual value is:

(a) in the case of the lessee, that part of the residual value which is guaranteed by the lessee or by a party on behalf of the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and

(b) in the case of the lessor, that part of the residual value which is guaranteed by or on behalf of the lessee, or by an independent third party who is financially capable of discharging the obligations under the guarantee.

3.13 Unguaranteed residual value of a leased asset is the amount by which the residual value of the asset exceeds its guaranteed residual value.

3.14 Gross investment in the lease is the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor and any unguaranteed residual value accruing to the lessor.

3.15 Unearned finance income is the difference between:

(a) the gross investment in the lease; and

(b) the present value of

(i) the minimum lease payments under a finance lease from the standpoint of the lessor; and

(ii) any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.

3.16 Net investment in the lease is the gross investment in the lease less unearned finance income.

3.17 The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of

(a) the minimum lease payments under a finance lease from the standpoint of the lessor; and

> *(b) any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.*

3.18 The <u>lessee's incremental borrowing rate of interest</u> is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

3.19 <u>Contingent rent</u> is that portion of the lease payments that is not fixed in amount but is based on a factor other than just the passage of time (e.g., percentage of sales, amount of usage, price indices, market rates of interest).

4. The definition of a lease includes agreements for the hire of an asset which contain a provision giving the hirer an option to acquire title to the asset upon the fulfillment of agreed conditions. These agreements are commonly known as hire purchase agreements. Hire purchase agreements include agreements under which the property in the asset is to pass to the hirer on the payment of the last instalment and the hirer has a right to terminate the agreement at any time before the property so passes.

Classification of Leases

5. The classification of leases adopted in this Standard is based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor or the lessee. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return due to changing economic conditions. Rewards may be represented by the expectation of profitable operation over the economic life of the asset and of gain from appreciation in value or realisation of residual value.

6. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. Title may or may not eventually be transferred. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incident to ownership.

7. Since the transaction between a lessor and a lessee is based on a lease agreement common to both parties, it is appropriate to use consistent definitions. The application of these definitions to the differing

circumstances of the two parties may sometimes result in the same lease being classified differently by the lessor and the lessee.

8. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Examples of situations which would normally lead to a lease being classified as a finance lease are:

(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;

(b) the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised;

(c) the lease term is for the major part of the economic life of the asset even if title is not transferred;

(d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

(e) the leased asset is of a specialised nature such that only the lessee can use it without major modifications being made.

9. Indicators of situations which individually or in combination could also lead to a lease being classified as a finance lease are:

(a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

(b) gains or losses from the fluctuation in the fair value of the residual fall to the lessee (for example in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and

(c) the lessee can continue the lease for a secondary period at a rent which is substantially lower than market rent.

10. Lease classification is made at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a

different classification of the lease under the criteria in paragraphs 5 to 9 had the changed terms been in effect at the inception of the lease, the revised agreement is considered as a new agreement over its revised term. Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased asset) or changes in circumstances (for example, default by the lessee), however, do not give rise to a new classification of a lease for accounting purposes.

Leases in the Financial Statements of Lessees

Finance Leases

11. At the inception of a finance lease, the lessee should recognise the lease as an asset and a liability. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of the lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the standpoint of the lessee, the amount recorded as an asset and a liability should be the present value of the minimum lease payments from the standpoint of the lessee. In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used.

Example

(a) An enterprise (the lessee) acquires a machinery on lease from a leasing company (the lessor) on January 1, 20X0. The lease term covers the entire economic life of the machinery, i.e., 3 years. The fair value of the machinery on January 1, 20X0 is Rs.2,35,500. The lease agreement requires the lessee to pay an amount of Rs.1,00,000 per year beginning December 31, 20X0. The lessee has guaranteed a residual value of Rs.17,000 on December 31, 20X2 to the lessor. The lessor, however, estimates that the machinery would have a salvage value of only Rs.3,500 on December 31, 20X2.

The interest rate implicit in the lease is 16 per cent (approx.). This is calculated using the following formula:

$$\text{Fair value} = \frac{ALR}{(1+r)^1} + \frac{ALR}{(1+r)^2} + \ldots + \frac{ALR}{(1+r)^n} + \frac{RV}{(1+r)^n}$$

PREVIOUS HOME NEXT

where ALR is annual lease rental,

RV is residual value (both guaranteed and unguaranteed),

n is the lease term,

r is interest rate implicit in the lease.

The present value of minimum lease payments from the stand point of the lessee is Rs.2,35,500.

The lessee would record the machinery as an asset at Rs. 2,35,500 with a corresponding liability representing the present value of lease payments over the lease term (including the guaranteed residual value).

(b) In the above example, suppose the lessor estimates that the machinery would have a salvage value of Rs. 17,000 on December 31, 20X2. The lessee, however, guarantees a residual value of Rs. 5,000 only.

The interest rate implicit in the lease in this case would remain unchanged at 16% (approx.). The present value of the minimum lease payments from the standpoint of the lessee, using this interest rate implicit in the lease, would be Rs.2,27,805. As this amount is lower than the fair value of the leased asset (Rs.2,35,500), the lessee would recognise the asset and the liability arising from the lease at Rs. 2,27,805.

In case the interest rate implicit in the lease is not known to the lessee, the present value of the minimum lease payments from the standpoint of the lessee would be computed using the lessee's incremental borrowing rate.

12. Transactions and other events are accounted for and presented in accordance with their substance and financial reality and not merely with their legal form. While the legal form of a lease agreement is that the lessee may acquire no legal title to the leased asset, in the case of finance leases the substance and financial reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its economic life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge.

13. If such lease transactions are not reflected in the lessee's balance sheet, the economic resources and the level of obligations of an enterprise are understated thereby distorting financial ratios. It is therefore appropriate that a finance lease be recognised in the lessee's balance sheet both as an asset and as an obligation to pay future lease payments. At the inception of the lease, the asset and the liability for the future lease payments are recognised in the balance sheet at the same amounts.

14. It is not appropriate to present the liability for a leased asset as a deduction from the leased asset in the financial statements. The liability for a leased asset should be presented separately in the balance sheet as a current liability or a long-term liability as the case may be.

15. Initial direct costs are often incurred in connection with specific leasing activities, as in negotiating and securing leasing arrangements. The costs identified as directly attributable to activities performed by the lessee for a finance lease are included as part of the amount recognised as an asset under the lease.

16. Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

Example

In the example (a) illustrating paragraph 11, the lease payments would be apportioned by the lessee between the finance charge and the reduction of the outstanding liability as follows:

	Year	*Finance charge (Rs.)*	*Payment (Rs.)*	*Reduction in outstanding liability (Rs.)*	*Outstand-ing liability (Rs.)*
Year 1	(January 1)				2,35,500
	(December 31)	37,680	1,00,000	62,320	1,73,180
Year 2	(December 31)	27,709	1,00,000	72,291	1,00,889
Year 3	(December 31)	16,142	1,00,000	83,858	17,031*

* The difference between this figure and guaranteed residual value (Rs.17,000) is due to approximation in computing the interest rate implicit in the lease.

17. In practice, in allocating the finance charge to periods during the lease term, some form of approximation may be used to simplify the calculation.

18. A finance lease gives rise to a depreciation expense for the asset as well as a finance expense for each accounting period. The depreciation policy for a leased asset should be consistent with that for depreciable assets which are owned, and the depreciation recognised should be calculated on the basis set out in Accounting Standard (AS) 6, Depreciation Accounting. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the lease term or its useful life, whichever is shorter.

19. The depreciable amount of a leased asset is allocated to each accounting period during the period of expected use on a systematic basis consistent with the depreciation policy the lessee adopts for depreciable assets that are owned. If there is reasonable certainty that the lessee will obtain ownership by the end of the lease term, the period of expected use is the useful life of the asset; otherwise the asset is depreciated over the lease term or its useful life, whichever is shorter.

20. The sum of the depreciation expense for the asset and the finance expense for the period is rarely the same as the lease payments payable for the period, and it is, therefore, inappropriate simply to recognise the lease payments payable as an expense in the statement of profit and loss. Accordingly, the asset and the related liability are unlikely to be equal in amount after the inception of the lease.

21. To determine whether a leased asset has become impaired, an enterprise applies the Accounting Standard dealing with impairment of assets[4], that sets out the requirements as to how an enterprise should perform the review of the carrying amount of an asset, how it should determine the recoverable amount of an asset and when it should recognise, or reverse, an impairment loss.

22. The lessee should, in addition to the requirements of AS 10, Accounting for Fixed Assets, AS 6, Depreciation Accounting, and the governing statute, make the following disclosures for finance leases:

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[4] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

(a) *assets acquired under finance lease as segregated from the assets owned;*

(b) *for each class of assets, the net carrying amount at the balance sheet date;*

(c) *a reconciliation between the total of minimum lease payments at the balance sheet date and their present value. In addition, an enterprise should disclose the total of minimum lease payments at the balance sheet date, and their present value, for each of the following periods:*

(i) *not later than one year;*

(ii) *later than one year and not later than five years;*

(iii) *later than five years;*

(d) *contingent rents recognised as expense in the statement of profit and loss for the period;*

(e) *the total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date; and*

(f) *a general description of the lessee's significant leasing arrangements including, but not limited to, the following:*

(i) *the basis on which contingent rent payments are determined;*

(ii) *the existence and terms of renewal or purchase options and escalation clauses; and*

(iii) *restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.*

Provided that a Small and Medium Sized Company and a Small and Medium Sized Enterprise (Levels II and III non-corporate entities), as defined in Appendix 1 to this Compendium, may not comply with sub-paragraphs (c), (e) and (f).

PREVIOUS HOME NEXT

Operating Leases

23. Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

24. For operating leases, lease payments (excluding costs for services such as insurance and maintenance) are recognised as an expense in the statement of profit and loss on a straight line basis unless another systematic basis is more representative of the time pattern of the user's benefit, even if the payments are not on that basis.

25. The lessee should make the following disclosures for operating leases:

(a) the total of future minimum lease payments under non-cancellable operating leases for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years;

(iii) later than five years;

(b) the total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date;

(c) lease payments recognised in the statement of profit and loss for the period, with separate amounts for minimum lease payments and contingent rents;

(d) sub-lease payments received (or receivable) recognised in the statement of profit and loss for the period;

(e) a general description of the lessee's significant leasing arrangements including, but not limited to, the following:

(i) the basis on which contingent rent payments are determined;

(ii) the existence and terms of renewal or purchase options and escalation clauses; and

(iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

Provided that a Small and Medium Sized Company and a Small and Medium Sized Enterprise (Levels II and III non-corporate entities), as defined in Appendix 1 to this Compendium, may not comply with sub-paragraphs (a), (b) and (e).

Leases in the Financial Statements of Lessors

Finance Leases

26. The lessor should recognise assets given under a finance lease in its balance sheet as a receivable at an amount equal to the net investment in the lease.

27. Under a finance lease substantially all the risks and rewards incident to legal ownership are transferred by the lessor, and thus the lease payment receivable is treated by the lessor as repayment of principal, i.e., net investment in the lease, and finance income to reimburse and reward the lessor for its investment and services.

28. The recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on the net investment of the lessor outstanding in respect of the finance lease.

29. A lessor aims to allocate finance income over the lease term on a systematic and rational basis. This income allocation is based on a pattern reflecting a constant periodic return on the net investment of the lessor outstanding in respect of the finance lease. Lease payments relating to the accounting period, excluding costs for services, are reduced from both the principal and the unearned finance income.

30. Estimated unguaranteed residual values used in computing the lessor's gross investment in a lease are reviewed regularly. If there has been a reduction in the estimated unguaranteed residual value, the income allocation over the remaining lease term is revised and any reduction in

respect of amounts already accrued is recognised immediately. An upward adjustment of the estimated residual value is not made.

31. Initial direct costs, such as commissions and legal fees, are often incurred by lessors in negotiating and arranging a lease. For finance leases, these initial direct costs are incurred to produce finance income and are either recognised immediately in the statement of profit and loss or allocated against the finance income over the lease term.

32. The manufacturer or dealer lessor should recognise the transaction of sale in the statement of profit and loss for the period, in accordance with the policy followed by the enterprise for outright sales. If artificially low rates of interest are quoted, profit on sale should be restricted to that which would apply if a commercial rate of interest were charged. Initial direct costs should be recognised as an expense in the statement of profit and loss at the inception of the lease.

33. Manufacturers or dealers may offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to two types of income:

(a) the profit or loss equivalent to the profit or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts; and

(b) the finance income over the lease term.

34. The sales revenue recorded at the commencement of a finance lease term by a manufacturer or dealer lessor is the fair value of the asset. However, if the present value of the minimum lease payments accruing to the lessor computed at a commercial rate of interest is lower than the fair value, the amount recorded as sales revenue is the present value so computed. The cost of sale recognised at the commencement of the lease term is the cost, or carrying amount if different, of the leased asset less the present value of the unguaranteed residual value. The difference between the sales revenue and the cost of sale is the selling profit, which is recognised in accordance with the policy followed by the enterprise for sales.

35. Manufacturer or dealer lessors sometimes quote artificially low rates of interest in order to attract customers. The use of such a rate would result

in an excessive portion of the total income from the transaction being recognised at the time of sale. If artificially low rates of interest are quoted, selling profit would be restricted to that which would apply if a commercial rate of interest were charged.

36. Initial direct costs are recognised as an expense at the commencement of the lease term because they are mainly related to earning the manufacturer's or dealer's selling profit.

37. The lessor should make the following disclosures for finance leases:

(a) a reconciliation between the total gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date. In addition, an enterprise should disclose the total gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years;

(iii) later than five years;

(b) unearned finance income;

(c) the unguaranteed residual values accruing to the benefit of the lessor;

(d) the accumulated provision for uncollectible minimum lease payments receivable;

(e) contingent rents recognised in the statement of profit and loss for the period;

(f) a general description of the significant leasing arrangements of the lessor; and

(g) accounting policy adopted in respect of initial direct costs.

Provided that a Small and Medium Sized Company and a non-corporate Small and Medium Sized Enterprise falling in Level II and Level III, as defined in Appendix 1 to this Compendium, may not comply with sub-paragraphs (a) and (f). Further, a non-corporate Small and Medium Sized Enterprise falling in Level III, as defined in Appendix 1 to this Compendium, may not comply with sub-paragraph (g) also.

38. As an indicator of growth it is often useful to also disclose the gross investment less unearned income in new business added during the accounting period, after deducting the relevant amounts for cancelled leases.

Operating Leases

39. The lessor should present an asset given under operating lease in its balance sheet under fixed assets.

40. Lease income from operating leases should be recognised in the statement of profit and loss on a straight line basis over the lease term, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished.

41. Costs, including depreciation, incurred in earning the lease income are recognised as an expense. Lease income (excluding receipts for services provided such as insurance and maintenance) is recognised in the statement of profit and loss on a straight line basis over the lease term even if the receipts are not on such a basis, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished.

42. Initial direct costs incurred specifically to earn revenues from an operating lease are either deferred and allocated to income over the lease term in proportion to the recognition of rent income, or are recognised as an expense in the statement of profit and loss in the period in which they are incurred.

43. The depreciation of leased assets should be on a basis consistent with the normal depreciation policy of the lessor for similar assets, and the depreciation charge should be calculated on the basis set out in AS 6, Depreciation Accounting.

44. To determine whether a leased asset has become impaired, an enterprise applies the Accounting Standard dealing with impairment of assets[5] that sets out the requirements for how an enterprise should perform the review of the carrying amount of an asset, how it should determine the recoverable amount of an asset and when it should recognise, or reverse, an impairment loss.

45. A manufacturer or dealer lessor does not recognise any selling profit on entering into an operating lease because it is not the equivalent of a sale.

46. The lessor should, in addition to the requirements of AS 6, Depreciation Accounting and AS 10, Accounting for Fixed Assets, and the governing statute, make the following disclosures for operating leases:

(a) for each class of assets, the gross carrying amount, the accumulated depreciation and accumulated impairment losses at the balance sheet date; and

(i) the depreciation recognised in the statement of profit and loss for the period;

(ii) impairment losses recognised in the statement of profit and loss for the period;

(iii) impairment losses reversed in the statement of profit and loss for the period;

(b) the future minimum lease payments under non-cancellable operating leases in the aggregate and for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years;

(iii) later than five years;

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[5] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

(c) total contingent rents recognised as income in the statement of profit and loss for the period;

(d) a general description of the lessor's significant leasing arrangements; and

(e) accounting policy adopted in respect of initial direct costs.

Provided that a Small and Medium Sized Company and a non-corporate Small and Medium Sized Enterprise falling in Level II and Level III, as defined in Appendix 1 to this Compendium, may not comply with sub-paragraphs (b) and (d). Further, a non-corporate Small and Medium Sized Enterprise falling in Level III, as defined in Appendix 1 to this Compendium, may not comply with sub-paragraph (e) also.

Sale and Leaseback Transactions

47. A sale and leaseback transaction involves the sale of an asset by the vendor and the leasing of the same asset back to the vendor. The lease payments and the sale price are usually interdependent as they are negotiated as a package. The accounting treatment of a sale and leaseback transaction depends upon the type of lease involved.

48. If a sale and leaseback transaction results in a finance lease, any excess or deficiency of sales proceeds over the carrying amount should not be immediately recognised as income or loss in the financial statements of a seller-lessee. Instead, it should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

49. If the leaseback is a finance lease, it is not appropriate to regard an excess of sales proceeds over the carrying amount as income. Such excess is deferred and amortised over the lease term in proportion to the depreciation of the leased asset. Similarly, it is not appropriate to regard a deficiency as loss. Such deficiency is deferred and amortised over the lease term.

50. If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss should be recognised immediately. If the sale price is below fair value, any profit or loss should be recognised immediately except that, if the loss is compensated by future lease payments at below market price, it should

be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

51. If the leaseback is an operating lease, and the lease payments and the sale price are established at fair value, there has in effect been a normal sale transaction and any profit or loss is recognised immediately.

52. For operating leases, if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value should be recognised immediately.

53. For finance leases, no such adjustment is necessary unless there has been an impairment in value, in which case the carrying amount is reduced to recoverable amount in accordance with the Accounting Standard dealing with impairment of assets.

54. Disclosure requirements for lessees and lessors apply equally to sale and leaseback transactions. The required description of the significant leasing arrangements leads to disclosure of unique or unusual provisions of the agreement or terms of the sale and leaseback transactions.

55. Sale and leaseback transactions may meet the separate disclosure criteria set out in paragraph 12 of Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

Illustration

Sale and Leaseback Transactions that Result in Operating Leases

The illustration does not form part of the accounting standard. Its purpose is to illustrate the application of the accounting standard.

A sale and leaseback transaction that results in an operating lease may give rise to profit or a loss, the determination and treatment of which depends on the leased asset's carrying amount, fair value and selling price. The following table shows the requirements of the accounting standard in various circumstances.

Sale price established at fair value (paragraph 50)	**Carrying amount equal to fair value**	**Carrying amount less than fair value**	**Carrying amount above fair value**
Profit	No profit	Recognise profit immediately	Not applicable
Loss	No loss	Not applicable	Recognise loss immediately

Sale price below fair value (paragraph 50)			
Profit	No profit	Recognise profit immediately	No profit (note 1)
Loss not compensated by future lease payments at below market price	Recognise loss immediately	Recognise loss immediately	(note 1)
Loss compensated by future lease payments at below market price	Defer and amortise loss	Defer and amortise loss	(note 1)

Sale price above fair value (paragraph 50)			
Profit	Defer and amortise profit	Defer and amortise profit	Defer and amortise profit (note 2)
Loss	No loss	No loss	(note 1)

Note 1. These parts of the table represent circumstances that would have been dealt with under paragraph 52 of the Standard. Paragraph 52 requires the carrying amount of an asset to be written down to fair value where it is subject to a sale and leaseback.

Note 2. The profit would be the difference between fair value and sale price as the carrying amount would have been written down to fair value in accordance with paragraph 52.

Accounting Standard (AS) 20
(issued 2001)

Earnings Per Share

Contents

Accounting Standard (AS) 20*

(issued 2001)

Earnings Per Share

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

Objective

The objective of this Standard is to prescribe principles for the determination and presentation of earnings per share which will improve comparison of performance among different enterprises for the same period and among different accounting periods for the same enterprise. The focus of this Standard is on the denominator of the earnings per share calculation. Even though earnings per share data has limitations because of different accounting policies used for determining 'earnings', a consistently determined denominator enhances the quality of financial reporting.

Scope

1. This Standard should be applied by all the entities. However, a Small and Medium Sized Company and a Small and Medium Sized non-corporate entity falling in Level II or Level III, as defined in Appendix 1 to this Compendium, 'Applicability of Accounting Standards to Various Entities', may not disclose diluted earning per share (both including and excluding extraordinary items). Further, a non-corporate Small and Medium Sized Entity falling in level III as defined in Appendix 1 to this Compendium, may not disclose the information required by paragraph 48(ii) of the standard.

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* A limited revision to this Standard was made in 2004, pursuant to which paragraphs 48 and 51 of this Standard were revised.

[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. In consolidated financial statements, the information required by this Standard should be presented on the basis of consolidated information.[2]

3. In the case of a parent (holding enterprise), users of financial statements are usually concerned with, and need to be informed about, the results of operations of both the enterprise itself as well as of the group as a whole. Accordingly, in the case of such enterprises, this Standard requires the presentation of earnings per share information on the basis of consolidated financial statements as well as individual financial statements of the parent. In consolidated financial statements, such information is presented on the basis of consolidated information.

Definitions

4. For the purpose of this Standard, the following terms are used with the meanings specified:

4.1 An equity share is a share other than a preference share.

4.2 A preference share is a share carrying preferential rights to dividends and repayment of capital.

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

4.4 A potential equity share is a financial instrument or other contract that entitles, or may entitle, its holder to equity shares.

4.5 Share warrants or options are financial instruments that give the holder the right to acquire equity shares.

4.6 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.

5. Equity shares participate in the net profit for the period only after

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[2] Accounting Standard (AS) 21, 'Consolidated Financial Statements', specifies the requirements relating to consolidated financial statements.

preference shares. An enterprise may have more than one class of equity shares. Equity shares of the same class have the same rights to receive dividends.

6. A financial instrument is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity shares of another enterprise. For this purpose, a financial asset is any asset that is

(a) cash;

(b) a contractual right to receive cash or another financial asset from another enterprise;

(c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

(d) an equity share of another enterprise.

A financial liability is any liability that is a contractual obligation to deliver cash or another financial asset to another enterprise or to exchange financial instruments with another enterprise under conditions that are potentially unfavourable.

7. Examples of potential equity shares are:

(a) debt instruments or preference shares, that are convertible into equity shares;

(b) share warrants;

(c) options including employee stock option plans under which employees of an enterprise are entitled to receive equity shares as part of their remuneration and other similar plans; and

(d) shares which would be issued upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares), such as the acquisition of a business or other assets, or shares issuable under a loan contract upon default of payment of principal or interest, if the contract so provides.

Presentation

8. An enterprise should present basic and diluted earnings per share on the face of the statement of profit and loss for each class of equity shares that has a different right to share in the net profit for the period. An enterprise should present basic and diluted earnings per share with equal prominence for all periods presented.

9. This Standard requires an enterprise to present basic and diluted earnings per share, even if the amounts disclosed are negative (a loss per share).

Measurement

Basic Earnings Per Share

10. Basic earnings per share should be calculated by dividing the net profit or loss for the period attributable to equity shareholders by the weighted average number of equity shares outstanding during the period.

Earnings - Basic

11. For the purpose of calculating basic earnings per share, the net profit or loss for the period attributable to equity shareholders should be the net profit or loss for the period after deducting preference dividends and any attributable tax thereto for the period.

12. All items of income and expense which are recognised in a period, including tax expense and extraordinary items, are included in the determination of the net profit or loss for the period unless an Accounting Standard requires or permits otherwise *(see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies)*. The amount of preference dividends and any attributable tax thereto for the period is deducted from the net profit for the period (or added to the net loss for the period) in order to calculate the net profit or loss for the period attributable to equity shareholders.

13. The amount of preference dividends for the period that is deducted from the net profit for the period is:

(a) the amount of any preference dividends on non-cumulative preference shares provided for in respect of the period; and

(b) the full amount of the required preference dividends for cumulative preference shares for the period, whether or not the dividends have been provided for. The amount of preference dividends for the period does not include the amount of any preference dividends for cumulative preference shares paid or declared during the current period in respect of previous periods.

14. If an enterprise has more than one class of equity shares, net profit or loss for the period is apportioned over the different classes of shares in accordance with their dividend rights.

Per Share - Basic

15. For the purpose of calculating basic earnings per share, the number of equity shares should be the weighted average number of equity shares outstanding during the period.

16. The weighted average number of equity shares outstanding during the period reflects the fact that the amount of shareholders' capital may have varied during the period as a result of a larger or lesser number of shares outstanding at any time. It is the number of equity shares outstanding at the beginning of the period, adjusted by the number of equity shares bought back or issued during the period multiplied by the time-weighting factor. The time-weighting factor is the number of days for which the specific shares are outstanding as a proportion of the total number of days in the period; a reasonable approximation of the weighted average is adequate in many circumstances.

Illustration I attached to the Standard illustrates the computation of weighted average number of shares.

17. In most cases, shares are included in the weighted average number of shares from the date the consideration is receivable, for example:

(a) equity shares issued in exchange for cash are included when cash is receivable;

(b) equity shares issued as a result of the conversion of a debt instrument to equity shares are included as of the date of conversion;

(c) equity shares issued in lieu of interest or principal on other financial instruments are included as of the date interest ceases to accrue;

(d) equity shares issued in exchange for the settlement of a liability of the enterprise are included as of the date the settlement becomes effective;

(e) equity shares issued as consideration for the acquisition of an asset other than cash are included as of the date on which the acquisition is recognised; and

(f) equity shares issued for the rendering of services to the enterprise are included as the services are rendered.

In these and other cases, the timing of the inclusion of equity shares is determined by the specific terms and conditions attaching to their issue. Due consideration should be given to the substance of any contract associated with the issue.

18. Equity shares issued as part of the consideration in an amalgamation in the nature of purchase are included in the weighted average number of shares as of the date of the acquisition because the transferee incorporates the results of the operations of the transferor into its statement of profit and loss as from the date of acquisition. Equity shares issued during the reporting period as part of the consideration in an amalgamation in the nature of merger are included in the calculation of the weighted average number of shares from the beginning of the reporting period because the financial statements of the combined enterprise for the reporting period are prepared as if the combined entity had existed from the beginning of the reporting period. Therefore, the number of equity shares used for the calculation of basic earnings per share in an amalgamation in the nature of merger is the aggregate of the weighted average number of shares of the combined enterprises, adjusted to equivalent shares of the enterprise whose shares are outstanding after the amalgamation.

19. Partly paid equity shares are treated as a fraction of an equity share to

the extent that they were entitled to participate in dividends relative to a fully paid equity share during the reporting period.

Illustration II attached to the Standard illustrates the computations in respect of partly paid equity shares.

20. Where an enterprise has equity shares of different nominal values but with the same dividend rights, the number of equity shares is calculated by converting all such equity shares into equivalent number of shares of the same nominal value.

21. Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding, and included in the computation of basic earnings per share from the date when all necessary conditions under the contract have been satisfied.

22. The weighted average number of equity shares outstanding during the period and for all periods presented should be adjusted for events, other than the conversion of potential equity shares, that have changed the number of equity shares outstanding, without a corresponding change in resources.

23. Equity shares may be issued, or the number of shares outstanding may be reduced, without a corresponding change in resources. Examples include:

(a) a bonus issue;

(b) a bonus element in any other issue, for example a bonus element in a rights issue to existing shareholders;

(c) a share split; and

(d) a reverse share split (consolidation of shares).

24. In case of a bonus issue or a share split, equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources. The number of equity shares outstanding before the event is adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported. For

example, upon a two-for-one bonus issue, the number of shares outstanding prior to the issue is multiplied by a factor of three to obtain the new total number of shares, or by a factor of two to obtain the number of additional shares.

Illustration III attached to the Standard illustrates the computation of weighted average number of equity shares in case of a bonus issue during the period.

25. The issue of equity shares at the time of exercise or conversion of potential equity shares will not usually give rise to a bonus element, since the potential equity shares will usually have been issued for full value, resulting in a proportionate change in the resources available to the enterprise. In a rights issue, on the other hand, the exercise price is often less than the fair value of the shares. Therefore, a rights issue usually includes a bonus element. The number of equity shares to be used in calculating basic earnings per share for all periods prior to the rights issue is the number of equity shares outstanding prior to the issue, multiplied by the following factor:

$$\frac{\text{Fair value per share immediately prior to the exercise of rights}}{\text{Theoretical ex-rights fair value per share}}$$

The theoretical ex-rights fair value per share is calculated by adding the aggregate fair value of the shares immediately prior to the exercise of the rights to the proceeds from the exercise of the rights, and dividing by the number of shares outstanding after the exercise of the rights. Where the rights themselves are to be publicly traded separately from the shares prior to the exercise date, fair value for the purposes of this calculation is established at the close of the last day on which the shares are traded together with the rights.

Illustration IV attached to the Standard illustrates the computation of weighted average number of equity shares in case of a rights issue during the period.

Diluted Earnings Per Share

26. For the purpose of calculating diluted earnings per share, the net profit or loss for the period attributable to equity shareholders and the weighted average number of shares outstanding during the period should be adjusted for the effects of all dilutive potential equity shares.

27. In calculating diluted earnings per share, effect is given to all dilutive potential equity shares that were outstanding during the period, that is:

(a) the net profit for the period attributable to equity shares is:

(i) increased by the amount of dividends recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period;

(ii) increased by the amount of interest recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period; and

(iii) adjusted for the after-tax amount of any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

(b) the weighted average number of equity shares outstanding during the period is increased by the weighted average number of additional equity shares which would have been outstanding assuming the conversion of all dilutive potential equity shares.

28. For the purpose of this Standard, share application money pending allotment or any advance share application money as at the balance sheet date, which is not statutorily required to be kept separately and is being utilised in the business of the enterprise, is treated in the same manner as dilutive potential equity shares for the purpose of calculation of diluted earnings per share.

Earnings - Diluted

29. For the purpose of calculating diluted earnings per share, the amount of net profit or loss for the period attributable to equity shareholders, as calculated in accordance with paragraph 11, should be adjusted by the following, after taking into account any attributable change in tax expense for the period:

(a) any dividends on dilutive potential equity shares which have been deducted in arriving at the net profit attributable to equity shareholders as calculated in accordance with paragraph 11;

(b) interest recognised in the period for the dilutive potential equity shares; and

(c) any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

30. After the potential equity shares are converted into equity shares, the dividends, interest and other expenses or income associated with those potential equity shares will no longer be incurred (or earned). Instead, the new equity shares will be entitled to participate in the net profit attributable to equity shareholders. Therefore, the net profit for the period attributable to equity shareholders calculated in accordance with paragraph 11 is increased by the amount of dividends, interest and other expenses that will be saved, and reduced by the amount of income that will cease to accrue, on the conversion of the dilutive potential equity shares into equity shares. The amounts of dividends, interest and other expenses or income are adjusted for any attributable taxes.

Illustration V attached to the standard illustrates the computation of diluted earnings in case of convertible debentures.

31. The conversion of some potential equity shares may lead to consequential changes in other items of income or expense. For example, the reduction of interest expense related to potential equity shares and the resulting increase in net profit for the period may lead to an increase in the expense relating to a non-discretionary employee profit sharing plan. For the purpose of calculating diluted earnings per share, the net profit or loss for the period is adjusted for any such consequential changes in income or expenses.

Per Share - Diluted

32. For the purpose of calculating diluted earnings per share, the number of equity shares should be the aggregate of the weighted average number of equity shares calculated in accordance with paragraphs 15 and 22, and the weighted average number of equity shares which would be issued on the conversion of all the dilutive potential equity shares into equity shares. Dilutive potential equity shares should be deemed to have been converted into equity shares at the beginning of the period or, if issued later, the date of the issue of the potential equity shares.

33. The number of equity shares which would be issued on the conversion of dilutive potential equity shares is determined from the terms of the potential equity shares. The computation assumes the most advantageous conversion rate or exercise price from the standpoint of the holder of the potential equity shares.

34. Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding and included in the computation of both the basic earnings per share and diluted earnings per share from the date when the conditions under a contract are met. If the conditions have not been met, for computing the diluted earnings per share, contingently issuable shares are included as of the beginning of the period (or as of the date of the contingent share agreement, if later). The number of contingently issuable shares included in this case in computing the diluted earnings per share is based on the number of shares that would be issuable if the end of the reporting period was the end of the contingency period. Restatement is not permitted if the conditions are not met when the contingency period actually expires subsequent to the end of the reporting period. The provisions of this paragraph apply equally to potential equity shares that are issuable upon the satisfaction of certain conditions (contingently issuable potential equity shares).

35. For the purpose of calculating diluted earnings per share, an enterprise should assume the exercise of dilutive options and other dilutive potential equity shares of the enterprise. The assumed proceeds from these issues should be considered to have been received from the issue of shares at fair value. The difference between the number of shares issuable and the number of shares that would have been issued at fair value should be treated as an issue of equity shares for no consideration.

36. Fair value for this purpose is the average price of the equity shares during the period. Theoretically, every market transaction for an enterprise's equity shares could be included in determining the average price. As a practical matter, however, a simple average of last six months weekly closing prices are usually adequate for use in computing the average price.

37. Options and other share purchase arrangements are dilutive when they would result in the issue of equity shares for less than fair value. The amount of the dilution is fair value less the issue price. Therefore, in order to calculate diluted earnings per share, each such arrangement is treated as consisting

of:

(a) a contract to issue a certain number of equity shares at their average fair value during the period. The shares to be so issued are fairly priced and are assumed to be neither dilutive nor anti-dilutive. They are ignored in the computation of diluted earnings per share; and

(b) a contract to issue the remaining equity shares for no consideration. Such equity shares generate no proceeds and have no effect on the net profit attributable to equity shares outstanding. Therefore, such shares are dilutive and are added to the number of equity shares outstanding in the computation of diluted earnings per share.

Illustration VI attached to the Standard illustrates the effects of share options on diluted earnings per share.

38. To the extent that partly paid shares are not entitled to participate in dividends during the reporting period they are considered the equivalent of warrants or options.

Dilutive Potential Equity Shares

39. Potential equity shares should be treated as dilutive when, and only when, their conversion to equity shares would decrease net profit per share from continuing ordinary operations.

40. An enterprise uses net profit from continuing ordinary activities as "the control figure" that is used to establish whether potential equity shares are dilutive or anti-dilutive. The net profit from continuing ordinary activities is the net profit from ordinary activities (as defined in AS 5) after deducting preference dividends and any attributable tax thereto and after excluding items relating to discontinued operations[3].

41. Potential equity shares are anti-dilutive when their conversion to equity shares would increase earnings per share from continuing ordinary activities or decrease loss per share from continuing ordinary activities. The effects

[3] Accounting Standard (AS) 24, 'Discontinuing Operations', specifies the requirements in respect of discontinued operations.

of anti-dilutive potential equity shares are ignored in calculating diluted earnings per share.

42. In considering whether potential equity shares are dilutive or anti-dilutive, each issue or series of potential equity shares is considered separately rather than in aggregate. The sequence in which potential equity shares are considered may affect whether or not they are dilutive. Therefore, in order to maximise the dilution of basic earnings per share, each issue or series of potential equity shares is considered in sequence from the most dilutive to the least dilutive. For the purpose of determining the sequence from most dilutive to least dilutive potential equity shares, the earnings per incremental potential equity share is calculated. Where the earnings per incremental share is the least, the potential equity share is considered most dilutive and vice-versa.

Illustration VII attached to the Standard illustrates the manner of determining the order in which dilutive securities should be included in the computation of weighted average number of shares.

43. Potential equity shares are weighted for the period they were outstanding. Potential equity shares that were cancelled or allowed to lapse during the reporting period are included in the computation of diluted earnings per share only for the portion of the period during which they were outstanding. Potential equity shares that have been converted into equity shares during the reporting period are included in the calculation of diluted earnings per share from the beginning of the period to the date of conversion; from the date of conversion, the resulting equity shares are included in computing both basic and diluted earnings per share.

Restatement

44. If the number of equity or potential equity shares outstanding increases as a result of a bonus issue or share split or decreases as a result of a reverse share split (consolidation of shares), the calculation of basic and diluted earnings per share should be adjusted for all the periods presented. If these changes occur after the balance sheet date but before the date on which the financial statements are approved by the board of directors, the per share calculations for those financial statements and any prior period financial statements presented should be based on the new number of shares. When per share calculations reflect such changes in the number of shares, that fact should be disclosed.

45. An enterprise does not restate diluted earnings per share of any prior period presented for changes in the assumptions used or for the conversion of potential equity shares into equity shares outstanding.

46. An enterprise is encouraged to provide a description of equity share transactions or potential equity share transactions, other than bonus issues, share splits and reverse share splits (consolidation of shares) which occur after the balance sheet date when they are of such importance that non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions. Examples of such transactions include:

(a) the issue of shares for cash;

(b) the issue of shares when the proceeds are used to repay debt or preference shares outstanding at the balance sheet date;

(c) the cancellation of equity shares outstanding at the balance sheet date;

(d) the conversion or exercise of potential equity shares, outstanding at the balance sheet date, into equity shares;

(e) the issue of warrants, options or convertible securities; and

(f) the satisfaction of conditions that would result in the issue of contingently issuable shares.

47. Earnings per share amounts are not adjusted for such transactions occurring after the balance sheet date because such transactions do not affect the amount of capital used to produce the net profit or loss for the period.

Disclosure

48. In addition to disclosures as required by paragraphs 8, 9 and 44 of this Standard, an enterprise should disclose the following:

(i) where the statement of profit and loss includes extraordinary items (within the meaning of AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies), the enterprise should disclose basic and diluted earnings per

share computed on the basis of earnings excluding extraordinary items (net of tax expense); and

(ii) (a) the amounts used as the numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to the net profit or loss for the period;

(b) the weighted average number of equity shares used as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other; and

(c) the nominal value of shares along with the earnings per share figures.

Provided that a non-corporate Small and Medium Sized Entity Falling in Level III, as difined in Appendix 1 to this Compendium, 'Applicability of Accounting Standards to Various Entities', may not comply with sub-paragraph (ii).

49. Contracts generating potential equity shares may incorporate terms and conditions which affect the measurement of basic and diluted earnings per share. These terms and conditions may determine whether or not any potential equity shares are dilutive and, if so, the effect on the weighted average number of shares outstanding and any consequent adjustments to the net profit attributable to equity shareholders. Disclosure of the terms and conditions of such contracts is encouraged by this Standard.

50. If an enterprise discloses, in addition to basic and diluted earnings per share, per share amounts using a reported component of net profit other than net profit or loss for the period attributable to equity shareholders, such amounts should be calculated using the weighted average number of equity shares determined in accordance with this Standard. If a component of net profit is used which is not reported as a line item in the statement of profit and loss, a reconciliation should be provided between the component used and a line item which is reported in the statement of profit and loss. Basic and diluted per share amounts should be disclosed with equal prominence.

51. An enterprise may wish to disclose more information than this Standard

PREVIOUS HOME NEXT

requires. Such information may help the users to evaluate the performance of the enterprise and may take the form of per share amounts for various components of net profit. Such disclosures are encouraged. However, when such amounts are disclosed, the denominators need to be calculated in accordance with this Standard in order to ensure the comparability of the per share amounts disclosed.

Illustrations

Note: These illustrations do not form part of the Accounting Standard. Their purpose is to illustrate the application of the Accounting Standard.

Illustration I

Example - Weighted Average Number of Shares
(Accounting year 01-01-20X1 to 31-12-20X1)

		No. of Shares Issued	*No. of Shares Bought Back*	*No. of Shares Outstanding*
1st January, 20X1	Balance at beginning of year	1,800	-	1,800
31st May, 20X1	Issue of shares for cash	600	-	2,400
1st Nov., 20X1	Buy Back of shares	-	300	2,100
31st Dec., 20X1	Balance at end of year	2,400	300	2,100

Computation of Weighted Average:
(1,800 x 5/12) + (2,400 x 5/12) + (2,100 x 2/12) = 2,100 shares.

The weighted average number of shares can alternatively be computed as follows:
(1,800 x12/12) + (600 x 7/12) - (300 x 2/12) = 2,100 shares

Illustration II

Example – Partly paid shares

(Accounting year 01-01-20X1 to 31-12-20X1)

		No. of shares issued	*Nominal value of shares*	*Amount paid*
1st January, 20X1	Balance at beginning of year	1,800	Rs. 10	Rs. 10
31st October, 20X1	Issue of Shares	600	Rs. 10	Rs. 5

Assuming that partly paid shares are entitled to participate in the dividend to the extent of amount paid, number of partly paid equity shares would be taken as 300 for the purpose of calculation of earnings per share.

Computation of weighted average would be as follows:

(1,800x12/12) + (300x2/12) = 1,850 shares.

Illustration III

Example - Bonus Issue
(Accounting year 01-01-20XX to 31-12-20XX)

Net profit for the year 20X0	Rs. 18,00,000
Net profit for the year 20X1	Rs. 60,00,000
No. of equity shares outstanding until 30th September 20X1	20,00,000
Bonus issue 1st October 20X1	2 equity shares for each equity share outstanding at 30th September, 20X1 20,00,000 x 2 = 40,00,000
Earnings per share for the year 20X1	$\frac{\text{Rs. } 60,00,000}{(20,00,000 + 40,00,000)}$ = Re. 1.00
Adjusted earnings per share for the year 20X0	$\frac{\text{Rs. } 18,00,000}{(20,00,000 + 40,00,000)}$ = Re. 0.30
Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of the year 20X0, the earliest period reported.	

Illustration IV

Example - Rights Issue

(Accounting year 01-01-20XX to 31-12-20XX)

Net profit	Year 20X0 : Rs. 11,00,000 Year 20X1 : Rs. 15,00,000
No. of shares outstanding prior to rights issue	5,00,000 shares
Rights issue	One new share for each five outstanding (i.e. 1,00,000 new shares) Rights issue price : Rs. 15.00 Last date to exercise rights: 1^{st} March 20X1
Fair value of one equity share immediately prior to exercise of rights on 1^{st} March 20X1	Rs. 21.00

Computation of theoretical ex-rights fair value per share

$$\frac{\text{Fair value of all outstanding shares immediately prior to exercise of rights+total amount received from exercise}}{\text{Number of shares outstanding prior to exercise + number of shares issued in the exercise}}$$

$$\frac{(\text{Rs. } 21.00 \times 5{,}00{,}000 \text{ shares}) + (\text{Rs. } 15.00 \times 1{,}00{,}000 \text{ shares})}{5{,}00{,}000 \text{ shares} + 1{,}00{,}000 \text{ shares}}$$

Theoretical ex-rights fair value per share = Rs. 20.00

Computation of adjustment factor

$$\frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex-rights value per share}} \quad \frac{\text{Rs. } (21.00)}{\text{Rs. } (20.00)} = 1.05$$

Computation of earnings per share

	Year 20X0	Year 20X1
EPS for the year 20X0 as originally reported: Rs.11,00,000/5,00,000 shares	Rs. 2.20	

EPS for the year 20X0 restated for rights issue: Rs.11,00,000/ (5,00,000 shares x 1.05)	Rs. 2.10	
EPS for the year 20X1 including effects of rights issue $\dfrac{\text{Rs. } 15{,}00{,}000}{(5{,}00{,}000 \times 1.05 \times 2/12) + (6{,}00{,}000 \times 10/12)}$		Rs. 2.55

Illustration V

Example - Convertible Debentures

(Accounting year 01-01-20XX to 31-12-20XX)

Net profit for the current year	Rs. 1,00,00,000
No. of equity shares outstanding	50,00,000
Basic earnings per share	Rs. 2.00
No. of 12% convertible debentures of Rs. 100 each Each debenture is convertible into 10 equity shares	1,00,000
Interest expense for the current year	Rs. 12,00,000
Tax relating to interest expense (30%)	Rs. 3,60,000
Adjusted net profit for the current year	Rs. (1,00,00,000 + 12,00,000 - 3,60,000) = Rs. 1,08,40,000
No. of equity shares resulting from conversion of debentures	10,00,000
No. of equity shares used to compute diluted earnings per share	50,00,000 + 10,00,000 = 60,00,000
Diluted earnings per share	1,08,40,000/60,00,000 = Re. 1.81

Illustration VI

Example - Effects of Share Options on Diluted Earnings Per Share
(Accounting year 01-01-20XX to 31-12-20XX)

Net profit for the year 20X1	Rs. 12,00,000
Weighted average number of equity shares outstanding during the year 20X1	5,00,000 shares
Average fair value of one equity share during the year 20X1	Rs. 20.00
Weighted average number of shares under option during the year 20X1	1,00,000 shares
Exercise price for shares under option during the year 20X1	Rs. 15.00

Computation of earnings per share

	Earnings	*Shares*	*Earnings per share*
Net profit for the year 20X1	Rs. 12,00,000		
Weighted average number of shares outstanding during year 20X1		5,00,000	
Basic earnings per share			Rs. 2.40
Number of shares under option		1,00,000	
Number of shares that would have been issued at fair value: (100,000 x 15.00)/20.00	*	(75,000)	
Diluted earnings per share	Rs. 12,00,000	5,25,000	Rs. 2.29

**The earnings have not been increased as the total number of shares has been increased only by the number of shares (25,000) deemed for the purpose of the computation to have been issued for no consideration {see para 37(b)}*

Illustration VII

Example - Determining the Order in Which to Include Dilutive Securities in the Computation of Weighted Average Number of Shares

(Accounting year 01-01-20XX to 31-12-20XX)

Earnings, i.e., Net profit attributable to equity shareholders	Rs. 1,00,00,000
No. of equity shares outstanding	20,00,000
Average fair value of one equity share during the year	Rs. 75.00
Potential Equity Shares	
Options	1,00,000 with exercise price of Rs. 60
Convertible Preference Shares Attributable tax, e.g., corporate dividend tax	8,00,000 shares entitled to a cumulative dividend of Rs. 8 per share. Each preference share is convertible into 2 equity shares. 10%
12% Convertible Debentures of Rs. 100 each	Nominal amount Rs. 10,00,00,000. Each debenture is convertible into 4 equity shares.
Tax rate	30%

Increase in Earnings Attributable to Equity Shareholders on Conversion of Potential Equity Shares

	Increase in Earnings	*Increase in no. of Equity Shares*	*Earnings per Incremental Share*
Options			
Increase in earnings	Nil		
No. of incremental shares issued for no consideration {1,00,000 x (75 - 60) / 75}		20,000	Nil
Convertible Preference Shares			
Increase in net profit attributable to equity shareholders as adjusted by attributable tax [(Rs.8 x 8,00,000)+ 10%(8 x 8,00,000)]	Rs. 70,40,000		
No. of incremental shares {2 x 8,00,000}		16,00,000	Rs. 4.40
12% Convertible Debentures			
Increase in net profit {Rs. 10,00,00,000 x 0.12 x (1 - 0.30)}	Rs. 84,00,000		
No. of incremental shares {10,00,000 x 4}		40,00,000	Rs. 2.10

It may be noted from the above that options are most dilutive as their earnings per incremental share is nil. Hence, for the purpose of computation of diluted earnings per share, options will be considered first. 12% convertible debentures being second most dilutive will be considered next and thereafter convertible preference shares will be considered (see para 42).

Computation of Diluted Earnings Per Share

	Net Profit Attributable (Rs.)	*No. of Equity Shares*	*Net profit attributable Per Share (Rs.)*	
As reported	1,00,00,000	20,00,000	5.00	
Options		20,000		
	1,00,00,000	20,20,000	4.95	Dilutive
12% Convertible Debentures	84,00,000	40,00,000		
	1,84,00,000	60,20,000	3.06	Dilutive
Convertible Preference Shares	70,40,000	16,00,000		
	2,54,40,000	76,20,000	3.34	Anti-Dilutive

Since diluted earnings per share is increased when taking the convertible preference shares into account (from Rs. 3.06 to Rs 3.34), the convertible preference shares are anti-dilutive and are ignored in the calculation of diluted earnings per share. Therefore, diluted earnings per share is Rs. 3.06.

Accounting Standard (AS) 21
(issued 2001)

Consolidated Financial Statements

Contents

Accounting Standard (AS) 21
(issued 2001)

Consolidated Financial Statements[1]

[This Accounting Standard includes paragraphs set in ***bold italic*** *type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[2] and the 'Applicability of Accounting Standards to Various Entities' (See Appendix 1 to this Compendium).]*

Objective

The objective of this Standard is to lay down principles and procedures for preparation and presentation of consolidated 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.

Scope

1. This Standard 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 Standard should also be applied in accounting for investments in subsidiaries in the separate financial statements of a parent.

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[1] 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.

[2] 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.

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 Standard 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 AS 13, Accounting for Investments[3]); and

(c) accounting for investments in joint ventures (at present governed by AS 13, Accounting for Investments[4]).

Definitions

5. For the purpose of this Standard, the following terms are used with the meanings specified:

5.1 Control:

(a) the ownership, directly or indirectly through subsidiary(ies), of more than one-half of the voting power of an enterprise; or

(b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from its activities.

5.2 A subsidiary is an enterprise that is controlled by another enterprise (known as the parent).

5.3 A parent is an enterprise that has one or more subsidiaries.

[3] Accounting Standard (AS) 23, 'Accounting for Investments in Associates in Consolidated Financial Statements', specifies the requirements relating to accounting for investments in associates in Consolidated Financial Statements.

[4] Accounting Standard (AS) 27, 'Financial Reporting of Interests in Joint Ventures', specifies the requirements relating to accounting for investments in joint ventures..

5.4 A <u>group</u> is a parent and all its subsidiaries.

5.5 <u>Consolidated financial statements</u> are the financial statements of a group presented as those of a single enterprise.

5.6 <u>Equity</u> is the residual interest in the assets of an enterprise after deducting all its liabilities.

5.7 <u>Minority interest</u> is that part of the net results of operations and of the net assets of a subsidiary attributable to interests which are not owned, directly or indirectly through subsidiary(ies), by the parent.

6. Consolidated financial statements normally include consolidated balance sheet, consolidated statement of profit and loss, and notes, other statements and explanatory material that form an integral part thereof. Consolidated cash flow statement is presented in case a parent presents its own cash flow statement. The consolidated financial statements are presented, to the extent possible, in the same format as that adopted by the parent for its separate financial statements.

Explanation:

All the notes appearing in the separate financial statements of the parent enterprise and its subsidiaries need not be included in the notes to the consolidated financial statement. For preparing consolidated financial statements, the following principles may be observed in respect of notes and other explanatory material that form an integral part thereof:

(a) Notes which are necessary for presenting a true and fair view of the consolidated financial statements are included in the consolidated financial statements as an integral part thereof.

(b) Only the notes involving items which are material need to be disclosed. Materiality for this purpose is assessed in relation to the information contained in consolidated financial statements. In view of this, it is possible that certain notes which are disclosed in separate financial statements of a parent or a subsidiary would not be required to be disclosed in the consolidated financial statements when the test of materiality is applied in the context of consolidated financial statements.

(c) Additional statutory information disclosed in separate financial statements of the subsidiary and/or a parent having no bearing on the true and fair view of the consolidated financial statements need not be disclosed in the consolidated financial statements. An illustration of such information in the case of companies is attached to the Standard.

Presentation of Consolidated Financial Statements

7. A parent which presents consolidated financial statements should present these statements in addition to its separate financial statements.

8. Users of the financial statements of a parent are usually concerned with, and need to be informed about, the financial position and results of operations of not only the enterprise itself but also of the group as a whole. This need is served by providing the users -

(a) separate financial statements of the parent; and

(b) consolidated financial statements, which present financial information about the group as that of a single enterprise without regard to the legal boundaries of the separate legal entities.

Scope of Consolidated Financial Statements

9. A parent which presents consolidated financial statements should consolidate all subsidiaries, domestic as well as foreign, other than those referred to in paragraph 11.

10. The consolidated financial statements are prepared on the basis of financial statements of parent and all enterprises that are controlled by the parent, other than those subsidiaries excluded for the reasons set out in paragraph 11. Control exists when the parent owns, directly or indirectly through subsidiary(ies), more than one-half of the voting power of an enterprise. Control also exists when an enterprise controls the composition of the board of directors (in the case of a company) or of the corresponding governing body (in case of an enterprise not being a company) so as to obtain economic benefits from its activities. An enterprise may control the composition of the governing bodies of entities such as gratuity trust, provident fund trust etc. Since the objective of control over such entities is not to obtain

economic benefits from their activities, these are not considered for the purpose of preparation of consolidated financial statements. For the purpose of this Standard, an enterprise is considered to control the composition of:

(i) the board of directors of a company, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors of that company. An enterprise is deemed to have the power to appoint a director, if any of the following conditions is satisfied:

(a) a person cannot be appointed as director without the exercise in his favour by that enterprise of such a power as aforesaid; or

(b) a person's appointment as director follows necessarily from his appointment to a position held by him in that enterprise; or

(c) the director is nominated by that enterprise or a subsidiary thereof.

(ii) the governing body of an enterprise that is not a company, if it has the power, without the consent or the concurrence of any other person, to appoint or remove all majority of members of the governing body of that other enterprise. An enterprise is deemed to have the power to appoint a member, if any of the following conditions is satisfied:

(a) a person cannot be appointed as member of the governing body without the exercise in his favour by that other enterprise of such a power as aforesaid; or

(b) a person's appointment as member of the governing body follows necessarily from his appointment to a position held by him in that other enterprise; or

(c) the member of the governing body is nominated by that other enterprise.

Explanation:

It is possible that an enterprise is controlled by two enterprises — one controls by virtue of ownership of majority of the voting power of that enterprise and other controls, by virtue of an agreement or otherwise, the composition of the board of directors so as to obtain economic benefit from its activities. In such a rare situation, when an enterprise is controlled by two enterprises as per the definition of 'control', the first mentioned enterprise will be considered as subsidiary of both the controlling enterprises within the meaning of this Standard and, therefore, both the enterprises need to consolidate the financial statements of that enterprise as per the requirements of this Standard.

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; 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, Accounting for Investments. The reasons for not consolidating a subsidiary should be disclosed in the consolidated financial statements.

Explanation:

(a) Where an enterprise owns majority of voting power by virtue of ownership of the shares of another enterprise and all the shares are held as 'stock-in-trade' and are acquired and held exclusively with a view to their subsequent disposal in the near future, the control by the first mentioned enterprise is considered to be temporary within the meaning of paragraph 11(a).

(b) The period of time, which is considered as near future for the purposes of this Standard primarily depends on the facts and circumstances of each case. However, ordinarily, the meaning of the words 'near future' is considered as not more than twelve months from acquisition of relevant investments unless a longer

period can be justified on the basis of facts and circumstances of the case. The intention with regard to disposal of the relevant investment is considered at the time of acquisition of the investment. Accordingly, if the relevant investment is acquired without an intention to its subsequent disposal in near future, and subsequently, it is decided to dispose off the investments, such an investment is not excluded from consolidation, until the investment is actually disposed off. Conversely, if the relevant investment is acquired with an intention to its subsequent disposal in near future, but, due to some valid reasons, it could not be disposed off within that period, the same will continue to be excluded from consolidation, provided there is no change in the intention.

12. Exclusion of a subsidiary from consolidation on the ground that its business activities are dissimilar from those of the other enterprises within the group is not justified because better information is provided by consolidating such subsidiaries and disclosing additional information in the consolidated financial statements about the different business activities of subsidiaries. For example, the disclosures required by Accounting Standard (AS) 17, Segment Reporting, help to explain the significance of different business activities within the group.

Consolidation Procedures

13. In preparing consolidated financial statements, the financial statements of the parent and its subsidiaries should be combined on a line by line basis by adding together like items of assets, liabilities, income and expenses. In order that the consolidated financial statements present financial information about the group as that of a single enterprise, the following steps should be taken:

(a) the cost to the parent of its investment in each subsidiary and the parent's portion of equity of each subsidiary, at the date on which investment in each subsidiary is made, should be eliminated;

(b) any excess of the cost to the parent of its investment in a subsidiary over the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made, should be described as goodwill to be recognised as an asset in the consolidated financial statements;

(c) *when the cost to the parent of its investment in a subsidiary is less than the parent's portion of equity of the subsidiary, at the date on which investment in the subsidiary is made, the difference should be treated as a capital reserve in the consolidated financial statements;*

(d) *minority interests in the net income of consolidated subsidiaries for the reporting period should be identified and adjusted against the income of the group in order to arrive at the net income attributable to the owners of the parent; and*

(e) *minority interests in the net assets of consolidated subsidiaries should be identified and presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders. Minority interests in the net assets consist of:*

  (i) *the amount of equity attributable to minorities at the date on which investment in a subsidiary is made; and*

  (ii) *the minorities' share of movements in equity since the date the parent-subsidiary relationship came in existence.*

Where the carrying amount of the investment in the subsidiary is different from its cost, the carrying amount is considered for the purpose of above computations.

Explanation:

(a) *The tax expense (comprising current tax and deferred tax) to be shown in the consolidated financial statements should be the aggregate of the amounts of tax expense appearing in the separate financial statements of the parent and its subsidiaries.*

(b) *The parent's share in the post-acquisition reserves of a subsidiary, forming part of the corresponding reserves in the consolidated balance sheet, is not required to be disclosed separately in the consolidated balance sheet keeping in view the objective of consolidated financial statements to present financial information of the group as a whole. In view of this, the consolidated reserves disclosed in the consolidated balance sheet are inclusive of the parent's share in the post-acquisition reserves of a subsidiary.*

14. The parent's portion of equity in a subsidiary, at the date on which investment is made, is determined on the basis of information contained in the financial statements of the subsidiary as on the date of investment. However, if the financial statements of a subsidiary, as on the date of investment, are not available and if it is impracticable to draw the financial statements of the subsidiary as on that date, financial statements of the subsidiary for the immediately preceding period are used as a basis for consolidation. Adjustments are made to these financial statements for the effects of significant transactions or other events that occur between the date of such financial statements and the date of investment in the subsidiary.

15. If an enterprise makes two or more investments in another enterprise at different dates and eventually obtains control of the other enterprise, the consolidated financial statements are presented only from the date on which holding-subsidiary relationship comes in existence. If two or more investments are made over a period of time, the equity of the subsidiary at the date of investment, for the purposes of paragraph 13 above, is generally determined on a step-by-step basis; however, if small investments are made over a period of time and then an investment is made that results in control, the date of the latest investment, as a practicable measure, may be considered as the date of investment.

16. Intragroup balances and intragroup transactions and resulting unrealised profits should be eliminated in full. Unrealised losses resulting from intragroup transactions should also be eliminated unless cost cannot be recovered.

17. Intragroup balances and intragroup transactions, including sales, expenses and dividends, are eliminated in full. Unrealised profits resulting from intragroup transactions that are included in the carrying amount of assets, such as inventory and fixed assets, are eliminated in full. Unrealised losses resulting from intragroup transactions that are deducted in arriving at the carrying amount of assets are also eliminated unless cost cannot be recovered.

18. The financial statements used in the consolidation should be drawn up to the same reporting date. If it is not practicable to draw up the financial statements of one or more subsidiaries to such date and, accordingly, those financial statements are drawn up to different reporting dates, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the parent's

financial statements. In any case, the difference between reporting dates should not be more than six months.

19. The financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements are usually drawn up to the same date. When the reporting dates are different, the subsidiary often prepares, for consolidation purposes, statements as at the same date as that of the parent. When it is impracticable to do this, financial statements drawn up to different reporting dates may be used provided the difference in reporting dates is not more than six months. The consistency principle requires that the length of the reporting periods and any difference in the reporting dates should be the same from period to period.

20. Consolidated financial statements should be prepared using uniform accounting policies for like transactions and other events in similar circumstances. If it is not practicable to use uniform accounting policies in preparing the consolidated financial statements, that fact should be disclosed together with the proportions of the items in the consolidated financial statements to which the different accounting policies have been applied.

21. If a member of the group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to its financial statements when they are used in preparing the consolidated financial statements.

22. The results of operations of a subsidiary are included in the consolidated financial statements as from the date on which parent-subsidiary relationship came in existence. The results of operations of a subsidiary with which parent-subsidiary relationship ceases to exist are included in the consolidated statement of profit and loss until the date of cessation of the relationship. The difference between the proceeds from the disposal of investment in a subsidiary and the carrying amount of its assets less liabilities as of the date of disposal is recognised in the consolidated statement of profit and loss as the profit or loss on the disposal of the investment in the subsidiary. In order to ensure the comparability of the financial statements from one accounting period to the next, supplementary information is often provided about the effect of the acquisition and disposal of subsidiaries on the financial position at the reporting date and the results for the reporting period and on the corresponding amounts for the preceding period.

PREVIOUS HOME NEXT

23. An investment in an enterprise should be accounted for in accordance with Accounting Standard (AS) 13, Accounting for Investments, from the date that the enterprise ceases to be a subsidiary and does not become an associate[5].

24. The carrying amount of the investment at the date that it ceases to be a subsidiary is regarded as cost thereafter.

25. Minority interests should be presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders. Minority interests in the income of the group should also be separately presented.

26. The losses applicable to the minority in a consolidated subsidiary may exceed the minority interest in the equity of the subsidiary. The excess, and any further losses applicable to the minority, are adjusted against the majority interest except to the extent that the minority has a binding obligation to, and is able to, make good the losses. If the subsidiary subsequently reports profits, all such profits are allocated to the majority interest until the minority's share of losses previously absorbed by the majority has been recovered.

27. If a subsidiary has outstanding cumulative preference shares which are held outside the group, the parent computes its share of profits or losses after adjusting for the subsidiary's preference dividends, whether or not dividends have been declared.

Accounting for Investments in Subsidiaries in a Parent's Separate Financial Statements

28. In a parent's separate financial statements, investments in subsidiaries should be accounted for in accordance with Accounting Standard (AS) 13, Accounting for Investments.

[5] Accounting Standard (AS) 23, 'Accounting for Investments in Associates in Consolidated Financial Statements', defines the term 'associate' and specifies the requirements relating to accounting for investments in associates in Consolidated Financial Statements.

Disclosure

29. In addition to disclosures required by paragraph 11 and 20, following disclosures should be made:

(a) in consolidated financial statements a list of all subsidiaries including the name, country of incorporation or residence, proportion of ownership interest and, if different, proportion of voting power held;

(b) in consolidated financial statements, where applicable:

(i) the nature of the relationship between the parent and a subsidiary, if the parent does not own, directly or indirectly through subsidiaries, more than one-half of the voting power of the subsidiary;

(ii) the effect of the acquisition and disposal of subsidiaries on the financial position at the reporting date, the results for the reporting period and on the corresponding amounts for the preceding period; and

(iii) the names of the subsidiary(ies) of which reporting date(s) is/are different from that of the parent and the difference in reporting dates.

Transitional Provisions

30. On the first occasion that consolidated financial statements are presented, comparative figures for the previous period need not be presented. In all subsequent years full comparative figures for the previous period should be presented in the consolidated financial statements.

Illustration

Note: This illustration does not form part of the Accounting Standard. Its purpose is to assist in clarifying the meaning of the Accounting Standard.

In the case of companies, the information such as the following given in the notes to the separate financial statements of the parent and/or the subsidiary, need not be included in the consolidated financial statements:

(i) Source from which bonus shares are issued, e.g., capitalisation of profits or Reserves or from Share Premium Account.

(ii) Disclosure of all unutilised monies out of the issue indicating the form in which such unutilised funds have been invested.

(iii) The name(s) of small scale industrial undertaking(s) to whom the company owe any sum together with interest outstanding for more than thirty days.

(iv) A statement of investments (whether shown under "Investment" or under "Current Assets" as stock-in-trade) separately classifying trade investments and other investments, showing the names of the bodies corporate (indicating separately the names of the bodies corporate under the same management) in whose shares or debentures, investments have been made (including all investments, whether existing or not, made subsequent to the date as at which the previous balance sheet was made out) and the nature and extent of the investment so made in each such body corporate.

(v) Quantitative information in respect of sales, raw materials consumed, opening and closing stocks of goods produced/traded and purchases made, wherever applicable.

(vi) A statement showing the computation of net profits in accordance with section 349 of the Companies Act, 1956, with relevant details of the calculation of the commissions payable by way of percentage of such profits to the directors (including managing directors) or manager (if any).

(vii) In the case of manufacturing companies, quantitative information in regard to the licensed capacity (where licence is in force); the installed capacity; and the actual production.

(viii) Value of imports calculated on C.I.F. basis by the company during the financial year in respect of :

(a) raw materials;

(b) components and spare parts;

(c) capital goods.

(ix) Expenditure in foreign currency during the financial year on account of royalty, know-how, professional, consultation fees, interest, and other matters.

(x) Value of all imported raw materials, spare parts and components consumed during the financial year and the value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption.

(xi) The amount remitted during the year in foreign currencies on account of dividends, with a specific mention of the number of non-resident shareholders, the number of shares held by them on which the dividends were due and the year to which the dividends related.

(xii) Earnings in foreign exchange classified under the following heads, namely:

(a) export of goods calculated on F.O.B. basis;

(b) royalty, know-how, professional and consultation fees;

(c) interest and dividend;

(d) other income, indicating the nature thereof.

Accounting Standard (AS) 22
(issued 2001)

Accounting for Taxes on Income

Contents

Accounting Standard (AS) 22

(issued 2001)

Accounting for Taxes on Income

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

Objective

The objective of this Standard is to prescribe accounting treatment for taxes on income. Taxes on income is one of the significant items in the statement of profit and loss of an enterprise. In accordance with the matching concept, taxes on income are accrued in the same period as the revenue and expenses to which they relate. Matching of such taxes against revenue for a period poses special problems arising from the fact that in a number of cases, taxable income may be significantly different from the accounting income. This divergence between taxable income and accounting income arises due to two main reasons. Firstly, there are differences between items of revenue and expenses as appearing in the statement of profit and loss and the items which are considered as revenue, expenses or deductions for tax purposes. Secondly, there are differences between the amount in respect of a particular item of revenue or expense as recognised in the statement of profit and loss and the corresponding amount which is recognised for the computation of taxable income.

Scope

1. This Standard should be applied in accounting for taxes on income. This includes the determination of the amount of the expense or saving

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[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.

related to taxes on income in respect of an accounting period and the disclosure of such an amount in the financial statements.

2. For the purposes of this Standard, taxes on income include all domestic and foreign taxes which are based on taxable income.

3. This Standard does not specify when, or how, an enterprise should account for taxes that are payable on distribution of dividends and other distributions made by the enterprise.

Definitions

4. For the purpose of this Standard, the following terms are used with the meanings specified:

4.1 <u>Accounting income</u> (loss) is the net profit or loss for a period, as reported in the statement of profit and loss, before deducting income tax expense or adding income tax saving.

4.2 <u>Taxable income</u> (tax loss) is the amount of the income (loss) for a period, determined in accordance with the tax laws, based upon which income tax payable (recoverable) is determined.

4.3 <u>Tax expense</u> (tax saving) is the aggregate of current tax and deferred tax charged or credited to the statement of profit and loss for the period.

4.4 <u>Current tax</u> is the amount of income tax determined to be payable (recoverable) in respect of the taxable income (tax loss) for a period.

4.5 <u>Deferred tax</u> is the tax effect of timing differences.

4.6 <u>Timing differences</u> are the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods.

4.7 <u>Permanent differences</u> are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently.

5. Taxable income is calculated in accordance with tax laws. In some circumstances, the requirements of these laws to compute taxable income

differ from the accounting policies applied to determine accounting income. The effect of this difference is that the taxable income and accounting income may not be the same.

6. The differences between taxable income and accounting income can be classified into permanent differences and timing differences. Permanent differences are those differences between taxable income and accounting income which originate in one period and do not reverse subsequently. For instance, if for the purpose of computing taxable income, the tax laws allow only a part of an item of expenditure, the disallowed amount would result in a permanent difference.

7. Timing differences are those differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods. Timing differences arise because the period in which some items of revenue and expenses are included in taxable income do not coincide with the period in which such items of revenue and expenses are included or considered in arriving at accounting income. For example, machinery purchased for scientific research related to business is fully allowed as deduction in the first year for tax purposes whereas the same would be charged to the statement of profit and loss as depreciation over its useful life. The total depreciation charged on the machinery for accounting purposes and the amount allowed as deduction for tax purposes will ultimately be the same, but periods over which the depreciation is charged and the deduction is allowed will differ. Another example of timing difference is a situation where, for the purpose of computing taxable income, tax laws allow depreciation on the basis of the written down value method, whereas for accounting purposes, straight line method is used. Some other examples of timing differences arising under the Indian tax laws are given in Illustration 1.

8. Unabsorbed depreciation and carry forward of losses which can be set-off against future taxable income are also considered as timing differences and result in deferred tax assets, subject to consideration of prudence (see paragraphs 15-18).

Recognition

9. Tax expense for the period, comprising current tax and deferred tax, should be included in the determination of the net profit or loss for the period.

10. Taxes on income are considered to be an expense incurred by the enterprise in earning income and are accrued in the same period as the revenue and expenses to which they relate. Such matching may result into timing differences. The tax effects of timing differences are included in the tax expense in the statement of profit and loss and as deferred tax assets (subject to the consideration of prudence as set out in paragraphs 15-18) or as deferred tax liabilities, in the balance sheet.

11. An example of tax effect of a timing difference that results in a deferred tax asset is an expense provided in the statement of profit and loss but not allowed as a deduction under Section 43B of the Income-tax Act, 1961. This timing difference will reverse when the deduction of that expense is allowed under Section 43B in subsequent year(s). An example of tax effect of a timing difference resulting in a deferred tax liability is the higher charge of depreciation allowable under the Income-tax Act, 1961, compared to the depreciation provided in the statement of profit and loss. In subsequent years, the differential will reverse when comparatively lower depreciation will be allowed for tax purposes.

12. Permanent differences do not result in deferred tax assets or deferred tax liabilities.

13. Deferred tax should be recognised for all the timing differences, subject to the consideration of prudence in respect of deferred tax assets as set out in paragraphs 15-18.

Explanation:

(a) The deferred tax in respect of timing differences which reverse during the tax holiday period is not recognised to the extent the enterprise's gross total income is subject to the deduction during the tax holiday period as per the requirements of sections 80-IA/80IB of the Income-tax Act, 1961 (hereinafter referred to as the 'Act'). In case of sections 10A/10B of the Act (covered under Chapter III of the Act dealing with incomes which do not form part of total income), the deferred tax in respect of timing differences which reverse during the tax holiday period is not recognised to the extent deduction from the total income of an enterprise is allowed during the tax holiday period as per the provisions of the said sections.

(b) ***Deferred tax in respect of timing differences which reverse after the tax holiday period is recognised in the year in which the timing differences originate. However, recognition of deferred tax assets is subject to the consideration of prudence as laid down in paragraphs 15 to 18.***

(c) ***For the above purposes, the timing differences which originate first are considered to reverse first.***

The application of the above explaination is illustrated in the Illustration attached to the Standard.

14. This Standard requires recognition of deferred tax for all the timing differences. This is based on the principle that the financial statements for a period should recognise the tax effect, whether current or deferred, of all the transactions occurring in that period.

15. Except in the situations stated in paragraph 17, deferred tax assets should be recognised and carried forward only to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realised.

16. While recognising the tax effect of timing differences, consideration of prudence cannot be ignored. Therefore, deferred tax assets are recognised and carried forward only to the extent that there is a reasonable certainty of their realisation. This reasonable level of certainty would normally be achieved by examining the past record of the enterprise and by making realistic estimates of profits for the future.

17. Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence[4] ***that sufficient future taxable income will be available against which such deferred tax assets can be realised.***

Explanation:

1. ***Determination of virtual certainty that sufficient future taxable income will be available is a matter of judgement based on convincing evidence and will have to be evaluated on a case to case basis. Virtual certainty refers to the extent of certainty, which,***

for all practical purposes, can be considered certain. Virtual certainty cannot be based merely on forecasts of performance such as business plans. Virtual certainty is not a matter of perception and is to be supported by convincing evidence. Evidence is a matter of fact. To be convincing, the evidence should be available at the reporting date in a concrete form, for example, a profitable binding export order, cancellation of which will result in payment of heavy damages by the defaulting party. On the other hand, a projection of the future profits made by an enterprise based on the future capital expenditures or future restructuring etc. submitted even to an outside agency, e.g., to a credit agency for obtaining loans and accepted by that agency cannot, in isolation, be considered as convincing evidence.

2 ***(a)*** ***As per the relevant provisions of the Income-tax Act, 1961 (here in after referred to as the 'Act'), the 'loss' arising under the head 'Capital gains' can be carried forward and set-off in future years, only against the income arising under that head as per the requirements of the Act.***

(b) ***Where an enterprise's statement of profit and loss includes an item of 'loss' which can be set-off in future for taxation purposes, only against the income arising under the head 'Capital gains' as per the requirements of the Act, that item is a timing difference to the extent it is not set-off in the current year and is allowed to be set-off against the income arising under the head 'Capital gains' in subsequent years subject to the provisions of the Act. In respect of such 'loss', deferred tax asset is recognised and carried forward subject to the consideration of prudence. Accordingly, in respect of such 'loss', deferred tax asset is recognised and carried forward only to the extent that there is a virtual certainty, supported by convincing evidence, that sufficient future taxable income will be available under the head 'Capital gains' against which the loss can be set-off as per the provisions of the Act. Whether the test of virtual certainty is fulfilled or not would depend on the facts and circumstances of each case. The examples of situations in which the test of virtual certainty, supported by convincing evidence, for the purposes of the recognition of deferred tax asset in respect of loss arising under the head 'Capital gains' is normally fulfilled, are sale of an asset giving rise to capital gain (eligible***

to set-off the capital loss as per the provisions of the Act) after the balance sheet date but before the financial statements are approved, and binding sale agreement which will give rise to capital gain (eligible to set-off the capital loss as per the provisions of the Act).

(c) In cases where there is a difference between the amounts of 'loss' recognised for accounting purposes and tax purposes because of cost indexation under the Act in respect of long-term capital assets, the deferred tax asset is recognised and carried forward (subject to the consideration of prudence) on the amount which can be carried forward and set-off in future years as per the provisions of the Act.

18. The existence of unabsorbed depreciation or carry forward of losses under tax laws is strong evidence that future taxable income may not be available. Therefore, when an enterprise has a history of recent losses, the enterprise recognises deferred tax assets only to the extent that it has timing differences the reversal of which will result in sufficient income or there is other convincing evidence that sufficient taxable income will be available against which such deferred tax assets can be realised. In such circumstances, the nature of the evidence supporting its recognition is disclosed.

Re-assessment of Unrecognised Deferred Tax Assets

19. At each balance sheet date, an enterprise re-assesses unrecognised deferred tax assets. The enterprise recognises previously unrecognised deferred tax assets to the extent that it has become reasonably certain or virtually certain, as the case may be (see paragraphs 15 to 18), that sufficient future taxable income will be available against which such deferred tax assets can be realised. For example, an improvement in trading conditions may make it reasonably certain that the enterprise will be able to generate sufficient taxable income in the future.

Measurement

20. Current tax should be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the applicable tax rates and tax laws.

21. Deferred tax assets and liabilities should be measured using the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.

Explanation:

(a) The payment of tax under section 115JB of the Income-tax Act, 1961 (hereinafter referred to as the 'Act') is a current tax for the period.

(b) In a period in which a company pays tax under section 115JB of the Act, the deferred tax assets and liabilities in respect of timing differences arising during the period, tax effect of which is required to be recognised under this Standard, is measured using the regular tax rates and not the tax rate under section 115JB of the Act.

(c) In case an enterprise expects that the timing differences arising in the current period would reverse in a period in which it may pay tax under section 115JB of the Act, the deferred tax assets and liabilities in respect of timing differences arising during the current period, tax effect of which is required to be recognised under AS 22, is measured using the regular tax rates and not the tax rate under section 115JB of the Act.

22. Deferred tax assets and liabilities are usually measured using the tax rates and tax laws that have been enacted. However, certain announcements of tax rates and tax laws by the government may have the substantive effect of actual enactment. In these circumstances, deferred tax assets and liabilities are measured using such announced tax rate and tax laws.

23. When different tax rates apply to different levels of taxable income, deferred tax assets and liabilities are measured using average rates.

24. Deferred tax assets and liabilities should not be discounted to their present value.

25. The reliable determination of deferred tax assets and liabilities on a discounted basis requires detailed scheduling of the timing of the reversal of each timing difference. In a number of cases such scheduling is

impracticable or highly complex. Therefore, it is inappropriate to require discounting of deferred tax assets and liabilities. To permit, but not to require, discounting would result in deferred tax assets and liabilities which would not be comparable between enterprises. Therefore, this Standard does not require or permit the discounting of deferred tax assets and liabilities.

Review of Deferred Tax Assets

26. The carrying amount of deferred tax assets should be reviewed at each balance sheet date. An enterprise should write-down the carrying amount of a deferred tax asset to the extent that it is no longer reasonably certain or virtually certain, as the case may be (see paragraphs 15 to 18), that sufficient future taxable income will be available against which deferred tax asset can be realised. Any such write-down may be reversed to the extent that it becomes reasonably certain or virtually certain, as the case may be (see paragraphs 15 to 18), that sufficient future taxable income will be available.

Presentation and Disclosure

27. An enterprise should offset assets and liabilities representing current tax if the enterprise:

(a) has a legally enforceable right to set off the recognised amounts; and

(b) intends to settle the asset and the liability on a net basis.

28. An enterprise will normally have a legally enforceable right to set off an asset and liability representing current tax when they relate to income taxes levied under the same governing taxation laws and the taxation laws permit the enterprise to make or receive a single net payment.

29. An enterprise should offset deferred tax assets and deferred tax liabilities if:

(a) the enterprise has a legally enforceable right to set off assets against liabilities representing current tax; and

(b) the deferred tax assets and the deferred tax liabilities relate to taxes on income levied by the same governing taxation laws.

30. Deferred tax assets and liabilities should be distinguished from assets and liabilities representing current tax for the period. Deferred tax assets and liabilities should be disclosed under a separate heading in the balance sheet of the enterprise, separately from current assets and current liabilities.

Explanation:

Deferred tax assets (net of the deferred tax liabilities, if any, in accordance with paragraph 29) is disclosed on the face of the balance sheet separately after the head 'Investments' and deferred tax liabilities (net of the deferred tax assets, if any, in accordance with paragraph 29) is disclosed on the face of the balance sheet separately after the head 'Unsecured Loans.'

31. The break-up of deferred tax assets and deferred tax liabilities into major components of the respective balances should be disclosed in the notes to accounts.

32. The nature of the evidence supporting the recognition of deferred tax assets should be disclosed, if an enterprise has unabsorbed depreciation or carry forward of losses under tax laws.

Transitional Provisions

33. On the first occasion that the taxes on income are accounted for in accordance with this Standard the enterprise should recognise, in the financial statements, the deferred tax balance that has accumulated prior to the adoption of this Standard as deferred tax asset/liability with a corresponding credit/charge to the revenue reserves, subject to the consideration of prudence in case of deferred tax assets (see paragraphs 15-18). The amount so credited/charged to the revenue reserves should be the same as that which would have resulted if this Standard had been in effect from the beginning.

34. For the purpose of determining accumulated deferred tax in the period in which this Standard is applied for the first time, the opening balances of assets and liabilities for accounting purposes and for tax purposes are

compared and the differences, if any, are determined. The tax effects of these differences, if any, should be recognised as deferred tax assets or liabilities, if these differences are timing differences. For example, in the year in which an enterprise adopts this Standard, the opening balance of a fixed asset is Rs. 100 for accounting purposes and Rs. 60 for tax purposes. The difference is because the enterprise applies written down value method of depreciation for calculating taxable income whereas for accounting purposes straight line method is used. This difference will reverse in future when depreciation for tax purposes will be lower as compared to the depreciation for accounting purposes. In the above case, assuming that enacted tax rate for the year is 40% and that there are no other timing differences, deferred tax liability of Rs. 16 [(Rs. 100 - Rs. 60) x 40%] would be recognised. Another example is an expenditure that has already been written off for accounting purposes in the year of its incurrence but is allowable for tax purposes over a period of time. In this case, the asset representing that expenditure would have a balance only for tax purposes but not for accounting purposes. The difference between balance of the asset for tax purposes and the balance (which is nil) for accounting purposes would be a timing difference which will reverse in future when this expenditure would be allowed for tax purposes. Therefore, a deferred tax asset would be recognised in respect of this difference subject to the consideration of prudence (see paragraphs 15 - 18).

Illustration I

Examples of Timing Differences

Note: This illustration does not form part of the Accounting Standard. The purpose of this illustration is to assist in clarifying the meaning of the Accounting Standard. The sections mentioned hereunder are references to sections in the Income-tax Act, 1961, as amended by the Finance Act, 2001.

1. Expenses debited in the statement of profit and loss for accounting purposes but allowed for tax purposes in subsequent years, e.g.

   a) Expenditure of the nature mentioned in section 43B (e.g. taxes, duty, cess, fees, etc.) accrued in the statement of profit and loss on mercantile basis but allowed for tax purposes in subsequent years on payment basis.

   b) Payments to non-residents accrued in the statement of profit and loss on mercantile basis, but disallowed for tax purposes under section 40(a)(i) and allowed for tax purposes in subsequent years when relevant tax is deducted or paid.

c) Provisions made in the statement of profit and loss in anticipation of liabilities where the relevant liabilities are allowed in subsequent years when they crystallize.

2. Expenses amortized in the books over a period of years but are allowed for tax purposes wholly in the first year (e.g. substantial advertisement expenses to introduce a product, etc. treated as deferred revenue expenditure in the books) or if amortization for tax purposes is over a longer or shorter period (e.g. preliminary expenses under section 35D, expenses incurred for amalgamation under section 35DD, prospecting expenses under section 35E).

3. Where book and tax depreciation differ. This could arise due to:

a) Differences in depreciation rates.

b) Differences in method of depreciation e.g. SLM or WDV.

c) Differences in method of calculation e.g. calculation of depreciation with reference to individual assets in the books but on block basis for tax purposes and calculation with reference to time in the books but on the basis of full or half depreciation under the block basis for tax purposes.

d) Differences in composition of actual cost of assets.

4. Where a deduction is allowed in one year for tax purposes on the basis of a deposit made under a permitted deposit scheme (e.g. tea development account scheme under section 33AB or site restoration fund scheme under section 33ABA) and expenditure out of withdrawal from such deposit is debited in the statement of profit and loss in subsequent years.

5. Income credited to the statement of profit and loss but taxed only in subsequent years e.g. conversion of capital assets into stock in trade.

6. If for any reason the recognition of income is spread over a number of years in the accounts but the income is fully taxed in the year of receipt.

Illustration II

Note: This illustration does not form part of the Accounting Standard. Its purpose is to illustrate the application of the Accounting Standard. Extracts from statement of profit and loss are provided to show the effects of the transactions described below.

Illustration 1

A company, ABC Ltd., prepares its accounts annually on 31st March. On 1st April, 20x1, it purchases a machine at a cost of Rs. 1,50,000. The machine has a useful life of three years and an expected scrap value of zero. Although it is eligible for a 100% first year depreciation allowance for tax purposes, the straight-line method is considered appropriate for accounting purposes. ABC Ltd. has profits before depreciation and taxes of Rs. 2,00,000 each year and the corporate tax rate is 40 per cent each year.

The purchase of machine at a cost of Rs. 1,50,000 in 20x1 gives rise to a tax saving of Rs. 60,000. If the cost of the machine is spread over three years of its life for accounting purposes, the amount of the tax saving should also be spread over the same period as shown below:

Statement of Profit and Loss
(for the three years ending 31st March, 20x1, 20x2, 20x3)

(Rupees in thousands)

	20x1	20x2	20x3
Profit before depreciation and taxes	200	200	200
Less: Depreciation for accounting purposes	50	50	50
Profit before taxes	150	150	150
Less: Tax expense			
Current tax			
0.40 (200 – 150)	20		
0.40 (200)		80	80
Deferred tax			

Tax effect of timing differences originating during the year			
0.40 (150 – 50)	40		
Tax effect of timing differences reversing during the year			
0.40 (0 – 50)		(20)	(20)
Tax expense	60	60	60
Profit after tax	90	90	90
Net timing differences	100	50	0
Deferred tax liability	40	20	0

In 20x1, the amount of depreciation allowed for tax purposes exceeds the amount of depreciation charged for accounting purposes by Rs. 1,00,000 and, therefore, taxable income is lower than the accounting income. This gives rise to a deferred tax liability of Rs. 40,000. In 20x2 and 20x3, accounting income is lower than taxable income because the amount of depreciation charged for accounting purposes exceeds the amount of depreciation allowed for tax purposes by Rs. 50,000 each year. Accordingly, deferred tax liability is reduced by Rs. 20,000 each in both the years. As may be seen, tax expense is based on the accounting income of each period.

In 20x1, the profit and loss account is debited and deferred tax liability account is credited with the amount of tax on the originating timing difference of Rs. 1,00,000 while in each of the following two years, deferred tax liability account is debited and profit and loss account is credited with the amount of tax on the reversing timing difference of Rs. 50,000.

The following Journal entries will be passed:

Year 20x1

Profit and Loss A/c	Dr.	20,000	
To Current tax A/c			20,000
(Being the amount of taxes payable for the year 20x1 provided for)			
Profit and Loss A/c	Dr.	40,000	
To Deferred tax A/c			40,000
(Being the deferred tax liability created for originating timing difference of Rs. 1,00,000)			

Year 20x2

Profit and Loss A/c	Dr.	80,000	
To Current tax A/c			80,000
(Being the amount of taxes payable for the year 20x2 provided for)			
Deferred tax A/c	Dr.	20,000	
To Profit and Loss A/c			20,000
(Being the deferred tax liability adjusted for reversing timing difference of Rs. 50,000)			

Year 20x3

Profit and Loss A/c	Dr.	80,000	
To Current tax A/c			80,000
(Being the amount of taxes payable for the year 20x3 provided for)			
Deferred tax A/c	Dr.	20,000	
To Profit and Loss A/c			20,000
(Being the deferred tax liability adjusted for reversing timing difference of Rs. 50,000)			

In year 20x1, the balance of deferred tax account i.e., Rs. 40,000 would be shown separately from the current tax payable for the year in terms of paragraph 30 of the Statement. In Year 20x2, the balance of deferred tax account would be Rs. 20,000 and be shown separately from the current tax payable for the year as in year 20x1. In Year 20x3, the balance of deferred tax liability account would be nil.

Illustration 2

In the above illustration, the corporate tax rate has been assumed to be same in each of the three years. If the rate of tax changes, it would be necessary for the enterprise to adjust the amount of deferred tax liability carried forward by applying the tax rate that has been enacted or substantively enacted by the balance sheet date on accumulated timing differences at the end of the accounting year (see paragraphs 21 and 22). For example, if in Illustration 1, the substantively enacted tax rates for 20x1, 20x2 and 20x3 are 40%, 35% and 38% respectively, the amount of deferred tax liability would be computed as follows:

The deferred tax liability carried forward each year would appear in the balance sheet as under:

31st March, 20x1 =	0.40 (1,00,000)	= Rs. 40,000
31st March, 20x2 =	0.35 (50,000)	= Rs. 17,500
31st March, 20x3 =	0.38 (Zero)	= Rs. Zero

Accordingly, the amount debited/(credited) to the profit and loss account (with corresponding credit or debit to deferred tax liability) for each year would be as under:

31st March, 20x1	Debit	= Rs. 40,000
31st March, 20x2	(Credit)	= Rs. (22,500)
31st March, 20x3	(Credit)	= Rs. (17,500)

Illustration 3

A company, ABC Ltd., prepares its accounts annually on 31st March. The company has incurred a loss of Rs. 1,00,000 in the year 20x1 and made profits of Rs. 50,000 and 60,000 in year 20x2 and year 20x3 respectively. It is assumed that under the tax laws, loss can be carried forward for 8 years and tax rate is 40% and at the end of year 20x1, it was virtually certain, supported by convincing evidence, that the company would have sufficient taxable income in the future years against which unabsorbed depreciation and carry forward of losses can be set-off. It is also assumed that there is no difference between taxable income and accounting income except that set-off of loss is allowed in years 20x2 and 20x3 for tax purposes.

Statement of Profit and Loss
(for the three years ending 31st March, 20x1, 20x2, 20x3)

(Rupees in thousands)

	20x1	20x2	20x3
Profit (loss)	(1[illegible]	50	60
Less: Current tax	—	—	(4)
Deferred tax:			
Tax effect of timing differences originating during the year	40		
Tax effect of timing differences reversing during the year		(20)	(20)
Profit (loss) after tax effect	(60)	30	36

Illustration 4

Note: The purpose of this illustration is to assist in clarifying the meaning of the explanation to paragraph 13 of the Standard.

Facts:

1. The income before depreciation and tax of an enterprise for 15 years is Rs. 1000 lakhs per year, both as per the books of account and for income-tax purposes.

2. The enterprise is subject to 100 percent tax-holiday for the first 10 years under section 80-IA. Tax rate is assumed to be 30 percent.

3. At the beginning of year 1, the enterprise has purchased one machine for Rs. 1500 lakhs. Residual value is assumed to be nil.

4. For accounting purposes, the enterprise follows an accounting policy to provide depreciation on the machine over 15 years on straight-line basis.

5. For tax purposes, the depreciation rate relevant to the machine is 25% on written down value basis.

The following computations will be made, ignoring the provisions of section 115JB (MAT), in this regard:

Table 1
Computation of depreciation on the machine for accounting purposes and tax purposes

(Amounts in Rs. lakhs)

Year	Depreciation for accounting purposes	Depreciation for tax purposes
1	100	375
2	100	281
3	100	211
4	100	158
5	100	119
6	100	89
7	100	67
8	100	50
9	100	38
10	100	28
11	100	21
12	100	16
13	100	12
14	100	9
15	100	7

At the end of the 15th year, the carrying amount of the machinery for accounting purposes would be nil whereas for tax purposes, the carrying amount is Rs. 19 lakhs which is eligible to be allowed in subsequent years.

Table 2
Computation of Timing differences

(Amounts in Rs. lakhs)

1	2	3	4	5	6	7	8	9
Year	Income before depreciation and tax (both for accounting purposes and tax purposes)	Accounting Income after depreciation	Gross Total Income after deducting depreciation under tax laws)	Deduction under section 80-IA	Taxable Income (4-5)	Total Difference between accounting income and taxable income (3-6)	Permanent Difference (deduction pursuant to section 80-IA)	Timing Difference (due to different amounts of depreciationfor accounting purposes and tax purposes) (0= Originating and R=Reversing)
1	1000	900	625	625	Nil	900	625	275 (O)
2	1000	900	719	719	Nil	900	719	181 (O)
3	1000	900	789	789	Nil	900	789	111 (O)
4	1000	900	842	842	Nil	900	842	58 (O)
5	1000	900	881	881	Nil	900	881	19(0)
6	1000	900	911	911	Nil	900	911	11 (R)
7	1000	900	933	933	Nil	900	933	33 (R)
8	1000	900	950	950	Nil	900	950	50 (R)
9	1000	900	962	962	Nil	900	962	62 (R)
10	1000	900	972	972	Nil	900	972	72 (R)
11	1000	900	979	Nil	979	-79	Nil	79 (R)
12	1000	900	984	Nil	984	-84	Nil	84 (R)
13	1000	900	988	Nil	988	-88	Nil	88 (R)
14	1000	900	991	Nil	991	-91	Nil	91 (R)
15	1000	900	993	Nil	993	-93	Nil	74 (R)
								19 (O)

Notes:

1. Timing differences originating during the tax holiday period are Rs. 644 lakhs, out of which Rs. 228 lakhs are reversing during the tax holiday period and Rs. 416 lakhs are reversing after the tax holiday period. Timing difference of Rs. 19 lakhs is originating in the 15th year which would reverse in subsequent years when for accounting purposes depreciation would be nil but for tax purposes the written down value of the machinery of Rs. 19 lakhs would be eligible to be allowed as depreciation.

2. As per the Standard, deferred tax on timing differences which reverse during the tax holiday period should not be recognised. For this purpose, timing differences which originate first are considered to reverse first. Therefore, the reversal of timing difference of Rs. 228 lakhs during the tax holiday period, would be considered to be out of the timing difference which originated in year 1. The rest of the timing difference originating in year 1 and timing differences originating in years 2 to 5 would be considered to be reversing after the tax holiday period. Therefore, in year 1, deferred tax would be recognised on the timing difference of Rs. 47 lakhs (Rs. 275 lakhs - Rs. 228 lakhs) which would reverse after the tax holiday period. Similar computations would be made for the subsequent years. The deferred tax assets/liabilities to be recognised during different years would be computed as per the following Table.

Table 3
Computation of current tax and deferred tax

(Amounts in Rs. lakhs)

Year	Current tax (Taxable Income x 30%)	Deferred tax (Timing difference x 30%)	Accumulated Deferred tax (L= Liability and A = Asset)	Tax expense
1	Nil	47 × 30%= 14 (see note 2 above)	14 (L)	14
2	Nil	118 × 130%=54	68 (L)	54
3	Nil	111× 30%=33	101 (L)	33
4	Nil	58 × 30%= 17	118 (L)	17
5	Nil	19 × 30%=6	124 (L)	6
6	Nil	Nil[1]	124 (L)	Nil
7	Nil	Nil[1]	124 (L)	Nil
8	Nil	Nil[1]	124 (L)	Nil
9	Nil	Nil[1]	124 (L)	Nil
10	Nil	Nil[1]	124 (L)	Nil
11	294	–79 × 30%=-24	100 (L)	270
12	295	–84 × 30%=-25	75 (L)	270
13	296	–88 × 30%=-26	49 (L)	270
14	297	–91 × 30%=-27	22 (L)	270
15	298	–74 × 30%=-22	Nil	270
		–19 × 30%=-6	6(A)[2]	

[1.] No deferred tax is recognised since in respect of timing differences reversing during the tax holiday period, no deferred tax was recognised at their origination.

[2.] Deferred tax asset of Rs. 6 lakhs would be recognised at the end of year 15 subject to consideration of prudence as per As 22. If it is so recognised, the said deferred tax asset would be realized in subsequent periods when for tax purposes depreciation would be allowed but for accounting purposes no depreciation would be recognised.

Accounting Standard (AS) 23
(issued 2001)

Accounting for Investments in Associates in Consolidated Financial Statements

Contents

Accounting Standard (AS) 23
(issued 2001)

Accounting for Investments in Associates in Consolidated Financial Statements[1]

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[2] and the 'Applicability of Accounting Standards to Various Entities' (See Appendix 1 to this Compendium).]*

Objective

The objective of this Standard is to set out principles and procedures for recognising, in the consolidated financial statements, the effects of the investments in associates on the financial position and operating results of a group.

Scope

1. This Standard should be applied in accounting for investments in associates in the preparation and presentation of consolidated financial statements by an investor.

2. This Standard does not deal with accounting for investments in associates

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[1] 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).

[2] 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.

in the preparation and presentation of separate financial statements by an investor.[3]

Definitions

3. For the purpose of this Standard, the following terms are used with the meanings specified:

3.1 An <u>associate</u> is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture[4] of the investor.

3.2 <u>Significant influence</u> is the power to participate in the financial and/or operating policy decisions of the investee but not control over those policies.

3.3 <u>Control:</u>

(a) the ownership, directly or indirectly through subsidiary(ies), of more than one-half of the voting power of an enterprise; or

(b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from its activities.

3.4 A <u>subsidiary</u> is an enterprise that is controlled by another enterprise (known as the parent).

3.5 A <u>parent</u> is an enterprise that has one or more subsidiaries.

3.6 A <u>group</u> is a parent and all its subsidiaries.

3.7 <u>Consolidated financial statements</u> are the financial statements of a group presented as those of a single enterprise.

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[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] Accounting Standard (AS) 27, 'Financial Reporting of Interests in Joint Ventures', defines the term 'joint venture' and specifies the requirements relating to accounting for investments in joint ventures.

3.8 <u>The equity method</u> is a method of accounting whereby the investment is initially recorded at cost, identifying any goodwill/capital reserve arising at the time of acquisition. The carrying amount of the investment is adjusted thereafter for the post acquisition change in the investor's share of net assets of the investee. The consolidated statement of profit and loss reflects the investor's share of the results of operations of the investee.

3.9 <u>Equity</u> is the residual interest in the assets of an enterprise after deducting all its liabilities.

4. For the purpose of this Standard significant influence does not extend to power to govern the financial and/or operating policies of an enterprise. Significant influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investor holds, directly or indirectly through subsidiary(ies), 20% or more of the voting power of the investee, it is presumed that the investor has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly through subsidiary(ies), less than 20% of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

Explantion :

In considering the share ownership, the potential equity shares of the investees held by the investor are not taken into account for determining the voting power of the investor.

5. The existence of significant influence by an investor is usually evidenced in one or more of the following ways:

(a) Representation on the board of directors or corresponding governing body of the investee;

(b) participation in policy making processes;

(c) material transactions between the investor and the investee;

(d) interchange of managerial personnel; or

(e) provision of essential technical information.

6. Under the equity method, the investment is initially recorded at cost, identifying any goodwill/capital reserve arising at the time of acquisition and the carrying amount is increased or decreased to recognise the investor's share of the profits or losses of the investee after the date of acquisition. Distributions received from an investee reduce the carrying amount of the investment. Adjustments to the carrying amount may also be necessary for alterations in the investor's proportionate interest in the investee arising from changes in the investee's equity that have not been included in the statement of profit and loss. Such changes include those arising from the revaluation of fixed assets and investments, from foreign exchange translation differences and from the adjustment of differences arising on amalgamations.

Explanations:

(a) Adjustments to the carrying amount of investment in an investee arising from changes in the investee's equity that have not been included in the statement of profit and loss of the investee are directly made in the carrying amount of investment without routing it through the consolidated statement of profit and loss. The corresponding debit/credit is made in the relevant head of the equity interest in the consolidated balance sheet. For example, in case the adjustment arises because of revaluation of fixed assets by the investee, apart from adjusting the carrying amount of investment to the extent of proportionate share of the investor in the revalued amount, the corresponding amount of revaluation reserve is shown in the consolidated balance sheet.

(b) In case an associate has made a povision for proposed dividend in its financial statements, the investor's share of the results of operations of the associate is computed without taking in to consideration the proposed dividend.

Accounting for Investments – Equity Method

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; 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, Accounting for Investments. The reasons for not applying the equity method in accounting for investments in an associate should be disclosed in the consolidated financial statements.

Explanation:

The period of time, which is considered as near future for the purposes of this Standard, primarily depends on the facts and circumstances of each case. However, ordinarily, the meaning of the words 'near future' is considered as not more than twelve months from acquisition of relevant investments unless a longer period can be justified on the basis of facts and circumstances of the case. The intention with regard to disposal of the relevant investment is considered at the time of acquisition of the investment. Accordingly, if the relevant investment is acquired without an intention to its subsequent disposal in near future, and subsequently, it is decided to dispose off the investment, such an investment is not excluded from application of the equity method, until the investment is actually disposed off. Conversely, if the relevant investment is acquired with an intention to its subsequent disposal in near future, however, due to some valid reasons, it could not be disposed off within that period, the same will continue to be excluded from application of the equity method, provided there is no change in the intention.

8. Recognition of income on the basis of distributions received may not be an adequate measure of the income earned by an investor on an investment in an associate because the distributions received may bear little relationship to the performance of the associate. As the investor has significant influence over the associate, the investor has a measure of responsibility for the associate's performance and, as a result, the return on its investment. The investor accounts for this stewardship by extending the scope of its consolidated financial statements to include its share of results of such an associate and so provides an analysis of earnings and investment from which more useful ratios can be calculated. As a result, application of the equity method in consolidated financial statements provides more informative reporting of the net assets and net income of the investor.

9. An investor should discontinue the use of the equity method from the date that:

> ***(a) it ceases to have significant influence in an associate but retains, either in whole or in part, its investment; or***
>
> ***(b) the use of the equity method is no longer appropriate because the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor.***

From the date of discontinuing the use of the equity method, investments in such associates should be accounted for in accordance with Accounting Standard (AS) 13, Accounting for Investments. For this purpose, the carrying amount of the investment at that date should be regarded as cost thereafter.

Application of the Equity Method

10. Many of the procedures appropriate for the application of the equity method are similar to the consolidation procedures set out in Accounting Standard (AS) 21, Consolidated Financial Statements. Furthermore, the broad concepts underlying the consolidation procedures used in the acquisition of a subsidiary are adopted on the acquisition of an investment in an associate.

11. An investment in an associate is accounted for under the equity method from the date on which it falls within the definition of an associate. On acquisition of the investment any difference between the cost of acquisition and the investor's share of the equity of the associate is described as goodwill or capital reserve, as the case may be.

12. Goodwill/capital reserve arising on the acquisition of an associate by an investor should be included in the carrying amount of investment in the associate but should be disclosed separately.

13. In using equity method for accounting for investment in an associate, unrealised profits and losses resulting from transactions between the investor (or its consolidated subsidiaries) and the associate should be eliminated to the extent of the investor's interest in the associate. Unrealised losses should not be eliminated if and to the extent the cost of the transferred asset cannot be recovered.

14. The most recent available financial statements of the associate are used by the investor in applying the equity method; they are usually drawn up to the same date as the financial statements of the investor. When the reporting dates of the investor and the associate are different, the associate often prepares, for the use of the investor, statements as at the same date as the financial statements of the investor. When it is impracticable to do this, financial statements drawn up to a different reporting date may be used. The consistency principle requires that the length of the reporting periods, and any difference in the reporting dates are consistent from period to period.

15. When financial statements with a different reporting date are used, adjustments are made for the effects of any significant events or transactions between the investor (or its consolidated subsidiaries) and the associate that occur between the date of the associate's financial statements and the date of the investor's consolidated financial statements.

16. The investor usually prepares consolidated financial statements using uniform accounting policies for the like transactions and events in similar circumstances. In case an associate uses accounting policies other than those adopted for the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to the associate's financial statements when they are used by the investor in applying the equity method. If it is not practicable to do so, that fact is disclosed along with a brief description of the differences between the accounting policies.

17. If an associate has outstanding cumulative preference shares held outside the group, the investor computes its share of profits or losses after adjusting for the preference dividends whether or not the dividends have been declared.

18. If, under the equity method, an investor's share of losses of an associate equals or exceeds the carrying amount of the investment, the investor ordinarily discontinues recognising its share of further losses and the investment is reported at nil value. Additional losses are provided for to the extent that the investor has incurred obligations or made payments on behalf of the associate to satisfy obligations of the associate that the investor has guaranteed or to which the investor is otherwise committed. If the associate subsequently reports profits, the investor resumes including its share of those

profits only after its share of the profits equals the share of net losses that have not been recognised.

19. Where an associate presents consolidated financial statements, the results and net assets to be taken into account are those reported in that associate's consolidated financial statements.

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.

Contingencies

21. In accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date[5], the investor discloses in the consolidated financial statements:

(a) its share of the contingencies and capital commitments of an associate for which it is also contingently liable; and

(b) those contingencies that arise because the investor is severally liable for the liabilities of the associate.

Disclosure

22. In addition to the disclosures required by paragraphs 7 and 12, an appropriate listing and description of associates including the proportion of ownership interest and, if different, the proportion of voting power held should be disclosed in the consolidated financial statements.

23. Investments in associates accounted for using the equity method should be classified as long-term investments and disclosed separately in the consolidated balance sheet. The investor's share of the profits or losses of such investments should be disclosed separately in the consolidated

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[5] Pursuant to AS 29, Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory, 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 Accounting Standards.

statement of profit and loss. The investor's share of any extraordinary or prior period items should also be separately disclosed.

24. The name(s) of the associate(s) of which reporting date(s) is/are different from that of the financial statements of an investor and the differences in reporting dates should be disclosed in the consolidated financial statements.

25. In case an associate uses accounting policies other than those adopted for the consolidated financial statements for like transactions and events in similar circumstances and it is not practicable to make appropriate adjustments to the associate's financial statements, the fact should be disclosed along with a brief description of the differences in the accounting policies.

Transitional Provisions

26. On the first occasion when investment in an associate is accounted for in consolidated financial statements in accordance with this Standard the carrying amount of investment in the associate should be brought to the amount that would have resulted had the equity method of accounting been followed as per this Standard since the acquisition of the associate. The corresponding adjustment in this regard should be made in the retained earnings in the consolidated financial statements.

Accounting Standard (AS) 24
(issued 2002)

Discontinuing Operations

Contents

Accounting Standard (AS) 24

(issued 2002)

Discontinuing Operations

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

This Accounting Standard is not mondatory for non-corporate entities falling in Level III, as defined in Appendix 1 to this Compendium 'Applicability of Accounting Standards to Various Entities'.

Objective

The objective of this Standard is to establish principles for reporting information about discontinuing operations, thereby enhancing the ability of users of financial statements to make projections of an enterprise's cash flows, earnings-generating capacity, and financial position by segregating information about discontinuing operations from information about continuing operations.

Scope

1. This Standard applies to all discontinuing operations of an enterprise.

2. The requirements related to cash flow statement contained in this Standard are applicable where an enterprise prepares and presents a cash flow statement.

[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.

Definitions

Discontinuing Operation

3. A <u>discontinuing operation</u> is a component of an enterprise:

(a) that the enterprise, pursuant to a single plan, is:

(i) disposing of substantially in its entirety, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders; or

(ii) disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually; or

(iii) terminating through abandonment; and

(b) that represents a separate major line of business or geographical area of operations; and

(c) that can be distinguished operationally and for financial reporting purposes.

4. Under criterion (a) of the definition (paragraph 3 (a)), a discontinuing operation may be disposed of in its entirety or piecemeal, but always pursuant to an overall plan to discontinue the entire component.

5. If an enterprise sells a component substantially in its entirety, the result can be a net gain or net loss. For such a discontinuance, a binding sale agreement is entered into on a specific date, although the actual transfer of possession and control of the discontinuing operation may occur at a later date. Also, payments to the seller may occur at the time of the agreement, at the time of the transfer, or over an extended future period.

6. Instead of disposing of a component substantially in its entirety, an enterprise may discontinue and dispose of the component by selling its assets and settling its liabilities piecemeal (individually or in small groups). For piecemeal disposals, while the overall result may be a net

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gain or a net loss, the sale of an individual asset or settlement of an individual liability may have the opposite effect. Moreover, there is no specific date at which an overall binding sale agreement is entered into. Rather, the sales of assets and settlements of liabilities may occur over a period of months or perhaps even longer. Thus, disposal of a component may be in progress at the end of a financial reporting period. To qualify as a discontinuing operation, the disposal must be pursuant to a single co-ordinated plan.

7. An enterprise may terminate an operation by abandonment without substantial sales of assets. An abandoned operation would be a discontinuing operation if it satisfies the criteria in the definition. However, changing the scope of an operation or the manner in which it is conducted is not an abandonment because that operation, although changed, is continuing.

8. Business enterprises frequently close facilities, abandon products or even product lines, and change the size of their work force in response to market forces. While those kinds of terminations generally are not, in themselves, discontinuing operations as that term is defined in paragraph 3 of this Standard they can occur in connection with a discontinuing operation.

9. Examples of activities that do not necessarily satisfy criterion (a) of paragraph 3, but that might do so in combination with other circumstances, include:

(a) gradual or evolutionary phasing out of a product line or class of service;

(b) discontinuing, even if relatively abruptly, several products within an ongoing line of business;

(c) shifting of some production or marketing activities for a particular line of business from one location to another; and

(d) closing of a facility to achieve productivity improvements or other cost savings.

An example in relation to consolidated financial statements is selling a subsidiary whose activities are similar to those of the parent or other subsidiaries.

10. A reportable business segment or geographical segment as defined in Accounting Standard (AS) 17, Segment Reporting, would normally satisfy criterion (b) of the definition of a discontinuing operation (paragraph 3), that is, it would represent a separate major line of business or geographical area of operations. A part of such a segment may also satisfy criterion (b) of the definition. For an enterprise that operates in a single business or geographical segment and therefore does not report segment information, a major product or service line may also satisfy the criteria of the definition.

11. A component can be distinguished operationally and for financial reporting purposes - criterion (c) of the definition of a discontinuing operation (paragraph 3) - if all the following conditions are met:

(a) the operating assets and liabilities of the component can be directly attributed to it;

(b) its revenue can be directly attributed to it;

(c) at least a majority of its operating expenses can be directly attributed to it.

12. Assets, liabilities, revenue, and expenses are directly attributable to a component if they would be eliminated when the component is sold, abandoned or otherwise disposed of. If debt is attributable to a component, the related interest and other financing costs are similarly attributed to it.

13. Discontinuing operations, as defined in this Standard are expected to occur relatively infrequently. All infrequently occurring events do not necessarily qualify as discontinuing operations. Infrequently occurring events that do not qualify as discontinuing operations may result in items of income or expense that require separate disclosure pursuant to Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, because their size, nature, or incidence make them relevant to explain the performance of the enterprise for the period.

14. The fact that a disposal of a component of an enterprise is classified as a discontinuing operation under this Standard does not, in itself, bring into question the enterprise's ability to continue as a going concern.

Initial Disclosure Event

15. With respect to a discontinuing operation, the initial disclosure event is the occurrence of one of the following, whichever occurs earlier:

(a) the enterprise has entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation; or

(b) the enterprise's board of directors or similar governing body has both (i) approved a detailed, formal plan for the discontinuance and (ii) made an announcement of the plan.

16. A detailed, formal plan for the discontinuance normally includes:

(a) identification of the major assets to be disposed of;

(b) the expected method of disposal;

(c) the period expected to be required for completion of the disposal;

(d) the principal locations affected;

(e) the location, function, and approximate number of employees who will be compensated for terminating their services; and

(f) the estimated proceeds or salvage to be realised by disposal.

17. An enterprise's board of directors or similar governing body is considered to have made the announcement of a detailed, formal plan for discontinuance, if it has announced the main features of the plan to those affected by it, such as, lenders, stock exchanges, creditors, trade unions, etc., in a sufficiently specific manner so as to make the enterprise demonstrably committed to the discontinuance.

Recognition and Measurement

18. An enterprise should apply the principles of recognition and measurement that are set out in other Accounting Standards for the purpose of deciding as to when and how to recognise and measure the

changes in assets and liabilities and the revenue, expenses, gains, losses and cash flows relating to a discontinuing operation.

19. This Standard does not establish any recognition and measurement principles. Rather, it requires that an enterprise follow recognition and measurement principles established in other Accounting Standards, e.g., Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date[2] and Accounting Standard on Impairment of Assets[3].

Presentation and Disclosure

Initial Disclosure

20. An enterprise should include the following information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event (as defined in paragraph 15) occurs:

(a) a description of the discontinuing operation(s);

(b) the business or geographical segment(s) in which it is reported as per AS 17, Segment Reporting;

(c) the date and nature of the initial disclosure event;

(d) the date or period in which the discontinuance is expected to be completed if known or determinable;

(e) the carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled;

(f) the amounts of revenue and expenses in respect of the ordinary activities attributable to the discontinuing operation during the current financial reporting period;

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[2] Pursuant to AS 29, Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory, all paragraphs of AS 4 that deal with contingencies stand withdrawn except to the extend they deal with impairment of assets not covered by other Accounting Standards.

[3] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

(g) ***the amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense[4] related thereto; and***

(h) ***the amounts of net cash flows attributable to the operating, investing, and financing activities of the discontinuing operation during the current financial reporting period.***

21. For the purpose of presentation and disclosures required by this Standard, the items of assets, liabilities, revenues, expenses, gains, losses, and cash flows can be attributed to a discontinuing operation only if they will be disposed of, settled, reduced, or eliminated when the discontinuance is completed. To the extent that such items continue after completion of the discontinuance, they are not allocated to the discontinuing operation. For example, salary of the continuing staff of a discontinuing operation.

22. If an initial disclosure event occurs between the balance sheet date and the date on which the financial statements for that period are approved by the board of directors in the case of a company or by the corresponding approving authority in the case of any other enterprise, disclosures as required by Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date, are made.

Other Disclosures

23. When an enterprise disposes of assets or settles liabilities attributable to a discontinuing operation or enters into binding agreements for the sale of such assets or the settlement of such liabilities, it should include, in its financial statements, the following information when the events occur:

(a) ***for any gain or loss that is recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation, (i) the amount of the pre-tax gain or loss and (ii) income tax expense relating to the gain or loss; and***

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[4] As defined in Accounting Standard (AS) 22, Accounting for Taxes on Income.

(b) the net selling price or range of prices (which is after deducting expected disposal costs) of those net assets for which the enterprise has entered into one or more binding sale agreements, the expected timing of receipt of those cash flows and the carrying amount of those net assets on the balance sheet date.

24. The asset disposals, liability settlements, and binding sale agreements referred to in the preceding paragraph may occur concurrently with the initial disclosure event, or in the period in which the initial disclosure event occurs, or in a later period.

25. If some of the assets attributable to a discontinuing operation have actually been sold or are the subject of one or more binding sale agreements entered into between the balance sheet date and the date on which the financial statements are approved by the board of directors in case of a company or by the corresponding approving authority in the case of any other enterprise, the disclosures required by Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date, are made.

Updating the Disclosures

26. In addition to the disclosures in paragraphs 20 and 23, an enterprise should include, in its financial statements, for periods subsequent to the one in which the initial disclosure event occurs, a description of any significant changes in the amount or timing of cash flows relating to the assets to be disposed or liabilities to be settled and the events causing those changes.

27. Examples of events and activities that would be disclosed include the nature and terms of binding sale agreements for the assets, a demerger or spin-off by issuing equity shares of the new company to the enterprise's shareholders, and legal or regulatory approvals.

28. The disclosures required by paragraphs 20, 23 and 26 should continue in financial statements for periods up to and including the period in which the discontinuance is completed. A discontinuance is completed when the plan is substantially completed or abandoned, though full payments from the buyer(s) may not yet have been received.

29. If an enterprise abandons or withdraws from a plan that was previously reported as a discontinuing operation, that fact, reasons therefor and its effect should be disclosed.

30. For the purpose of applying paragraph 29, disclosure of the effect includes reversal of any prior impairment loss[5] or provision that was recognised with respect to the discontinuing operation.

Separate Disclosure for Each Discontinuing Operation

31. Any disclosures required by this Standard should be presented separately for each discontinuing operation.

Presentation of the Required Disclosures

32. The disclosures required by paragraphs 20, 23, 26, 28, 29 and 31 should be presented in the notes to the financial statements except the following which should be shown on the face of the statement of profit and loss:

- ***(a) the amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto (paragraph 20 (g)); and***

- ***(b) the amount of the pre-tax gain or loss recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation (paragraph 23 (a)).***

Illustrative Presentation and Disclosures

33. Illustration 1 attached to the standard illustrates the presentation and disclosures required by this Standard.

Restatement of Prior Periods

34. Comparative information for prior periods that is presented in financial statements prepared after the initial disclosure event should

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[5] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to reversal of impairment loss.

be restated to segregate assets, liabilities, revenue, expenses, and cash flows of continuing and discontinuing operations in a manner similar to that required by paragraphs 20, 23, 26, 28, 29, 31 and 32.

35. Illustration 2 attached to this Standard illustrates application of paragraph 34.

Disclosure in Interim Financial Reports

36. Disclosures in an interim financial report in respect of a discontinuing operation should be made in accordance with AS 25, Interim Financial Reporting, including:

(a) any significant activities or events since the end of the most recent annual reporting period relating to a discontinuing operation; and

(b) any significant changes in the amount or timing of cash flows relating to the assets to be disposed or liabilities to be settled.

Illustration 1

Illustrative Disclosures

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

Facts

- Delta Company has three segments, Food Division, Beverage Division and Clothing Division.

- Clothing Division, is deemed inconsistent with the long-term strategy of the Company. Management has decided, therefore, to dispose of the Clothing Division.

- On 15 November 20X1, the Board of Directors of Delta Company approved a detailed, formal plan for disposal of Clothing Division, and an announcement was made. On that date, the carrying amount of the Clothing Division's net assets was Rs. 90 lakhs (assets of Rs. 105 lakhs minus liabilities of Rs. 15 lakhs).

- The recoverable amount of the assets carried at Rs. 105 lakhs was estimated to be Rs. 85 lakhs and the Company had concluded that a pre-tax impairment loss of Rs. 20 lakhs should be recognised.

- At 31 December 20Xl, the carrying amount of the Clothing Division's net assets was Rs. 70 lakhs (assets of Rs. 85 lakhs minus liabilities of Rs. 15 lakhs). There was no further impairment of assets between 15 November 20X1 and 31 December 20X1 when the financial statements were prepared.

- On 30 September 20X2, the carrying amount of the net assets of the Clothing Division continued to be Rs. 70 lakhs. On that day, Delta Company signed a legally binding contract to sell the Clothing Division.

- The sale is expected to be completed by 31 January 20X3. The recoverable amount of the net assets is Rs. 60 lakhs. Based on that amount, an additional impairment loss of Rs. 10 lakhs is recognised.

- In addition, prior to 31 January 20X3, the sale contract obliges Delta Company to terminate employment of certain employees of the Clothing Division, which would result in termination cost of Rs. 30 lakhs, to be paid by 30 June 20X3. A liability and related expense in this regard is also recognised.

- The Company continued to operate the Clothing Division throughout 20X2.

- At 31 December 20X2, the carrying amount of the Clothing Division's net assets is Rs. 45 lakhs, consisting of assets of Rs. 80 lakhs minus liabilities of Rs. 35 lakhs (including provision for expected termination cost of Rs. 30 lakhs).

- Delta Company prepares its financial statements annually as of 31 December. It does not prepare a cash flow statement.

- Other figures in the following financial statements are assumed to illustrate the presentation and disclosures required by the Standard.

I. Financial Statements for 20X1

1.1 Statement of Profit and Loss for 20X1

The Statement of Profit and Loss of Delta Company for the year 20X1 can be presented as follows:

(Amount in Rs. lakhs)

		20X1		20X0
Turnover		140		150
Operating expenses		(92)		(105)
Impairment loss		(20)		(---)
Pre-tax profit from operating activities		28		45
Interest expense		(15)		(20)
Profit before tax		13		25
Profit from continuing operations before tax (see Note 5)	15		12	
Income tax expense	(7)		(6)	
Profit from continuing operations after tax		8		6
Profit (loss) from discontinuing operations before tax (see Note 5)	(2)		13	
Income tax expense	1		(7)	
Profit (loss) from discontinuing operations after tax		(1)		6
Profit from operating activities after tax		**7**		**12**

1.2 Note to Financial Statements for 20X1

The following is Note 5 to Delta Company's financial statements:

On 15 November 20Xl, the Board of Directors announced a plan to dispose of Company's Clothing Division, which is also a separate segment as per AS 17, Segment Reporting. The disposal is consistent with the Company's long-term strategy to focus its activities in the areas of food and beverage manufacture and distribution, and to divest unrelated activities. The Company is actively seeking a buyer for the Clothing Division and hopes to complete the sale by the end of 20X2. At 31 December 20Xl, the carrying amount of the assets of the Clothing Division was Rs. 85 lakhs (previous year Rs. 120 lakhs) and its liabilities were Rs. 15 lakhs (previous year Rs. 20 lakhs). The following statement shows the revenue and expenses of continuing and discontinuing operations:

(Amount in Rs. lakhs)

	Continuing Operations (Food and Beverage Divisions)		**Discontinuing Operation (Clothing Division)**		**Total**	
	20X1	**20X0**	**20X1**	**20X0**	**20X1**	**20X0**
Turnover	90	80	50	70	140	150
Operating Expenses	(65)	(60)	(27)	(45)	(92)	(105)
Impairment Loss	----	----	(20)	(---)	(20)	(---)
Pre-tax profit from operating activities	25	20	3	25	28	45
Interest expense	(10)	(8)	(5)	(12)	(15)	(20)
Profit (loss) before tax	15	12	(2)	13	13	25
Income tax expense	(7)	(6)	1	(7)	(6)	(13)
Profit (loss) from operating activities after tax	8	6	(1)	6	7	12

II. Financial Statements for 20X2

2.1 Statement of Profit and Loss for 20X2

The Statement of Profit and Loss of Delta Company for the year 20X2 can be presented as follows:

(Amount in Rs. lakhs)

		20X2		20X1
Turnover		140		140
Operating expenses		(90)		(92)
Impairment loss		(10)		(20)
Provision for employee termination benefits		(30)		--
Pre-tax profit from operating activities		10		28
Interest expense		(25)		(15)
Profit (loss) before tax		(15)		13
Profit from continuing operations before tax (see Note 5)	20		15	
Income tax expense	(6)		(7)	
Profit from continuing operations after tax		14		8
Loss from discontinuing operations before tax (see Note 5)	(35)		(2)	
Income tax expense	10		1	
Loss from discontinuing operations after tax		(25)		(1)
Profit (loss) from operating activities after tax		**(11)**		**7**

2.2 Note to Financial Statements for 20X2

The following is Note 5 to Delta Company's financial statements:

On 15 November 20Xl, the Board of Directors had announced a plan to dispose of Company's Clothing Division, which is also a separate segment as per AS 17, Segment Reporting. The disposal is consistent with the Company's long-term strategy to focus its activities in the areas of food and beverage manufacture and distribution, and to divest unrelated activities. On 30 September 20X2, the Company signed a contract to sell the Clothing Division to Z Corporation for Rs. 60 lakhs.

Clothing Division's assets are written down by Rs. 10 lakhs (previous year Rs. 20 lakhs) before income tax saving of Rs. 3 lakhs (previous year Rs. 6 lakhs) to their recoverable amount.

The Company has recognised provision for termination benefits of Rs. 30 lakhs (previous year Rs. nil) before income tax saving of Rs. 9 lakhs (previous year Rs. nil) to be paid by 30 June 20X3 to certain employees of the Clothing Division whose jobs will be terminated as a result of the sale.

At 31 December 20X2, the carrying amount of assets of the Clothing Division was Rs. 80 lakhs (previous year Rs. 85 lakhs) and its liabilities were Rs. 35 lakhs (previous year Rs. 15 lakhs), including the provision for expected termination cost of Rs. 30 lakhs (previous year Rs. nil). The process of selling the Clothing Division is likely to be completed by 31 January 20X3.

The following statement shows the revenue and expenses of continuing and discontinuing operations:

(Amount in Rs. lakhs)

	Continuing Operations (Food and Beverage Divisions)		**Discontinuing Operation (Clothing Division)**		**Total**	
	20X2	**20X1**	**20X2**	**20X1**	**20X2**	**20X1**
Turnover	100	90	40	50	140	140
Operating Expenses	(60)	(65)	(30)	(27)	(90)	(92)
Impairment Loss	----	----	(10)	(20)	(10)	(20)
Provision for employee termination	----	----	(30)	----	(30)	---
Pre-tax profit (loss) from operating activities	40	25	(30)	3	10	28
Interest expense	(20)	(10)	(5)	(5)	(25)	(15)
Profit (loss) before tax	20	15	(35)	(2)	(15)	13
Income tax expense	(6)	(7)	10	1	4	(6)
Profit (loss) from operating activities after tax	14	8	(25)	(1)	(11)	7

III. Financial Statements for 20X3

The financial statements for 20X3, would disclose information related to discontinued operations in a manner similar to that for 20X2 including the fact of completion of discontinuance.

Illustration 2

Classification of Prior Period Operations

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

Facts

1. Paragraph 34 requires that comparative information for prior periods that is presented in financial statements prepared after the initial disclosure event be restated to segregate assets, liabilities, revenue, expenses, and cash flows of continuing and discontinuing operations in a manner similar to that required by paragraphs 20, 23, 26, 28, 29, 31 and 32.

2. Consider following facts:

   (a) Operations A, B, C, and D were all continuing in years 1 and 2;

   (b) Operation D is approved and announced for disposal in year 3 but actually disposed of in year 4;

   (c) Operation B is discontinued in year 4 (approved and announced for disposal and actually disposed of) and operation E is acquired; and

   (d) Operation F is acquired in year 5.

3. The following table illustrates the classification of continuing and discontinuing operations in years 3 to 5:

FINANCIAL STATEMENTS FOR YEAR 3 (Approved and Published early in Year 4)			
Year 2 Comparatives		**Year 3**	
Continuing	Discontinuing	Continuing	Discontinuing
A		A	
B		B	
C		C	
	D		D

FINANCIAL STATEMENTS FOR YEAR 4 (Approved and Published early in Year 5)			
Year 3 Comparatives		**Year 4**	
Continuing	Discontinuing	Continuing	Discontinuing
A		A	
	B		B
C		C	
	D		D
		E	

FINANCIAL STATEMENTS FOR YEAR 5 (Approved and Published early in Year 6)			
Year 4 Comparatives		**Year 5**	
Continuing	Discontinuing	Continuing	Discontinuing
A		A	
	B		
C		C	
	D		
E		E	
		F	

4. If, for whatever reason, five-year comparative financial statements were prepared in year 5, the classification of continuing and discontinuing operations would be as follows:

FINANCIAL STATEMENTS FOR YEAR 5									
Year 1 Comparatives		**Year 2 Comparatives**		**Year 3 Comparatives**		**Year 4 Comparatives**		**Year 5**	
Cont.	Disc.	Cont.	Disc.	Cont.	Disc.	Cont.	Disc.	Cont.	Disc.
A		A		A		A		A	
	B		B		B		B		
C		C		C		C		C	
	D		D		D		D		
						E		E	
								F	

Accounting Standard (AS) 25
(issued 2002)

Interim Financial Reporting

Contents

Continued../..

Accounting Standard (AS) 25

(issued 2002)

Interim Financial Reporting

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

Objective

The objective of this Standard is to prescribe the minimum content of an interim financial report and to prescribe the principles for recognition and measurement in a complete or condensed financial statements for an interim period. Timely and reliable interim financial reporting improves the ability of investors, creditors, and others to understand an enterprise's capacity to generate earnings and cash flows, its financial condition and liquidity.

Scope

1. This Standard does not mandate which enterprises should be required to present interim financial reports, how frequently, or how soon after the end of an interim period. If an enterprise is required or elects to prepare and present an interim financial report, it should comply with this Standard.

2. A statute governing an enterprise or a regulator may require an enterprise to prepare and present certain information at an interim date which may be different in form and/or content as required by this Standard. In such a case, the recognition and measurement principles as laid down in this Standard are applied in respect of such information, unless otherwise specified in the statute or by the regulator.

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[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.

3. The requirements related to cash flow statement, complete or condensed, contained in this Standard are applicable where an enterprise prepares and presents a cash flow statement for the purpose of its annual financial report.

Definitions

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

4.1 <u>Interim period</u> is a financial reporting period shorter than a full financial year.

4.2 <u>Interim financial report</u> means a financial report containing either a complete set of financial statements or a set of condensed financial statements (as described in this Standard) for an interim period.

5. During the first year of operations of an enterprise, its annual financial reporting period may be shorter than a financial year. In such a case, that shorter period is not considered as an interim period.

Content of an Interim Financial Report

6. A complete set of financial statements normally includes:

(a) balance sheet;

(b) statement of profit and loss;

(c) cash flow statement; and

(d) notes including those relating to accounting policies and other statements and explanatory material that are an integral part of the financial statements.

7. In the interest of timeliness and cost considerations and to avoid repetition of information previously reported, an enterprise may be required to or may elect to present less information at interim dates as compared with its annual financial statements. The benefit of timeliness of presentation may be partially offset by a reduction in detail in the information provided. Therefore, this Standard requires preparation and

presentation of an interim financial report containing, as a minimum, a set of condensed financial statements. The interim financial report containing condensed financial statements is intended to provide an update on the latest annual financial statements. Accordingly, it focuses on new activities, events, and circumstances and does not duplicate information previously reported.

8. This Standard does not prohibit or discourage an enterprise from presenting a complete set of financial statements in its interim financial report, rather than a set of condensed financial statements. This Standard also does not prohibit or discourage an enterprise from including, in condensed interim financial statements, more than the minimum line items or selected explanatory notes as set out in this Standard. The recognition and measurement principles set out in this Standard apply also to complete financial statements for an interim period, and such statements would include all disclosures required by this Standard (particularly the selected disclosures in paragraph 16) as well as those required by other Accounting Standards.

Minimum Components of an Interim Financial Report

9. An interim financial report should include, at a minimum, the following components:

(a) condensed balance sheet;

(b) condensed statement of profit and loss;

(c) condensed cash flow statement; and

(d) selected explanatory notes.

Form and Content of Interim Financial Statements

10. If an enterprise prepares and presents a complete set of financial statements in its interim financial report, the form and content of those statements should conform to the requirements as applicable to annual complete set of financial statements.

11. If an enterprise prepares and presents a set of condensed financial statements in its interim financial report, those condensed statements

should include, at a minimum, each of the headings and sub-headings that were included in its most recent annual financial statements and the selected explanatory notes as required by this Standard. Additional line items or notes should be included if their omission would make the condensed interim financial statements misleading.

12. If an enterprise presents basic and diluted earnings per share in its annual financial statements in accordance with Accounting Standard (AS) 20, Earnings Per Share, basic and diluted earnings per share should be presented in accordance with AS 20 on the face of the statement of profit and loss, complete or condensed, for an interim period.

13. If an enterprise's annual financial report included the consolidated financial statements in addition to the parent's separate financial statements, the interim financial report includes both the consolidated financial statements and separate financial statements, complete or condensed.

14. Illustration I attached to the Standard provides illustrative format of condensed financial statements.

Selected Explanatory Notes

15. A user of an enterprise's interim financial report will ordinarily have access to the most recent annual financial report of that enterprise. It is, therefore, not necessary for the notes to an interim financial report to provide relatively insignificant updates to the information that was already reported in the notes in the most recent annual financial report. At an interim date, an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the enterprise since the last annual reporting date is more useful.

16. An enterprise should include the following information, as a minimum, in the notes to its interim financial statements, if material and if not disclosed elsewhere in the interim financial report:

(a) a statement that the same accounting policies are followed in the interim financial statements as those followed in the most recent annual financial statements or, if those policies have been changed, a description of the nature and effect of the change;

(b) *explanatory comments about the seasonality of interim operations;*

(c) *the nature and amount of items affecting assets, liabilities, equity, net income, or cash flows that are unusual because of their nature, size, or incidence (see paragraphs 12 to 14 of Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies);*

(d) *the nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amounts reported in prior financial years, if those changes have a material effect in the current interim period;*

(e) *issuances, buy-backs, repayments and restructuring of debt, equity and potential equity shares;*

(f) *dividends, aggregate or per share (in absolute or percentage terms), separately for equity shares and other shares;*

(g) *segment revenue, segment capital employed (segment assets minus segment liabilities) and segment result for business segments or geographical segments, whichever is the enterprise's primary basis of segment reporting (disclosure of segment information is required in an enterprise's interim financial report only if the enterprise is required, in terms of AS 17, Segment Reporting, to disclose segment information in its annual financial statements);*

(h) *material events subsequent to the end of the interim period that have not been reflected in the financial statements for the interim period;*

(i) *the effect of changes in the composition of the enterprise during the interim period, such as amalgamations, acquisition or disposal of subsidiaries and long-term investments, restructurings, and discontinuing operations; and*

(j) *material changes in contingent liabilities since the last annual balance sheet date.*

The above information should normally be reported on a financial year-to-date basis. However, the enterprise should also disclose any events or transactions that are material to an understanding of the current interim period.

17. Other Accounting Standards specify disclosures that should be made in financial statements. In that context, financial statements mean complete set of financial statements normally included in an annual financial report and sometimes included in other reports. The disclosures required by those other Accounting Standards are not required if the enterprise's interim financial report includes only condensed financial statements and selected explanatory notes rather than a complete set of financial statements.

Periods for which Interim Financial Statements are required to be presented

18. Interim reports should include interim financial statements (condensed or complete) for periods as follows:

- ***(a) balance sheet as of the end of the current interim period and a comparative balance sheet as of the end of the immediately preceding financial year;***

- ***(b) statements of profit and loss for the current interim period and cumulatively for the current financial year to date, with comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year;***

- ***(c) cash flow statement cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.***

19. For an enterprise whose business is highly seasonal, financial information for the twelve months ending on the interim reporting date and comparative information for the prior twelve-month period may be useful. Accordingly, enterprises whose business is highly seasonal are encouraged to consider reporting such information in addition to the information called for in the preceding paragraph.

20. Illustration 2 attached to the Standard illustrates the periods required to be presented by an enterprise that reports half-yearly and an enterprise that reports quarterly.

Materiality

21. In deciding how to recognise, measure, classify, or disclose an item for interim financial reporting purposes, materiality should be assessed in relation to the interim period financial data. In making assessments of materiality, it should be recognised that interim measurements may rely on estimates to a greater extent than measurements of annual financial data.

22. The Preface to the Statements of Accounting Standards states that "The Accounting Standards are intended to apply only to items which are material". The Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of India, states that "information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information".

23. Judgement is always required in assessing materiality for financial reporting purposes. For reasons of understandability of the interim figures, materiality for making recognition and disclosure decision is assessed in relation to the interim period financial data. Thus, for example, unusual or extraordinary items, changes in accounting policies or estimates, and prior period items are recognised and disclosed based on materiality in relation to interim period data. The overriding objective is to ensure that an interim financial report includes all information that is relevant to understanding an enterprise's financial position and performance during the interim period.

Disclosure in Annual Financial Statements

24. An enterprise may not prepare and present a separate financial report for the final interim period because the annual financial statements are presented. In such a case, paragraph 25 requires certain disclosures to be made in the annual financial statements for that financial year.

25. If an estimate of an amount reported in an interim period is changed significantly during the final interim period of the financial year but a separate financial report is not prepared and presented for that final interim period, the nature and amount of that change in estimate should be disclosed in a note to the annual financial statements for that financial year.

26. Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, requires disclosure, in financial statements, of the nature and (if practicable) the amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods. Paragraph 16(d) of this Standard requires similar disclosure in an interim financial report. Examples include changes in estimate in the final interim period relating to inventory write-downs, restructurings, or impairment losses that were reported in an earlier interim period of the financial year. The disclosure required by the preceding paragraph is consistent with AS 5 requirements and is intended to be restricted in scope so as to relate only to the change in estimates. An enterprise is not required to include additional interim period financial information in its annual financial statements.

Recognition and Measurement

Same Accounting Policies as Annual

27. An enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an enterprise's reporting (annual, half-yearly, or quarterly) should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis.

28. Requiring that an enterprise apply the same accounting policies in its interim financial statements as in its annual financial statements may seem to suggest that interim period measurements are made as if each interim period stands alone as an independent reporting period. However, by providing that the frequency of an enterprise's reporting should not affect the measurement of its annual results, paragraph 27 acknowledges that an

interim period is a part of a financial year. Year-to-date measurements may involve changes in estimates of amounts reported in prior interim periods of the current financial year. But the principles for recognising assets, liabilities, income, and expenses for interim periods are the same as in annual financial statements.

29. To illustrate:

(a) the principles for recognising and measuring losses from inventory write-downs, restructurings, or impairments in an interim period are the same as those that an enterprise would follow if it prepared only annual financial statements. However, if such items are recognised and measured in one interim period and the estimate changes in a subsequent interim period of that financial year, the original estimate is changed in the subsequent interim period either by accrual of an additional amount of loss or by reversal of the previously recognised amount;

(b) a cost that does not meet the definition of an asset at the end of an interim period is not deferred on the balance sheet date either to await future information as to whether it has met the definition of an asset or to smooth earnings over interim periods within a financial year; and

(c) income tax expense is recognised in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year. Amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual income tax rate changes.

30. Under the Framework for the Preparation and Presentation of Financial Statements, recognition is the "process of incorporating in the balance sheet or statement of profit and loss an item that meets the definition of an element and satisfies the criteria for recognition". The definitions of assets, liabilities, income, and expenses are fundamental to recognition, both at annual and interim financial reporting dates.

31. For assets, the same tests of future economic benefits apply at interim dates as they apply at the end of an enterprise's financial year. Costs that, by

their nature, would not qualify as assets at financial year end would not qualify at interim dates as well. Similarly, a liability at an interim reporting date must represent an existing obligation at that date, just as it must at an annual reporting date.

32. Income is recognised in the statement of profit and loss when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. Expenses are recognised in the statement of profit and loss when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. The recognition of items in the balance sheet which do not meet the definition of assets or liabilities is not allowed.

33. In measuring assets, liabilities, income, expenses, and cash flows reported in its financial statements, an enterprise that reports only annually is able to take into account information that becomes available throughout the financial year. Its measurements are, in effect, on a year-to-date basis.

34. An enterprise that reports half-yearly, uses information available by mid-year or shortly thereafter in making the measurements in its financial statements for the first six-month period and information available by year-end or shortly thereafter for the twelve-month period. The twelve-month measurements will reflect any changes in estimates of amounts reported for the first six-month period. The amounts reported in the interim financial report for the first six-month period are not retrospectively adjusted. Paragraphs 16(d) and 25 require, however, that the nature and amount of any significant changes in estimates be disclosed.

35. An enterprise that reports more frequently than half-yearly, measures income and expenses on a year-to-date basis for each interim period using information available when each set of financial statements is being prepared. Amounts of income and expenses reported in the current interim period will reflect any changes in estimates of amounts reported in prior interim periods of the financial year. The amounts reported in prior interim periods are not retrospectively adjusted. Paragraphs 16(d) and 25 require, however, that the nature and amount of any significant changes in estimates be disclosed.

Revenues Received Seasonally or Occasionally

36. Revenues that are received seasonally or occasionally within a financial year should not be anticipated or deferred as of an interim date if anticipation or deferral would not be appropriate at the end of the enterprise's financial year.

37. Examples include dividend revenue, royalties, and government grants. Additionally, some enterprises consistently earn more revenues in certain interim periods of a financial year than in other interim periods, for example, seasonal revenues of retailers. Such revenues are recognised when they occur.

Costs Incurred Unevenly During the Financial Year

38. Costs that are incurred unevenly during an enterprise's financial year should be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year.

Applying the Recognition and Measurement principles

39. Illustration 3 attached to the Standard illustrates application of the general recognition and measurement principles set out in paragraphs 27 to 38.

Use of Estimates

40. The measurement procedures to be followed in an interim financial report should be designed to ensure that the resulting information is reliable and that all material financial information that is relevant to an understanding of the financial position or performance of the enterprise is appropriately disclosed. While measurements in both annual and interim financial reports are often based on reasonable estimates, the preparation of interim financial reports generally will require a greater use of estimation methods than annual financial reports.

41. Illustration 4 attached to the Standard illustrates the use of estimates in interim periods.

Restatement of Previously Reported Interim Periods

42. A change in accounting policy, other than one for which the transition is specified by an Accounting Standard, should be reflected by restating the financial statements of prior interim periods of the current financial year.

43. One objective of the preceding principle is to ensure that a single accounting policy is applied to a particular class of transactions throughout an entire financial year. The effect of the principle in paragraph 42 is to require that within the current financial year any change in accounting policy be applied retrospectively to the beginning of the financial year.

Transitional Provision

44. On the first occasion that an interim financial report is presented in accordance with this Standard, the following need not be presented in respect of all the interim periods of the current financial year:

(a) comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year; and

(b) comparative cash flow statement for the comparable year-to-date period of the immediately preceding financial year.

Illustration 1

Illustrative Format of Condensed Financial Statements

This illustration which does not form part of the Accounting Standard, provides illustrative format of condensed financial statements. Its purpose is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.

Paragraph 11 of the Accounting Standard provides that if an enterprise prepares and presents a set of condensed financial statements in its interim financial report, those condensed statements should include, at a minimum, each of the headings and sub-headings that were included in its most recent *annual financial statements and the selected explanatory notes as required by the Standard. Additional line items or notes should be included if their omission would make the condensed interim financial statements misleading.*

The purpose of the following illustrative format is primarily to illustrate the requirements of paragraph 11 of the Standard. It may be noted that these illustrative formats are subject to the requirements laid down in the Standard including those of paragraph 11.

Illustrative Format of Condensed Financial Statements for an enterprise other than a bank

(A) Condensed Balance Sheet

	Figures at the end of the current interim period	Figures at the end of the previous accounting year
I. Sources of Funds		
1. Capital		
2. Reserve and surplus		
3. Minority interests (in case of consolidated financial statements)		
4. Loan funds: (a) Secured loans (b) Unsecured loans		
Total		
II. Application of Funds		
1. Fixed assets (a) Tangible fixed assets (b) Intangible fixed assets		
2. Investments		
3. Current assets, loans and advances (a) Inventories (b) Sundry debtors (c) Cash and bank balances (d) Loans and advances (e) Others		
Less: Current liabilities and provisions (a) Liabilities (b) Provisions		
Net Current assets		
4. Miscellaneous expenditure to the extent not written off or adjusted		
5. Profit and loss account		
Total		

(B) Condensed Statement of Profit and Loss

	Three months ended	Corresponding three months of the previous accounting year	Year-to-date figures for current period	Year-to-date figures for the previous year
1. Turnover				
2. Other Income				
Total				
3. Changes in inventories of finished goods and work in progress				
4. Cost of raw materials and consumables used				
5. Salaries, wages and other staff costs				
6. Other expenses				
7. Interest				
8. Depreciation and amortisations				
Total				
9. Profit or loss from ordinary activities before tax				
10. Extraordinary items				
11. Profit or loss before tax				
12. Tax expense				
13. Profit or loss after tax				
14. Minority Interests (in case of consolidated financial statements)				
15. Net profit or loss for the period				
Earnings Per Share 1. Basic Earnings Per Share 2. Diluted Earnings Per Share				

(C) Condensed Cash Flow Statement

	Year-to-date figures for the current period	Year-to-date figures for the previous year
1. Cash flows from operating activities		
2. Cash flows from investing activities		
3. Cash flows from financing activities		
4. Net increase/(decrease) in cash and cash equivalents		
5. Cash and cash equivalents at beginning of period		
6. Cash and cash equivalents at end of period		

(D) Selected Explanatory Notes

This part should contain selected explanatory notes as required by paragraph 16 of this Standard.

Illustrative Format of Condensed Financial Statements for a Bank

(A) Condensed Balance Sheet

	Figures at the end of the current interim period	Figures at the end of the previous accounting year
I. Capital and Liabilities		
1. Capital		
2. Reserve and surplus		
3. Minority interests (in case of consolidated financial statements)		
4. Deposits		
5. Borrowings		
6. Other liabilities and provisions		
Total		
II. Assets		
1. Cash and balances with Reserve Bank of India		
2. Balances with banks and money at call and short notice		
3. Investments		
4. Advances		
5. Fixed assets (a) Tangible fixed assets (b) Intangible fixed assets		
6. Other Assets		
Total		

(B) Condensed Statement of Profit and Loss

	Three months ended	Corresponding three months of the previous accounting year	Year-to-date figures for current period	Year-to-date figures for the previous year
	1	2	3	4
1. Interest earned (a) Interest/discount on advances/bills (b) Interest on Investments (c) Interest on balances with Reserve Bank of India and other inter banks funds (d) Others				
2. Other Income				
Total Income				
1. Interest expended				
2. Operating expenses (a) Payments to and provisions for employees (b) Other operating expenses				
3. Total expenses (excluding provisions and contingencies)				
4. Operating profit (profit before provisions and contingencies)				
5. Provisions and contingencies				
6. Profit or loss from ordinary activities before tax				
7. Extraordinary items				
8. Profit or loss before tax				
9. Tax expense				

(B) Condensed Statement of Profit and Loss ***(Contd.)***

	Three months ended	Corresponding three months of the previous accounting year	Year-to-date figures for current period	Year-to-date figures for the previous year
10. Profit or loss after tax				
11. Minority Interests (in case of consolidated financial statements)				
12. Net profit or loss for the period				
Earnings Per Share 1. Basic Earnings Per Share 2. Diluted Earnings Per Share				

(C) Condensed Cash Flow Statement

	Year-to-date figures for the current period	Year-to-date figures for the previous year
1. Cash flows from operating activities		
2. Cash flows from investing activities		
3. Cash flows from financing activities		
4. Net increase/(decrease) in cash and cash equivalents		
5. Cash and cash equivalents at beginning of period		
6. Cash and cash equivalents at end of period		

(D) Selected Explanatory Notes

This part should contain selected explanatory notes as required by paragraph 16 of this Standard.

Illustration 2

Illustration of Periods Required to Be Presented

This illustration which does not form part of the Accounting Standard, Illustrates application of the principles in paragraphs 18 and 19. Its purpose is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.

Enterprise Preparing and Presenting Interim Financial Reports Half-Yearly

1. An enterprise whose financial year ends on 31 March, presents financial statements (condensed or complete) for following periods in its half-yearly interim financial report as of 30 September 2001:

Balance Sheet:		
As at	30 September 2001	31 March 2001
Statement of Profit and Loss:		
6 months ending	30 September 2001	30 September 2000
Cash Flow Statement[2]:		
6 months ending	30 September 2001	30 September 2000

Enterprise Preparing and Presenting Interim Financial Reports Quarterly

2. An enterprise whose financial year ends on 31 March, presents financial statements (condensed or complete) for following periods in its interim financial report for the second quarter ending 30 September 2001:

[2] It is assumed that the enterprise prepares a cash flow statement for the purpose of its Annual Report.

Balance Sheet:		
As at	30 September 2001	31 March 2001
Statement of Profit and Loss:		
6 months ending	30 September 2001	30 September 2000
3 months ending	30 September 2001	30 September 2000
Cash Flow Statement:		
6 months ending	30 September 2001	30 September 2000

Enterprise whose business is highly seasonal Preparing and Presenting Interim Financial Reports Quarterly

3. An enterprise whose financial year ends on 31 March, may present financial statements (condensed or complete) for the following periods in its interim financial report for the second quarter ending 30 September 2001:

Balance Sheet:		
As at	30 September 2001	31 March 2001
		30 September 2000
Statement of Profit and Loss:		
6 months ending	30 September 2001	30 September 2000
3 months ending	30 September 2001	30 September 2000
12 months ending	30 September 2001	30 September 2000
Cash Flow Statement:		
6 months ending	30 September 2001	30 September 2000
12 months ending	30 September 2001	30 September 2000

Illustration 3

Illustration of Applying the Recognition and Measurement Principles

This illustration, which does not form part of the Accounting Standard, illustrates application of the general recognition and measurement principles set out in paragraphs 27-38 of this Standard. Its purpose is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.

Gratuity and Other Defined Benefit Schemes

1. Provisions in respect of gratuity and other defined benefit schemes for an interim period are calculated on a year-to-date basis by using the actuarially determined rates at the end of the prior financial year, adjusted for significant market fluctuations since that time and for significant curtailments, settlements, or other significant one-time events.

Major Planned Periodic Maintenance or Overhaul

2. The cost of a major planned periodic maintenance or overhaul or other seasonal expenditure that is expected to occur late in the year is not anticipated for interim reporting purposes unless an event has caused the enterprise to have a present obligation. The mere intention or necessity to incur expenditure related to the future is not sufficient to give rise to an obligation.

Provisions

3. This Standard requires that an enterprise apply the same criteria for recognising and measuring a provision at an interim date as it would at the end of its financial year. The existence or non-existence of an obligation to transfer economic benefits is not a function of the length of the reporting period. It is a question of fact subsisting on the reporting date.

Year-End Bonuses

4. The nature of year-end bonuses varies widely. Some are earned simply

by continued employment during a time period. Some bonuses are earned based on monthly, quarterly, or annual measure of operating result. They may be purely discretionary, contractual, or based on years of historical precedent.

5. A bonus is anticipated for interim reporting purposes if, and only if, (a) the bonus is a legal obligation or an obligation arising from past practice for which the enterprise has no realistic alternative but to make the payments, and (b) a reliable estimate of the obligation can be made.

Intangible Assets

6. An enterprise will apply the definition and recognition criteria for an intangible asset in the same way in an interim period as in an annual period. Costs incurred before the recognition criteria for an intangible asset are met are recognised as an expense. Costs incurred after the specific point in time at which the criteria are met are recognised as part of the cost of an intangible asset. "Deferring" costs as assets in an interim balance sheet in the hope that the recognition criteria will be met later in the financial year is not justified.

Other Planned but Irregularly Occurring Costs

7. An enterprise's budget may include certain costs expected to be incurred irregularly during the financial year, such as employee training costs. These costs generally are discretionary even though they are planned and tend to recur from year to year. Recognising an obligation at an interim financial reporting date for such costs that have not yet been incurred generally is not consistent with the definition of a liability.

Measuring Income Tax Expense for Interim Period

8. Interim period income tax expense is accrued using the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate applied to the pre-tax income of the interim period.

9. This is consistent with the basic concept set out in paragraph 27 that the same accounting recognition and measurement principles should be applied in an interim financial report as are applied in annual financial statements. Income taxes are assessed on an annual basis. Therefore, interim period

income tax expense is calculated by applying, to an interim period's pre-tax income, the tax rate that would be applicable to expected total annual earnings, that is, the estimated average effective annual income tax rate. That estimated average annual income tax rate would reflect the tax rate structure expected to be applicable to the full year's earnings including enacted or substantively enacted changes in the income tax rates scheduled to take effect later in the financial year. The estimated average annual income tax rate would be re-estimated on a year-to-date basis, consistent with paragraph 27 of this Standard. Paragraph 16(d) requires disclosure of a significant change in estimate.

10. To the extent practicable, a separate estimated average annual effective income tax rate is determined for each governing taxation law and applied individually to the interim period pre-tax income under such laws. Similarly, if different income tax rates apply to different categories of income (such as capital gains or income earned in particular industries), to the extent practicable a separate rate is applied to each individual category of interim period pre-tax income. While that degree of precision is desirable, it may not be achievable in all cases, and a weighted average of rates across such governing taxation laws or across categories of income is used if it is a reasonable approximation of the effect of using more specific rates.

11. As illustration, an enterprise reports quarterly, earns Rs. 150 lakhs pre-tax profit in the first quarter but expects to incur losses of Rs 50 lakhs in each of the three remaining quarters (thus having zero income for the year), and is governed by taxation laws according to which its estimated average annual income tax rate is expected to be 35 per cent. The following table shows the amount of income tax expense that is reported in each quarter:

(Amount in Rs. lakhs)

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Annual
Tax Expense	52.5	(17.5)	(17.5)	(17.5)	0

Difference in Financial Reporting Year and Tax Year

12. If the financial reporting year and the income tax year differ, income tax expense for the interim periods of that financial reporting year is measured using separate weighted average estimated effective tax rates for

each of the income tax years applied to the portion of pre-tax income earned in each of those income tax years.

13. To illustrate, an enterprise's financial reporting year ends 30 September and it reports quarterly. Its year as per taxation laws ends 31 March. For the financial year that begins 1 October, Year 1 ends 30 September of Year 2, the enterprise earns Rs 100 lakhs pre-tax each quarter. The estimated weighted average annual income tax rate is 30 per cent in Year 1 and 40 per cent in Year 2.

(Amount in Rs. lakhs)

	Quarter Ending 31 Dec. Year 1	Quarter Ending 31 Mar. Year 1	Quarter Ending 30 June Year 2	Quarter Ending 30 Sep. Year 2	Year Ending 30 Sep. Year 2
Tax Expense	30	30	40	40	140

Tax Deductions/Exemptions

14. Tax statutes may provide deductions/exemptions in computation of income for determining tax payable. Anticipated tax benefits of this type for the full year are generally reflected in computing the estimated annual effective income tax rate, because these deductions/exemptions are calculated on an annual basis under the usual provisions of tax statutes. On the other hand, tax benefits that relate to a one-time event are recognised in computing income tax expense in that interim period, in the same way that special tax rates applicable to particular categories of income are not blended into a single effective annual tax rate.

Tax Loss Carryforwards

15. A deferred tax asset should be recognised in respect of carryforward tax losses to the extent that it is virtually certain, supported by convincing evidence, that future taxable income will be available against which the deferred tax assets can be realised. The criteria are to be applied at the end of each interim period and, if they are met, the effect of the tax loss carryforward is reflected in the computation of the estimated average annual effective income tax rate.

16. To illustrate, an enterprise that reports quarterly has an operating loss carryforward of Rs 100 lakhs for income tax purposes at the start of the current financial year for which a deferred tax asset has not been recognised. The enterprise earns Rs 100 lakhs in the first quarter of the current year and expects to earn Rs 100 lakhs in each of the three remaining quarters. Excluding the loss carryforward, the estimated average annual income tax rate is expected to be 40 per cent. The estimated payment of the annual tax on Rs. 400 lakhs of earnings for the current year would be Rs. 120 lakhs {(Rs. 400 lakhs - Rs. 100 lakhs) x 40%}. Considering the loss carryforward, the estimated average annual effective income tax rate would be 30% {(Rs. 120 lakhs/Rs. 400 lakhs) x 100}. This average annual effective income tax rate would be applied to earnings of each quarter. Accordingly, tax expense would be as follows:

(Amount in Rs. lakhs)

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Annual
Tax Expense	30.00	30.00	30.00	30.00	120.00

Contractual or Anticipated Purchase Price Changes

17. Volume rebates or discounts and other contractual changes in the prices of goods and services are anticipated in interim periods, if it is probable that they will take effect. Thus, contractual rebates and discounts are anticipated but discretionary rebates and discounts are not anticipated because the resulting liability would not satisfy the conditions of recognition, viz., that a liability must be a present obligation whose settlement is expected to result in an outflow of resources.

Depreciation and Amortisation

18. Depreciation and amortisation for an interim period is based only on assets owned during that interim period. It does not take into account asset acquisitions or disposals planned for later in the financial year.

Inventories

19. Inventories are measured for interim financial reporting by the same principles as at financial year end. AS 2 on Valuation of Inventories,

establishes standards for recognising and measuring inventories. Inventories pose particular problems at any financial reporting date because of the need to determine inventory quantities, costs, and net realisable values. Nonetheless, the same measurement principles are applied for interim inventories. To save cost and time, enterprises often use estimates to measure inventories at interim dates to a greater extent than at annual reporting dates. Paragraph 20 below provides an example of how to apply the net realisable value test at an interim date.

Net Realisable Value of Inventories

20. The net realisable value of inventories is determined by reference to selling prices and related costs to complete and sell the inventories. An enterprise will reverse a write-down to net realisable value in a subsequent interim period as it would at the end of its financial year.

Foreign Currency Translation Gains and Losses

21. Foreign currency translation gains and losses are measured for interim financial reporting by the same principles as at financial year end in accordance with the principles as stipulated in AS 11 on Accounting for the Effects of Changes in Foreign Exchange Rates.

Impairment of Assets

22. Accounting Standard on Impairment of Assets[3] requires that an impairment loss be recognised if the recoverable amount has declined below carrying amount.

23. An enterprise applies the same impairment tests, recognition, and reversal criteria at an interim date as it would at the end of its financial year. That does not mean, however, that an enterprise must necessarily make a detailed impairment calculation at the end of each interim period. Rather, an enterprise will assess the indications of significant impairment since the end of the most recent financial year to determine whether such a calculation is needed.

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[3] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

Illustration 4

Examples of the Use of Estimates

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

1. **Provisions:** Determination of the appropriate amount of a provision (such as a provision for warranties, restructuring costs, gratuity, etc.) may be complex and often costly and time-consuming. Enterprises sometimes engage outside experts to assist in annual calculations. Making similar estimates at interim dates often involves updating the provision made in the preceding annual financial statements rather than engaging outside experts to do a new calculation.

2. **Contingencies:** Measurement of contingencies may involve obtaining opinions of legal experts or other advisers. Formal reports from independent experts are sometimes obtained with respect to contingencies. Such opinions about litigation, claims, assessments, and other contingencies and uncertainties may or may not be needed at interim dates.

3. **Specialised industries:** Because of complexity, costliness, and time involvement, interim period measurements in specialised industries might be less precise than at financial year end. An example is calculation of insurance reserves by insurance companies.

Accounting Standard (AS) 26
(issued 2002)

Intangible Assets

Contents

Continued../..

Accounting Standard (AS) 26
(issued 2002)

Intangible Assets

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

Objective

The objective of this Standard is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Accounting Standard. This Standard requires an enterprise to recognise an intangible asset if, and only if, certain criteria are met. The Standard also specifies how to measure the carrying amount of intangible assets and requires certain disclosures about intangible assets.

Scope

1. This Standard should be applied by all enterprises in accounting for intangible assets, except:

- ***(a) intangible assets that are covered by another Accounting Standard;***

- ***(b) financial assets[2];***

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[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] A <u>financial asset</u> is any asset that is:

(a) cash;

(b) a contractual right to receive cash or another financial asset from another enterprise;

(c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

(d) an ownership interest in another enterprise.

(c) mineral rights and expenditure on the exploration for, or development and extraction of, minerals, oil, natural gas and similar non-regenerative resources; and

(d) intangible assets arising in insurance enterprises from contracts with policyholders.

This Standard should not be applied to expenditure in respect of termination benefits[3] also.

2. If another Accounting Standard deals with a specific type of intangible asset, an enterprise applies that Accounting Standard instead of this Standard. For example, this Standard does not apply to:

(a) intangible assets held by an enterprise for sale in the ordinary course of business (see AS 2, Valuation of Inventories, and AS 7, Construction Contracts);

(b) deferred tax assets (see AS 22, Accounting for Taxes on Income);

(c) leases that fall within the scope of AS 19, Leases; and

(d) goodwill arising on an amalgamation (see AS 14, Accounting for Amalgamations) and goodwill arising on consolidation (see AS 21, Consolidated Financial Statements).

3. This Standard applies to, among other things, expenditure on advertising, training, start-up, research and development activities. Research and development activities are directed to the development of knowledge. Therefore, although these activities may result in an asset with physical substance (for example, a prototype), the physical element of the asset is secondary to its intangible component, that is the knowledge embodied in it. This Standard also applies to rights under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights. These items are excluded from the scope of AS 19.

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[3] Termination benefits are employee benefits payable as a result of either:

(a) an enterprise's decision to terminate an employee's employment before the normal retirement date; or

(b) an employee's decision to accept voluntary redundancy in exchange for these benefits (voluntary retirement).

4. In the case of a finance lease, the underlying asset may be either tangible or intangible. After initial recognition, a lessee deals with an intangible asset held under a finance lease under this Standard.

5. Exclusions from the scope of an Accounting Standard may occur if certain activities or transactions are so specialised that they give rise to accounting issues that may need to be dealt with in a different way. Such issues arise in the expenditure on the exploration for, or development and extraction of, oil, gas and mineral deposits in extractive industries and in the case of contracts between insurance enterprises and their policyholders. Therefore, this Standard does not apply to expenditure on such activities. However, this Standard applies to other intangible assets used (such as computer software), and other expenditure (such as start-up costs), in extractive industries or by insurance enterprises. Accounting issues of specialised nature also arise in respect of accounting for discount or premium relating to borrowings and ancillary costs incurred in connection with the arrangement of borrowings, share issue expenses and discount allowed on the issue of shares. Accordingly, this Standard does not apply to such items also.

Definitions

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

6.1 An <u>intangible asset</u> is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

6.2 An <u>asset</u> is a resource:

(a) controlled by an enterprise as a result of past events; and

(b) from which future economic benefits are expected to flow to the enterprise.

6.3 <u>Monetary assets</u> are money held and assets to be received in fixed or determinable amounts of money.

6.4 <u>Non-monetary assets</u> are assets other than monetary assets.

6.5 Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

6.6 Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

6.7 Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

6.8 Depreciable amount is the cost of an asset less its residual value.

6.9 Useful life is either:

(a) the period of time over which an asset is expected to be used by the enterprise; or

(b) the number of production or similar units expected to be obtained from the asset by the enterprise.

6.10. Residual value is the amount which an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

6.11. Fair value of an asset is the amount for which that asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

6.12. An active market is a market where all the following conditions exist:

(a) the items traded within the market are homogeneous;

(b) willing buyers and sellers can normally be found at any time; and

(c) prices are available to the public.

6.13. An <u>impairment loss</u> is the amount by which the carrying amount of an asset exceeds its recoverable amount.[4]

6.14. <u>Carrying amount</u> is the amount at which an asset is recognised in the balance sheet, net of any accumulated amortisation and accumulated impairment losses thereon.

Intangible Assets

7. Enterprises frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights. Goodwill is another example of an item of intangible nature which either arises on acquisition or is internally generated.

8. Not all the items described in paragraph 7 will meet the definition of an intangible asset, that is, identifiability, control over a resource and expectation of future economic benefits flowing to the enterprise. If an item covered by this Standard does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. However, if the item is acquired in an amalgamation in the nature of purchase, it forms part of the goodwill recognised at the date of the amalgamation (see paragraph 55).

9. Some intangible assets may be contained in or on a physical substance such as a compact disk (in the case of computer software), legal documentation (in the case of a licence or patent) or film (in the case of motion pictures). The cost of the physical substance containing the intangible assets is usually not significant. Accordingly, the physical substance containing an intangible asset, though tangible in nature, is commonly treated as a part of the intangible asset contained in or on it.

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[4] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

10. In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. In determining whether such an asset should be treated under AS 10, Accounting for Fixed Assets, or as an intangible asset under this Standard, judgement is required to assess as to which element is predominant. For example, computer software for a computer controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as a fixed asset. The same applies to the operating system of a computer. Where the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

Identifiability

11. The definition of an intangible asset requires that an intangible asset be identifiable. To be identifiable, it is necessary that the intangible asset is clearly distinguished from goodwill. Goodwill arising on an amalgamation in the nature of purchase represents a payment made by the acquirer in anticipation of future economic benefits. The future economic benefits may result from synergy between the identifiable assets acquired or from assets which, individually, do not qualify for recognition in the financial statements but for which the acquirer is prepared to make a payment in the amalgamation.

12. An intangible asset can be clearly distinguished from goodwill if the asset is separable. An asset is separable if the enterprise could rent, sell, exchange or distribute the specific future economic benefits attributable to the asset without also disposing of future economic benefits that flow from other assets used in the same revenue earning activity.

13. Separability is not a necessary condition for identifiability since an enterprise may be able to identify an asset in some other way. For example, if an intangible asset is acquired with a group of assets, the transaction may involve the transfer of legal rights that enable an enterprise to identify the intangible asset. Similarly, if an internal project aims to create legal rights for the enterprise, the nature of these rights may assist the enterprise in identifying an underlying internally generated intangible asset. Also, even if an asset generates future economic benefits only in combination with other assets, the asset is identifiable if the enterprise can identify the future economic benefits that will flow from the asset.

Control

14. An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. The capacity of an enterprise to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control since an enterprise may be able to control the future economic benefits in some other way.

15. Market and technical knowledge may give rise to future economic benefits. An enterprise controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement (where permitted) or by a legal duty on employees to maintain confidentiality.

16. An enterprise may have a team of skilled staff and may be able to identify incremental staff skills leading to future economic benefits from training. The enterprise may also expect that the staff will continue to make their skills available to the enterprise. However, usually an enterprise has insufficient control over the expected future economic benefits arising from a team of skilled staff and from training to consider that these items meet the definition of an intangible asset. For a similar reason, specific management or technical talent is unlikely to meet the definition of an intangible asset, unless it is protected by legal rights to use it and to obtain the future economic benefits expected from it, and it also meets the other parts of the definition.

17. An enterprise may have a portfolio of customers or a market share and expect that, due to its efforts in building customer relationships and loyalty, the customers will continue to trade with the enterprise. However, in the absence of legal rights to protect, or other ways to control, the relationships with customers or the loyalty of the customers to the enterprise, the enterprise usually has insufficient control over the economic benefits from customer relationships and loyalty to consider that such items (portfolio of customers, market shares, customer relationships, customer loyalty) meet the definition of intangible assets.

Future Economic Benefits

18. The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the enterprise. For example, the use of intellectual property in a production process may reduce future production costs rather than increase future revenues.

Recognition and Initial Measurement of an Intangible Asset

19. The recognition of an item as an intangible asset requires an enterprise to demonstrate that the item meets the:

(a) definition of an intangible asset (see paragraphs 6-18); and

(b) recognition criteria set out in this Standard (see paragraphs 20-54).

20. An intangible asset should be recognised if, and only if:

(a) it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and

(b) the cost of the asset can be measured reliably.

21. An enterprise should assess the probability of future economic benefits using reasonable and supportable assumptions that represent best estimate of the set of economic conditions that will exist over the useful life of the asset.

22. An enterprise uses judgement to assess the degree of certainty attached to the flow of future economic benefits that are attributable to the use of the asset on the basis of the evidence available at the time of initial recognition, giving greater weight to external evidence.

23. An intangible asset should be measured initially at cost.

Separate Acquisition

24. If an intangible asset is acquired separately, the cost of the intangible

asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.

25. The cost of an intangible asset comprises its purchase price, including any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), and any directly attributable expenditure on making the asset ready for its intended use. Directly attributable expenditure includes, for example, professional fees for legal services. Any trade discounts and rebates are deducted in arriving at the cost.

26. If an intangible asset is acquired in exchange for shares or other securities of the reporting enterprise, the asset is recorded at its fair value, or the fair value of the securities issued, whichever is more clearly evident.

Acquisition as Part of an Amalgamation

27. An intangible asset acquired in an amalgamation in the nature of purchase is accounted for in accordance with Accounting Standard (AS) 14, Accounting for Amalgamations. Where in preparing the financial statements of the transferee company, the consideration is allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation, paragraphs 28 to 32 of this Standard need to be considered.

28. Judgement is required to determine whether the cost (i.e. fair value) of an intangible asset acquired in an amalgamation can be measured with sufficient reliability for the purpose of separate recognition. Quoted market prices in an active market provide the most reliable measurement of fair value. The appropriate market price is usually the current bid price. If current bid prices are unavailable, the price of the most recent similar transaction may provide a basis from which to estimate fair value, provided that there has not been a significant change in economic circumstances between the transaction date and the date at which the asset's fair value is estimated.

29. If no active market exists for an asset, its cost reflects the amount that the enterprise would have paid, at the date of the acquisition, for the asset in an arm's length transaction between knowledgeable and willing parties, based on the best information available. In determining this amount, an enterprise considers the outcome of recent transactions for similar assets.

30. Certain enterprises that are regularly involved in the purchase and sale of unique intangible assets have developed techniques for estimating their fair values indirectly. These techniques may be used for initial measurement of an intangible asset acquired in an amalgamation in the nature of purchase if their objective is to estimate fair value as defined in this Standard and if they reflect current transactions and practices in the industry to which the asset belongs. These techniques include, where appropriate, applying multiples reflecting current market transactions to certain indicators driving the profitability of the asset (such as revenue, market shares, operating profit, etc.) or discounting estimated future net cash flows from the asset.

31. In accordance with this Standard:

(a) a transferee recognises an intangible asset that meets the recognition criteria in paragraphs 20 and 21, even if that intangible asset had not been recognised in the financial statements of the transferor; and

(b) if the cost (i.e. fair value) of an intangible asset acquired as part of an amalgamation in the nature of purchase cannot be measured reliably, that asset is not recognised as a separate intangible asset but is included in goodwill (see paragraph 55).

32. Unless there is an active market for an intangible asset acquired in an amalgamation in the nature of purchase, the cost initially recognised for the intangible asset is restricted to an amount that does not create or increase any capital reserve arising at the date of the amalgamation.

Acquisition by way of a Government Grant

33. In some cases, an intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant. This may occur when a government transfers or allocates to an enterprise intangible assets such as airport landing rights, licences to operate radio or television stations, import licences or quotas or rights to access other restricted resources. AS 12, Accounting for Government Grants, requires that government grants in the form of non-monetary assets, given at a concessional rate should be accounted for on the basis of their acquisition cost. AS 12 also requires that in case a non-monetary asset is given free of

cost, it should be recorded at a nominal value. Accordingly, intangible asset acquired free of charge, or for nominal consideration, by way of government grant is recognised at a nominal value or at the acquisition cost, as appropriate; any expenditure that is directly attributable to making the asset ready for its intended use is also included in the cost of the asset.

Exchanges of Assets

34. An intangible asset may be acquired in exchange or part exchange for another asset. In such a case, the cost of the asset acquired is determined in accordance with the principles laid down in this regard in AS 10, Accounting for Fixed Assets.

Internally Generated Goodwill

35. Internally generated goodwill should not be recognised as an asset.

36. In some cases, expenditure is incurred to generate future economic benefits, but it does not result in the creation of an intangible asset that meets the recognition criteria in this Standard. Such expenditure is often described as contributing to internally generated goodwill. Internally generated goodwill is not recognised as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

37. Differences between the market value of an enterprise and the carrying amount of its identifiable net assets at any point in time may be due to a range of factors that affect the value of the enterprise. However, such differences cannot be considered to represent the cost of intangible assets controlled by the enterprise.

Internally Generated Intangible Assets

38. It is sometimes difficult to assess whether an internally generated intangible asset qualifies for recognition. It is often difficult to:

(a) identify whether, and the point of time when, there is an identifiable asset that will generate probable future economic benefits; and

(b) determine the cost of the asset reliably. In some cases, the cost of generating an intangible asset internally cannot be distinguished from the cost of maintaining or enhancing the enterprise's internally generated goodwill or of running day-to-day operations.

Therefore, in addition to complying with the general requirements for the recognition and initial measurement of an intangible asset, an enterprise applies the requirements and guidance in paragraphs 39-54 below to all internally generated intangible assets.

39. To assess whether an internally generated intangible asset meets the criteria for recognition, an enterprise classifies the generation of the asset into:

(a) a research phase; and

(b) a development phase.

Although the terms 'research' and 'development' are defined, the terms 'research phase' and 'development phase' have a broader meaning for the purpose of this Standard.

40. If an enterprise cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the enterprise treats the expenditure on that project as if it were incurred in the research phase only.

Research Phase

41. No intangible asset arising from research (or from the research phase of an internal project) should be recognised. Expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred.

42. This Standard takes the view that, in the research phase of a project, an enterprise cannot demonstrate that an intangible asset exists from which future economic benefits are probable. Therefore, this expenditure is recognised as an expense when it is incurred.

43. Examples of research activities are:

(a) activities aimed at obtaining new knowledge;

(b) the search for, evaluation and final selection of, applications of research findings or other knowledge;

(c) the search for alternatives for materials, devices, products, processes, systems or services; and

(d) the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Development Phase

44. An intangible asset arising from development (or from the development phase of an internal project) should be recognised if, and only if, an enterprise can demonstrate all of the following:

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale;

(b) its intention to complete the intangible asset and use or sell it;

(c) its ability to use or sell the intangible asset;

(d) how the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and

(f) its ability to measure the expenditure attributable to the intangible asset during its development reliably.

45. In the development phase of a project, an enterprise can, in some instances, identify an intangible asset and demonstrate that future economic benefits from the asset are probable. This is because the development phase of a project is further advanced than the research phase.

46. Examples of development activities are:

(a) the design, construction and testing of pre-production or pre-use prototypes and models;

(b) the design of tools, jigs, moulds and dies involving new technology;

(c) the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and

(d) the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

47. To demonstrate how an intangible asset will generate probable future economic benefits, an enterprise assesses the future economic benefits to be received from the asset using the principles in Accounting Standard on Impairment of Assets[5]. If the asset will generate economic benefits only in combination with other assets, the enterprise applies the concept of cash-generating units as set out in Accounting Standard on Impairment of Assets.

48. Availability of resources to complete, use and obtain the benefits from an intangible asset can be demonstrated by, for example, a business plan showing the technical, financial and other resources needed and the enterprise's ability to secure those resources. In certain cases, an enterprise demonstrates the availability of external finance by obtaining a lender's indication of its willingness to fund the plan.

49. An enterprise's costing systems can often measure reliably the cost of generating an intangible asset internally, such as salary and other expenditure incurred in securing copyrights or licences or developing computer software.

50. Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance should not be recognised as intangible assets.

51. This Standard takes the view that expenditure on internally generated brands, mastheads, publishing titles, customer lists and items similar in substance cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognised as intangible assets.

[5] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

Cost of an Internally Generated Intangible Asset

52. The cost of an internally generated intangible asset for the purpose of paragraph 23 is the sum of expenditure incurred from the time when the intangible asset first meets the recognition criteria in paragraphs 20-21 and 44. Paragraph 58 prohibits reinstatement of expenditure recognised as an expense in previous annual financial statements or interim financial reports.

53. The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and making the asset ready for its intended use. The cost includes, if applicable:

(a) expenditure on materials and services used or consumed in generating the intangible asset;

(b) the salaries, wages and other employment related costs of personnel directly engaged in generating the asset;

(c) any expenditure that is directly attributable to generating the asset, such as fees to register a legal right and the amortisation of patents and licences that are used to generate the asset; and

(d) overheads that are necessary to generate the asset and that can be allocated on a reasonable and consistent basis to the asset (for example, an allocation of the depreciation of fixed assets, insurance premium and rent). Allocations of overheads are made on bases similar to those used in allocating overheads to inventories (see AS 2, Valuation of Inventories). AS 16, Borrowing Costs, establishes criteria for the recognition of interest as a component of the cost of a qualifying asset. These criteria are also applied for the recognition of interest as a component of the cost of an internally generated intangible asset.

54. The following are not components of the cost of an internally generated intangible asset:

(a) selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to making the asset ready for use;

(b) clearly identified inefficiencies and initial operating losses incurred before an asset achieves planned performance; and

(c) expenditure on training the staff to operate the asset.

Example Illustrating Paragraph 52

An enterprise is developing a new production process. During the year 20X1, expenditure incurred was Rs. 10 lakhs, of which Rs. 9 lakhs was incurred before 1 December 20X1 and Rs. 1 lakh was incurred between 1 December 20X1 and 31 December 20X1. The enterprise is able to demonstrate that, at 1 December 20X1, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be Rs. 5 lakhs.

At the end of 20X1, the production process is recognised as an intangible asset at a cost of Rs. 1 lakh (expenditure incurred since the date when the recognition criteria were met, that is, 1 December 20X1). The Rs. 9 lakhs expenditure incurred before 1 December 20X1 is recognised as an expense because the recognition criteria were not met until 1 December 20X1. This expenditure will never form part of the cost of the production process recognised in the balance sheet.

During the year 20X2, expenditure incurred is Rs. 20 lakhs. At the end of 20X2, the recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be Rs. 19 lakhs.

At the end of the year 20X2, the cost of the production process is Rs. 21 lakhs (Rs. 1 lakh expenditure recognised at the end of 20X1 plus Rs. 20 lakhs expenditure recognised in 20X2). The enterprise recognises an impairment loss of Rs. 2 lakhs to adjust the carrying amount of the process before impairment loss (Rs. 21 lakhs) to its recoverable amount (Rs. 19 lakhs). This impairment loss will be reversed in a subsequent period if the requirements for the reversal of an impairment loss in Accounting Standard on Impairment of Assets[6]*, are met.*

[6] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

Recognition of an Expense

55. Expenditure on an intangible item should be recognised as an expense when it is incurred unless:

(a) it forms part of the cost of an intangible asset that meets the recognition criteria (see paragraphs 19-54); or

(b) the item is acquired in an amalgamation in the nature of purchase and cannot be recognised as an intangible asset. If this is the case, this expenditure (included in the cost of acquisition) should form part of the amount attributed to goodwill (capital reserve) at the date of acquisition (see AS 14, Accounting for Amalgamations).

56. In some cases, expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired or created that can be recognised. In these cases, the expenditure is recognised as an expense when it is incurred. For example, expenditure on research is always recognised as an expense when it is incurred (see paragraph 41). Examples of other expenditure that is recognised as an expense when it is incurred include:

(a) expenditure on start-up activities (start-up costs), unless this expenditure is included in the cost of an item of fixed asset under AS 10. Start-up costs may consist of preliminary expenses incurred in establishing a legal entity such as legal and secretarial costs, expenditure to open a new facility or business (pre-opening costs) or expenditures for commencing new operations or launching new products or processes (pre-operating costs);

(b) expenditure on training activities;

(c) expenditure on advertising and promotional activities; and

(d) expenditure on relocating or re-organising part or all of an enterprise.

57. Paragraph 55 does not apply to payments for the delivery of goods or services made in advance of the delivery of goods or the rendering of services. Such prepayments are recognised as assets.

Past Expenses not to be Recognised as an Asset

58. Expenditure on an intangible item that was initially recognised as an expense by a reporting enterprise in previous annual financial statements or interim financial reports should not be recognised as part of the cost of an intangible asset at a later date.

Subsequent Expenditure

59. Subsequent expenditure on an intangible asset after its purchase or its completion should be recognised as an expense when it is incurred unless:

> ***(a) it is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance; and***
>
> ***(b) the expenditure can be measured and attributed to the asset reliably.***

If these conditions are met, the subsequent expenditure should be added to the cost of the intangible asset.

60. Subsequent expenditure on a recognised intangible asset is recognised as an expense if this expenditure is required to maintain the asset at its originally assessed standard of performance. The nature of intangible assets is such that, in many cases, it is not possible to determine whether subsequent expenditure is likely to enhance or maintain the economic benefits that will flow to the enterprise from those assets. In addition, it is often difficult to attribute such expenditure directly to a particular intangible asset rather than the business as a whole. Therefore, only rarely will expenditure incurred after the initial recognition of a purchased intangible asset or after completion of an internally generated intangible asset result in additions to the cost of the intangible asset.

61. Consistent with paragraph 50, subsequent expenditure on brands, mastheads, publishing titles, customer lists and items similar in substance (whether externally purchased or internally generated) is always recognised as an expense to avoid the recognition of internally generated goodwill.

Measurement Subsequent to Initial Recognition

62. After initial recognition, an intangible asset should be carried at its cost less any accumulated amortisation and any accumulated impairment losses.

Amortisation

Amortisation Period

63. The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when the asset is available for use.

64. As the future economic benefits embodied in an intangible asset are consumed over time, the carrying amount of the asset is reduced to reflect that consumption. This is achieved by systematic allocation of the cost of the asset, less any residual value, as an expense over the asset's useful life. Amortisation is recognised whether or not there has been an increase in, for example, the asset's fair value or recoverable amount. Many factors need to be considered in determining the useful life of an intangible asset including:

(a) the expected usage of the asset by the enterprise and whether the asset could be efficiently managed by another management team;

(b) typical product life cycles for the asset and public information on estimates of useful lives of similar types of assets that are used in a similar way;

(c) technical, technological or other types of obsolescence;

(d) the stability of the industry in which the asset operates and changes in the market demand for the products or services output from the asset;

(e) expected actions by competitors or potential competitors;

(f) the level of maintenance expenditure required to obtain the expected future economic benefits from the asset and the company's ability and intent to reach such a level;

(g) the period of control over the asset and legal or similar limits on the use of the asset, such as the expiry dates of related leases; and

(h) whether the useful life of the asset is dependent on the useful life of other assets of the enterprise.

65. Given the history of rapid changes in technology, computer software and many other intangible assets are susceptible to technological obsolescence. Therefore, it is likely that their useful life will be short.

66. Estimates of the useful life of an intangible asset generally become less reliable as the length of the useful life increases. This Standard adopts a presumption that the useful life of intangible assets is unlikely to exceed ten years.

67. In some cases, there may be persuasive evidence that the useful life of an intangible asset will be a specific period longer than ten years. In these cases, the presumption that the useful life generally does not exceed ten years is rebutted and the enterprise:

(a) amortises the intangible asset over the best estimate of its useful life;

(b) estimates the recoverable amount of the intangible asset at least annually in order to identify any impairment loss (see paragraph 83); and

(c) discloses the reasons why the presumption is rebutted and the factor(s) that played a significant role in determining the useful life of the asset (see paragraph 94(a)).

Examples

A. An enterprise has purchased an exclusive right to generate hydro-electric power for sixty years. The costs of generating hydro-electric power are much lower than the costs of obtaining power from alternative sources. It is expected that the geographical area surrounding the power station will demand a significant amount of power from the power station for at least sixty years.

> *The enterprise amortises the right to generate power over sixty years, unless there is evidence that its useful life is shorter.*
>
> B. An enterprise has purchased an exclusive right to operate a toll motorway for thirty years. There is no plan to construct alternative routes in the area served by the motorway. It is expected that this motorway will be in use for at least thirty years.
>
> *The enterprise amortises the right to operate the motorway over thirty years, unless there is evidence that its useful life is shorter.*

68. The useful life of an intangible asset may be very long but it is always finite. Uncertainty justifies estimating the useful life of an intangible asset on a prudent basis, but it does not justify choosing a life that is unrealistically short.

69. If control over the future economic benefits from an intangible asset is achieved through legal rights that have been granted for a finite period, the useful life of the intangible asset should not exceed the period of the legal rights unless:

(a) the legal rights are renewable; and

(b) renewal is virtually certain.

70. There may be both economic and legal factors influencing the useful life of an intangible asset: economic factors determine the period over which future economic benefits will be generated; legal factors may restrict the period over which the enterprise controls access to these benefits. The useful life is the shorter of the periods determined by these factors.

71. The following factors, among others, indicate that renewal of a legal right is virtually certain:

(a) the fair value of the intangible asset is not expected to reduce as the initial expiry date approaches, or is not expected to reduce by more than the cost of renewing the underlying right;

(b) there is evidence (possibly based on past experience) that the legal rights will be renewed; and

(c) there is evidence that the conditions necessary to obtain the renewal of the legal right (if any) will be satisfied.

Amortisation Method

72. The amortisation method used should reflect the pattern in which the asset's economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used. The amortisation charge for each period should be recognised as an expense unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset.

73. A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the unit of production method. The method used for an asset is selected based on the expected pattern of consumption of economic benefits and is consistently applied from period to period, unless there is a change in the expected pattern of consumption of economic benefits to be derived from that asset. There will rarely, if ever, be persuasive evidence to support an amortisation method for intangible assets that results in a lower amount of accumulated amortisation than under the straight-line method.

74. Amortisation is usually recognised as an expense. However, sometimes, the economic benefits embodied in an asset are absorbed by the enterprise in producing other assets rather than giving rise to an expense. In these cases, the amortisation charge forms part of the cost of the other asset and is included in its carrying amount. For example, the amortisation of intangible assets used in a production process is included in the carrying amount of inventories (see AS 2, Valuation of Inventories).

Residual Value

75. The residual value of an intangible asset should be assumed to be zero unless:

(a) there is a commitment by a third party to purchase the asset at the end of its useful life; or

(b) there is an active market for the asset and:

> *(i) residual value can be determined by reference to that market; and*
>
> *(ii) it is probable that such a market will exist at the end of the asset's useful life.*

76. A residual value other than zero implies that an enterprise expects to dispose of the intangible asset before the end of its economic life.

77. The residual value is estimated using prices prevailing at the date of acquisition of the asset, for the sale of a similar asset that has reached the end of its estimated useful life and that has operated under conditions similar to those in which the asset will be used. The residual value is not subsequently increased for changes in prices or value.

Review of Amortisation Period and Amortisation Method

78. The amortisation period and the amortisation method should be reviewed at least at each financial year end. If the expected useful life of the asset is significantly different from previous estimates, the amortisation period should be changed accordingly. If there has been a significant change in the expected pattern of economic benefits from the asset, the amortisation method should be changed to reflect the changed pattern. Such changes should be accounted for in accordance with AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

79. During the life of an intangible asset, it may become apparent that the estimate of its useful life is inappropriate. For example, the useful life may be extended by subsequent expenditure that improves the condition of the asset beyond its originally assessed standard of performance. Also, the recognition of an impairment loss may indicate that the amortisation period needs to be changed.

80. Over time, the pattern of future economic benefits expected to flow to an enterprise from an intangible asset may change. For example, it may become apparent that a diminishing balance method of amortisation is appropriate rather than a straight-line method. Another example is if use of the rights represented by a licence is deferred pending action on other

components of the business plan. In this case, economic benefits that flow from the asset may not be received until later periods.

Recoverability of the Carrying Amount—Impairment Losses

81. To determine whether an intangible asset is impaired, an enterprise applies Accounting Standard on Impairment of Assets[7]. That Standard 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 an impairment loss.

82. If an impairment loss occurs before the end of the first annual accounting period commencing after acquisition for an intangible asset acquired in an amalgamation in the nature of purchase, the impairment loss is recognised as an adjustment to both the amount assigned to the intangible asset and the goodwill (capital reserve) recognised at the date of the amalgamation. However, if the impairment loss relates to specific events or changes in circumstances occurring after the date of acquisition, the impairment loss is recognised under Accounting Standard on Impairment of Assets and not as an adjustment to the amount assigned to the goodwill (capital reserve) recognised at the date of acquisition.

83. In addition to the requirements of Accounting Standard on Impairment of Assets, an enterprise should estimate the recoverable amount of the following intangible assets at least at each financial year end even if there is no indication that the asset is impaired:

(a) an intangible asset that is not yet available for use; and

(b) an intangible asset that is amortised over a period exceeding ten years from the date when the asset is available for use.

The recoverable amount should be determined under Accounting Standard on Impairment of Assets and impairment losses recognised accordingly.

[7] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

84. The ability of an intangible asset to generate sufficient future economic benefits to recover its cost is usually subject to great uncertainty until the asset is available for use. Therefore, this Standard requires an enterprise to test for impairment, at least annually, the carrying amount of an intangible asset that is not yet available for use.

85. It is sometimes difficult to identify whether an intangible asset may be impaired because, among other things, there is not necessarily any obvious evidence of obsolescence. This difficulty arises particularly if the asset has a long useful life. As a consequence, this Standard requires, as a minimum, an annual calculation of the recoverable amount of an intangible asset if its useful life exceeds ten years from the date when it becomes available for use.

86. The requirement for an annual impairment test of an intangible asset applies whenever the current total estimated useful life of the asset exceeds ten years from when it became available for use. Therefore, if the useful life of an intangible asset was estimated to be less than ten years at initial recognition, but the useful life is extended by subsequent expenditure to exceed ten years from when the asset became available for use, an enterprise performs the impairment test required under paragraph 83(b) and also makes the disclosure required under paragraph 94(a).

Retirements and Disposals

87. An intangible asset should be derecognised (eliminated from the balance sheet) on disposal or when no future economic benefits are expected from its use and subsequent disposal.

88. Gains or losses arising from the retirement or disposal of an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the statement of profit and loss.

89. An intangible asset that is retired from active use and held for disposal is carried at its carrying amount at the date when the asset is retired from active use. At least at each financial year end, an enterprise tests the asset for impairment under Accounting Standard on Impairment of Assets[8], and recognises any impairment loss accordingly.

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[8] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

Disclosure

General

90. The financial statements should disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:

(a) the useful lives or the amortisation rates used;

(b) the amortisation methods used;

(c) the gross carrying amount and the accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period;

(d) a reconciliation of the carrying amount at the beginning and end of the period showing:

(i) additions, indicating separately those from internal development and through amalgamation;

(ii) retirements and disposals;

(iii) impairment losses recognised in the statement of profit and loss during the period (if any);

(iv) impairment losses reversed in the statement of profit and loss during the period (if any);

(v) amortisation recognised during the period; and

(vi) other changes in the carrying amount during the period.

91. A class of intangible assets is a grouping of assets of a similar nature and use in an enterprise's operations. Examples of separate classes may include:

(a) brand names;

(b) mastheads and publishing titles;

(c) computer software;

(d) licences and franchises;

(e) copyrights, and patents and other industrial property rights, service and operating rights;

(f) recipes, formulae, models, designs and prototypes; and

(g) intangible assets under development.

The classes mentioned above are disaggregated (aggregated) into smaller (larger) classes if this results in more relevant information for the users of the financial statements.

92. An enterprise discloses information on impaired intangible assets under Accounting Standard on Impairment of Assets[9] in addition to the information required by paragraph 90(d)(iii) and (iv).

93. An enterprise discloses the change in an accounting estimate or accounting policy such as that arising from changes in the amortisation method, the amortisation period or estimated residual values, in accordance with AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

94. The financial statements should also disclose:

(a) if an intangible asset is amortised over more than ten years, the reasons why it is presumed that the useful life of an intangible asset will exceed ten years from the date when the asset is available for use. In giving these reasons, the enterprise should describe the factor(s) that played a significant role in determining the useful life of the asset;

(b) a description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the financial statements of the enterprise as a whole;

[9] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

(c) ***the existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities; and***

(d) ***the amount of commitments for the acquisition of intangible assets.***

95. When an enterprise describes the factor(s) that played a significant role in determining the useful life of an intangible asset that is amortised over more than ten years, the enterprise considers the list of factors in paragraph 64.

Research and Development Expenditure

96. The financial statements should disclose the aggregate amount of research and development expenditure recognised as an expense during the period.

97. Research and development expenditure comprises all expenditure that is directly attributable to research or development activities or that can be allocated on a reasonable and consistent basis to such activities (see paragraphs 53-54 for guidance on the type of expenditure to be included for the purpose of the disclosure requirement in paragraph 96).

Other Information

98. An enterprise is encouraged, but not required, to give a description of any fully amortised intangible asset that is still in use.

Transitional Provisions

99. Where, on the date of this Standard coming into effect, an enterprise is following an accounting policy of not amortising an intangible item or amortising an intangible item over a period longer than the period determined under paragraph 63 of this Standard and the period determined under paragraph 63 has expired on the date of this Standard coming into effect, the carrying amount appearing in the balance sheet in respect of that item should be eliminated with a corresponding adjustment to the opening balance of revenue reserves.

In the event the period determined under paragraph 63 has not expired on the date of this Standard coming into effect and:

(a) ***if the enterprise is following an accounting policy of not amortising an intangible item, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Standard, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period as determined in paragraph 63.***

(b) ***if the remaining period as per the accounting policy followed by the enterprise:***

(i) ***is shorter as compared to the balance of the period determined under paragraph 63, the carrying amount of the intangible item should be amortised over the remaining period as per the accounting policy followed by the enterprise,***

(ii) ***is longer as compared to the balance of the period determined under paragraph 63, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Standard, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period as determined in paragraph 63.***

100. Illustration B attached to the Standard illustrates the application of paragraph 99.

Illustration A

This illustration which does not form part of the Accounting Standard, provides illustrative application of the principles laid down in the Standard to internal use software and web-site costs. Its purpose is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.

I. Illustrative Application of the Accounting Standard to Internal Use Computer Software

Computer software for internal use can be internally generated or acquired.

Internally Generated Computer Software

1. Internally generated computer software for internal use is developed or modified internally by the enterprise solely to meet the needs of the enterprise and at no stage it is planned to sell it.

2. The stages of development of internally generated software may be categorised into the following two phases:

- Preliminary project stage, i.e., the research phase
- Development stage

Preliminary project stage

3. At the preliminary project stage the internally generated software should not be recognised as an asset. Expenditure incurred in the preliminary project stage should be recognised as an expense when it is incurred. The reason for such a treatment is that at this stage of the software project an enterprise can not demonstrate that an asset exists from which future economic benefits are probable.

4. When a computer software project is in the preliminary project stage, enterprises are likely to:

(a) Make strategic decisions to allocate resources between alternative projects at a given point in time. For example, should programmers develop a new payroll system or direct their efforts toward correcting existing problems in an operating payroll system.

(b) Determine the performance requirements (that is, what it is that they need the software to do) and systems requirements for the computer software project it has proposed to undertake.

(c) Explore alternative means of achieving specified performance requirements. For example, should an entity make or buy the software. Should the software run on a mainframe or a client server system.

(d) Determine that the technology needed to achieve performance requirements exists.

(e) Select a consultant to assist in the development and/or installation of the software.

Development Stage

5. An internally generated software arising at the development stage should be recognised as an asset if, and only if, an enterprise can demonstrate all of the following:

(a) the technical feasibility of completing the internally generated software so that it will be available for internal use;

(b) the intention of the enterprise to complete the internally generated software and use it to perform the functions intended. For example, the intention to complete the internally generated software can be demonstrated if the enterprise commits to the funding of the software project;

(c) the ability of the enterprise to use the software;

(d) how the software will generate probable future economic benefits. Among other things, the enterprise should demonstrate the usefulness of the software;

(e) the availability of adequate technical, financial and other resources to complete the development and to use the software; and

(f) the ability of the enterprise to measure the expenditure attributable to the software during its development reliably.

6. Examples of development activities in respect of internally generated software include:

(a) Design including detailed program design - which is the process of detail design of computer software that takes product function, feature, and technical requirements to their most detailed, logical form and is ready for coding.

(b) Coding which includes generating detailed instructions in a computer language to carry out the requirements described in the detail program design. The coding of computer software may begin prior to, concurrent with, or subsequent to the completion of the detail program design.

At the end of these stages of the development activity, the enterprise has a working model, which is an operative version of the computer software capable of performing all the major planned functions, and is ready for initial testing ("beta" versions).

(c) Testing which is the process of performing the steps necessary to determine whether the coded computer software product meets function, feature, and technical performance requirements set forth in the product design.

At the end of the testing process, the enterprise has a master version of the internal use software, which is a completed version together with the related user documentation and the training materials.

Cost of internally generated software

7. The cost of an internally generated software is the sum of the expenditure incurred from the time when the software first met the recognition criteria for an intangible asset as stated in paragraphs 20 and 21 of this Standard and paragraph 5 above. An expenditure which did not meet the recognition criteria as aforesaid and expensed in an earlier financial statements should not be reinstated if the recognition criteria are met later.

8. The cost of an internally generated software comprises all expenditure that can be directly attributed or allocated on a reasonable and consistent basis to create the software for its intended use. The cost include:

(a) expenditure on materials and services used or consumed in developing the software;

(b) the salaries, wages and other employment related costs of personnel directly engaged in developing the software;

(c) any expenditure that is directly attributable to generating software; and

(d) overheads that are necessary to generate the software and that can be allocated on a reasonable and consistent basis to the software (For example, an allocation of the depreciation of fixed assets, insurance premium and rent). Allocation of overheads are made on basis similar to those used in allocating the overhead to inventories.

9. The following are not components of the cost of an internally generated software:

(a) selling, administration and other general overhead expenditure unless this expenditure can be directly attributable to the development of the software;

(b) clearly identified inefficiencies and initial operating losses incurred before software achieves the planned performance; and

(c) expenditure on training the staff to use the internally generated software.

Software Acquired for Internal Use

10. The cost of a software acquired for internal use should be recognised as an asset if it meets the recognition criteria prescribed in paragraphs 20 and 21 of this Standard.

11. The cost of a software purchased for internal use comprises its purchase price, including any import duties and other taxes (other than those

subsequently recoverable by the enterprise from the taxing authorities) and any directly attributable expenditure on making the software ready for its use. Any trade discounts and rebates are deducted in arriving at the cost. In the determination of cost, matters stated in paragraphs 24 to 34 of the Standard need to be considered, as appropriate.

Subsequent expenditure

12. Enterprises may incur considerable cost in modifying existing software systems. Subsequent expenditure on software after its purchase or its completion should be recognised as an expense when it is incurred unless:

(a) it is probable that the expenditure will enable the software to generate future economic benefits in excess of its originally assessed standards of performance; and

(b) the expenditure can be measured and attributed to the software reliably.

If these conditions are met, the subsequent expenditure should be added to the carrying amount of the software. Costs incurred in order to restore or maintain the future economic benefits that an enterprise can expect from the originally assessed standard of performance of existing software systems is recognised as an expense when, and only when, the restoration or maintenance work is carried out.

Amortisation period

13. The depreciable amount of a software should be allocated on a systematic basis over the best estimate of its useful life. The amortisation should commence when the software is available for use.

14. As per this Standard, there is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. However, given the history of rapid changes in technology, computer software is susceptible to technological obsolescence. Therefore, it is likely that useful life of the software will be much shorter, say 3 to 5 years.

Amortisation method

15. The amortisation method used should reflect the pattern in which the software's economic benefits are consumed by the enterprise. If that pattern can not be determined reliably, the straight-line method should be used. The amortisation charge for each period should be recognised as an expenditure unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset. For example, the amortisation of a software used in a production process is included in the carrying amount of inventories.

II. Illustrative Application of the Accounting Standard to Web-Site Costs

1. An enterprise may incur internal expenditures when developing, enhancing and maintaining its own web site. The web site may be used for various purposes such as promoting and advertising products and services, providing electronic services, and selling products and services.

2. The stages of a web site's development can be described as follows:

   (a) Planning - includes undertaking feasibility studies, defining objectives and specifications, evaluating alternatives and selecting preferences;

   (b) Application and Infrastructure Development - includes obtaining a domain name, purchasing and developing hardware and operating software, installing developed applications and stress testing; and

   (c) Graphical Design and Content Development - includes designing the appearance of web pages and creating, purchasing, preparing and uploading information, either textual or graphical in nature, on the web site prior to the web site becoming available for use. This information may either be stored in separate databases that are integrated into (or accessed from) the web site or coded directly into the web pages.

3. Once development of a web site has been completed and the web site is available for use, the web site commences an operating stage. During this

stage, an enterprise maintains and enhances the applications, infrastructure, graphical design and content of the web site.

4. The expenditures for purchasing, developing, maintaining and enhancing hardware (e.g., web servers, staging servers, production servers and Internet connections) related to a web site are not accounted for under this Standard but are accounted for under AS 10, Accounting for Fixed Assets. Additionally, when an enterprise incurs an expenditure for having an Internet service provider host the enterprise's web site on it's own servers connected to the Internet, the expenditure is recognised as an expense.

5. An intangible asset is defined in paragraph 6 of this Standard as an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. Paragraph 7 of this Standard provides computer software as a common example of an intangible asset. By analogy, a web site is another example of an intangible asset. Accordingly, a web site developed by an enterprise for its own use is an internally generated intangible asset that is subject to the requirements of this Standard.

6. An enterprise should apply the requirements of this Standard to an internal expenditure for developing, enhancing and maintaining its own web site. Paragraph 55 of this Standard provides expenditure on an intangible item to be recognised as an expense when incurred unless it forms part of the cost of an intangible asset that meets the recognition criteria in paragraphs 19-54 of the Standard. Paragraph 56 of the Standard requires expenditure on start-up activities to be recognised as an expense when incurred. Developing a web site by an enterprise for its own use is not a start-up activity to the extent that an internally generated intangible asset is created. An enterprise applies the requirements and guidance in paragraphs 39-54 of this Standard to an expenditure incurred for developing its own web site in addition to the general requirements for recognition and initial measurement of an intangible asset. The cost of a web site, as described in paragraphs 52-54 of this Standard, comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and preparing the asset for its intended use.

The enterprise should evaluate the nature of each activity for which an expenditure is incurred (e.g., training employees and maintaining the web site) and the web site's stage of development or post-development:

(a) Paragraph 41 of this Standard requires an expenditure on research (or on the research phase of an internal project) to be recognised as an expense when incurred. The examples provided in paragraph 43 of this Standard are similar to the activities undertaken in the Planning stage of a web site's development. Consequently, expenditures incurred in the Planning stage of a web site's development are recognised as an expense when incurred.

(b) Paragraph 44 of this Standard requires an intangible asset arising from the development phase of an internal project to be recognised if an enterprise can demonstrate fulfillment of the six criteria specified. Application and Infrastructure Development and Graphical Design and Content Development stages are similar in nature to the development phase. Therefore, expenditures incurred in these stages should be recognised as an intangible asset if, and only if, in addition to complying with the general requirements for recognition and initial measurement of an intangible asset, an enterprise can demonstrate those items described in paragraph 44 of this Standard. In addition,

(i) an enterprise may be able to demonstrate how its web site will generate probable future economic benefits under paragraph 44(d) by using the principles in Accounting Standard on Impairment of Assets[10]. This includes situations where the web site is developed solely or primarily for promoting and advertising an enterprise's own products and services. Demonstrating how a web site will generate probable future economic benefits under paragraph 44(d) by assessing the economic benefits to be received from the web site and using the principles in Accounting Standard on Impairment of Assets, may be particularly difficult for an enterprise that develops a web site solely or primarily for advertising and promoting its own products and services; information is unlikely to be available for reliably estimating the amount obtainable from the sale of the web site in an arm's length transaction, or the future cash inflows and outflows to be derived from its continuing use and ultimate disposal. In this

[10] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

circumstance, an enterprise determines the future economic benefits of the cash-generating unit to which the web site belongs, if it does not belong to one. If the web site is considered a corporate asset (one that does not generate cash inflows independently from other assets and their carrying amount cannot be fully attributed to a cash-generating unit), then an enterprise applies the 'bottom-up' test and/or the 'top-down' test under Accounting Standard on Impairment of Assets.

(ii) an enterprise may incur an expenditure to enable use of content, which had been purchased or created for another purpose, on its web site (e.g., acquiring a license to reproduce information) or may purchase or create content specifically for use on its web site prior to the web site becoming available for use. In such circumstances, an enterprise should determine whether a separate asset, is identifiable with respect to such content (e.g., copyrights and licenses), and if a separate asset is not identifiable, then the expenditure should be included in the cost of developing the web site when the expenditure meets the conditions in paragraph 44 of this Standard. As per paragraph 20 of this Standard, an intangible asset is recognised if, and only if, it meets specified criteria, including the definition of an intangible asset. Paragraph 52 indicates that the cost of an internally generated intangible asset is the sum of expenditure incurred from the time when the intangible asset first meets the specified recognition criteria. When an enterprise acquires or creates content, it may be possible to identify an intangible asset (e.g., a license or a copyright) separate from a web site. Consequently, an enterprise determines whether an expenditure to enable use of content, which had been created for another purpose, on its web site becoming available for use results in a separate identifiable asset or the expenditure is included in the cost of developing the web site.

(c) the operating stage commences once the web site is available for use, and therefore an expenditure to maintain or enhance the web site after development has been completed should be recognised as an expense when it is incurred unless it meets the criteria in paragraph 59 of the Standard. Paragraph 60 explains that if the expenditure is required to maintain the asset at its originally assessed standard of performance, then the expenditure is recognised as an expense when incurred.

7. An intangible asset is measured subsequent to initial recognition by applying the requirements in paragraph 62 of this Standard. Additionally, since paragraph 68 of the Standard states that an intangible asset always has a finite useful life, a web site that is recognised as an asset is amortised over the best estimate of its useful life. As indicated in paragraph 65 of the Standard, web sites are susceptible to technological obsolescence, and given the history of rapid changes in technology, their useful life will be short.

8. The following table illustrates examples of expenditures that occur within each of the stages described in paragraphs 2 and 3 above and application of paragraphs 5 and 6 above. It is not intended to be a comprehensive checklist of expenditures that might be incurred.

Nature of Expenditure	**Accounting treatment**
Planning • undertaking feasibility studies • defining hardware and software specifications • evaluating alternative products and suppliers • selecting preferences	Expense when incurred
Application and Infrastructure Development • purchasing or developing hardware	Apply the requirements of AS 10
• obtaining a domain name • developing operating software (e.g., operating system and server software) • developing code for the application • installing developed applications on the web server • stress testing	Expense when incurred, unless it meets the recognition criteria under paragraphs 20 and 44

Graphical Design and Content Development • designing the appearance (e.g., layout and colour) of web pages • creating, purchasing, preparing (e.g., creating links and identifying tags), and uploading information, either textual or graphical in nature, on the web site prior to the web site becoming available for use. Examples of content include information about an enterprise, products or services offered for sale, and topics that subscribers access	If a separate asset is not identifiable, then expense when incurred, unless it meets the recognition criteria under paragraphs 20 and 44
Operating • updating graphics and revising content • adding new functions, features and content • registering the web site with search engines • backing up data • reviewing security access • analysing usage of the web site	Expense when incurred, unless in rare circumstances it meets the criteria in paragraph 59, in which case the expenditure is included in the cost of the web site
Other • selling, administrative and other general overhead expenditure unless it can be directly attributed to preparing the web site for use • clearly identified inefficiencies and initial operating losses incurred before the web site achieves planned performance (e.g., false start testing) • training employees to operate the web site	Expense when incurred

Illustration B

This Illustration which does not form part of the Accounting Standard, provides illustrative application of the requirements contained in paragraph 99 of this Accounting Standard in respect of transitional provisions.

Illustration 1 - Intangible Item was not amortised and the amortisation period determined under paragraph 63 has expired.

An intangible item is appearing in the balance sheet of A Ltd. at Rs. 10 lakhs as on 1-4-2003. The item was acquired for Rs. 10 lakhs on April 1, 1990 and was available for use from that date. The enterprise has been following an accounting policy of not amortising the item. Applying paragraph 63, the enterprise determines that the item would have been amortised over a period of 10 years from the date when the item was available for use i.e., April 1, 1990.

Since the amortisation period determined by applying paragraph 63 has already expired as on 1-4-2003, the carrying amount of the intangible item of Rs. 10 lakhs would be required to be eliminated with a corresponding adjustment to the opening balance of revenue reserves as on 1-4-2003.

Illustration 2 - Intangible Item is being amortised and the amortisation period determined under paragraph 63 has expired.

An intangible item is appearing in the balance sheet of A Ltd. at Rs. 8 lakhs as on 1-4-2003. The item was acquired for Rs. 20 lakhs on April 1, 1991 and was available for use from that date. The enterprise has been following a policy of amortising the item over a period of 20 years on straight-line basis. Applying paragraph 63, the enterprise determines that the item would have been amortised over a period of 10 years from the date when the item was available for use i.e., April 1, 1991.

Since the amortisation period determined by applying paragraph 63 has already expired as on 1-4-2003, the carrying amount of Rs. 8 lakhs would be required to be eliminated with a corresponding adjustment to the opening balance of revenue reserves as on 1-4-2003.

Illustratin 3 - Amortisation period determined under paragraph 63 has not expired and the remaining amortisation period as per the accounting policy followed by the enterprise is shorter.

An intangible item is appearing in the balance sheet of A Ltd. at Rs. 8 lakhs as on 1-4-2003. The item was acquired for Rs. 20 lakhs on April 1, 2000 and was available for use from that date. The enterprise has been following a policy of amortising the intangible item over a period of 5 years on straight line basis. Applying paragraph 63, the enterprise determines the amortisation period to be 8 years, being the best estimate of its useful life, from the date when the item was available for use i.e., April 1, 2000.

On 1-4-2003, the remaining period of amortisation is 2 years as per the accounting policy followed by the enterprise which is shorter as compared to the balance of amortisation period determined by applying paragraph 63, i.e., 5 years. Accordingly, the enterprise would be required to amortise the intangible item over the remaining 2 years as per the accounting policy followed by the enterprise.

Illustration 4 - Amortisation period determined under paragraph 63 has not expired and the remaining amortisation period as per the accounting policy followed by the enterprise is longer.

An intangible item is appearing in the balance sheet of A Ltd. at Rs. 18 lakhs as on 1-4-2003. The item was acquired for Rs. 24 lakhs on April 1, 2000 and was available for use from that date. The enterprise has been following a policy of amortising the intangible item over a period of 12 years on straight-line basis. Applying paragraph 63, the enterprise determines that the item would have been amortised over a period of 10 years on straight line basis from the date when the item was available for use i.e., April 1, 2000.

On 1-4-2003, the remaining period of amortisation is 9 years as per the accounting policy followed by the enterprise which is longer as compared to the balance of period stipulated in paragraph 63, i.e., 7 years. Accordingly, the enterprise would be required to restate the carrying amount of intangible item on 1-4-2003 at Rs. 16.8 lakhs (Rs. 24 lakhs - 3xRs. 2.4 lakhs, i.e., amortisation that would have been charged as per the Standard) and the difference of Rs. 1.2 lakhs (Rs. 18 lakhs-Rs. 16.8 lakhs) would be required to be adjusted against the *opening balance of the revenue reserves. The carrying amount of Rs. 16.8 lakhs would be amortised over 7 years which is the balance of the amortisation period as per paragraph 63.*

Illustratio 5 - Intangible Item is not amortised and amortisation period determined under paragraph 63 has not expired.

An intangible item is appearing in the balance sheet of A Ltd. at Rs. 20 lakhs as on 1-4-2003. The item was acquired for Rs. 20 lakhs on April 1, 2000 and was available for use from that date. The enterprise has been following an accounting policy of not amortising the item. Applying paragraph 63, the enterprise determines that the item would have been amortised over a period of 10 years on straight line basis from the date when the item was available for use i.e., April 1, 2000.

On 1-4-2003, the enterprise would be required to restate the carrying amount of intangible item at Rs. 14 lakhs (Rs. 20 lakhs - 3xRs. 2 lakhs, i.e., amortisation that would have been charged as per the Standard) and the difference of Rs. 6 lakhs (Rs. 20 lakhs-Rs. 14 lakhs) would be required to be adjusted against the opening balance of the revenue reserves. The carrying amount of Rs. 14 lakhs would be amortised over 7 years which is the balance of the amortisation period as per paragraph 63.

Accounting Standard (AS) 27
(issued 2002)

Financial Reporting of Interests in Joint Ventures

Contents

Accounting Standard (AS) 27
(issued 2002)

Financial Reporting of Interests in Joint Ventures

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

This Standard is mandatory in respect of separate financial statements of an enterprise. In respect of consolidated financial statements of an enterprise, this Standard is mandatory in nature where the enterprise prepares and presents the consolidated financial statements.

Objective

The objective of this Standard is to set out principles and procedures for accounting for interests in joint ventures and reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors.

Scope

1. This Standard 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.

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[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. The requirements relating to accounting for joint ventures in consolidated financial statements, contained in this Standard, are applicable only where consolidated financial statements are prepared and presented by the venturer.

Definitions

3. For the purpose of this Standard, the following terms are used with the meanings specified:

3.1 A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.

3.2 Joint control is the contractually agreed sharing of control over an economic activity.

3.3 Control is the power to govern the financial and operating policies of an economic activity so as to obtain benefits from it.

3.4 A venturer is a party to a joint venture and has joint control over that joint venture.

3.5 An investor in a joint venture is a party to a joint venture and does not have joint control over that joint venture.

3.6 Proportionate consolidation is a method of accounting and reporting whereby a venturer's share of each of the assets, liabilities, income and expenses of a jointly controlled entity is reported as separate line items in the venturer's financial statements.

Forms of Joint Venture

4. Joint ventures take many different forms and structures. This Standard identifies three broad types - jointly controlled operations, jointly controlled assets and jointly controlled entities - which are commonly described as, and meet the definition of, joint ventures. The following characteristics are common to all joint ventures:

(a) two or more venturers are bound by a contractual arrangement; and

(b) the contractual arrangement establishes joint control.

Contractual Arrangement

5. The existence of a contractual arrangement distinguishes interests which involve joint control from investments in associates in which the investor has significant influence (see Accounting Standard (AS) 23, Accounting for Investments in Associates in Consolidated Financial Statements). Activities which have no contractual arrangement to establish joint control are not joint ventures for the purposes of this Standard.

6. In some exceptional cases, an enterprise by a contractual arrangement establishes joint control over an entity which is a subsidiary of that enterprise within the meaning of Accounting Standard (AS) 21, Consolidated Financial Statements. In such cases, the entity is consolidated under AS 21 by the said enterprise, and is not treated as a joint venture as per this Standard. The consolidation of such an entity does not necessarily preclude other venturer(s) treating such an entity as a joint venture.

7. The contractual arrangement may be evidenced in a number of ways, for example by a contract between the venturers or minutes of discussions between the venturers. In some cases, the arrangement is incorporated in the articles or other by-laws of the joint venture. Whatever its form, the contractual arrangement is normally in writing and deals with such matters as:

(a) the activity, duration and reporting obligations of the joint venture;

(b) the appointment of the board of directors or equivalent governing body of the joint venture and the voting rights of the venturers;

(c) capital contributions by the venturers; and

(d) the sharing by the venturers of the output, income, expenses or results of the joint venture.

8. The contractual arrangement establishes joint control over the joint venture. Such an arrangement ensures that no single venturer is in a position to unilaterally control the activity. The arrangement identifies those decisions in areas essential to the goals of the joint venture which require the consent of all the venturers and those decisions which may require the consent of a specified majority of the venturers.

9. The contractual arrangement may identify one venturer as the operator or manager of the joint venture. The operator does not control the joint venture but acts within the financial and operating policies which have been agreed to by the venturers in accordance with the contractual arrangement and delegated to the operator.

Jointly Controlled Operations

10. The operation of some joint ventures involves the use of the assets and other resources of the venturers rather than the establishment of a corporation, partnership or other entity, or a financial structure that is separate from the venturers themselves. Each venturer uses its own fixed assets and carries its own inventories. It also incurs its own expenses and liabilities and raises its own finance, which represent its own obligations. The joint venture's activities may be carried out by the venturer's employees alongside the venturer's similar activities. The joint venture agreement usually provides means by which the revenue from the jointly controlled operations and any expenses incurred in common are shared among the venturers.

11. An example of a jointly controlled operation is when two or more venturers combine their operations, resources and expertise in order to manufacture, market and distribute, jointly, a particular product, such as an aircraft. Different parts of the manufacturing process are carried out by each of the venturers. Each venturer bears its own costs and takes a share of the revenue from the sale of the aircraft, such share being determined in accordance with the contractual arrangement.

12. In respect of its interests in jointly controlled operations, a venturer should recognise in its separate financial statements and consequently in its consolidated financial statements:

(a) the assets that it controls and the liabilities that it incurs; and

(b) the expenses that it incurs and its share of the income that it earns from the joint venture.

13. Because the assets, liabilities, income and expenses are already recognised in the separate financial statements of the venturer, and consequently in its consolidated financial statements, no adjustments or

other consolidation procedures are required in respect of these items when the venturer presents consolidated financial statements.

14. Separate accounting records may not be required for the joint venture itself and financial statements may not be prepared for the joint venture. However, the venturers may prepare accounts for internal management reporting purposes so that they may assess the performance of the joint venture.

Jointly Controlled Assets

15. Some joint ventures involve the joint control, and often the joint ownership, by the venturers of one or more assets contributed to, or acquired for the purpose of, the joint venture and dedicated to the purposes of the joint venture. The assets are used to obtain economic benefits for the venturers. Each venturer may take a share of the output from the assets and each bears an agreed share of the expenses incurred.

16. These joint ventures do not involve the establishment of a corporation, partnership or other entity, or a financial structure that is separate from the venturers themselves. Each venturer has control over its share of future economic benefits through its share in the jointly controlled asset.

17. An example of a jointly controlled asset is an oil pipeline jointly controlled and operated by a number of oil production companies. Each venturer uses the pipeline to transport its own product in return for which it bears an agreed proportion of the expenses of operating the pipeline. Another example of a jointly controlled asset is when two enterprises jointly control a property, each taking a share of the rents received and bearing a share of the expenses.

18. In respect of its interest in jointly controlled assets, a venturer should recognise, in its separate financial statements, and consequently in its consolidated financial statements:

(a) its share of the jointly controlled assets, classified according to the nature of the assets;

(b) any liabilities which it has incurred;

(c) ***its share of any liabilities incurred jointly with the other venturers in relation to the joint venture;***

(d) ***any income from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture; and***

(e) ***any expenses which it has incurred in respect of its interest in the joint venture.***

19. In respect of its interest in jointly controlled assets, each venturer includes in its accounting records and recognises in its separate financial statements and consequently in its consolidated financial statements:

(a) its share of the jointly controlled assets, classified according to the nature of the assets rather than as an investment, for example, a share of a jointly controlled oil pipeline is classified as a fixed asset;

(b) any liabilities which it has incurred, for example, those incurred in financing its share of the assets;

(c) its share of any liabilities incurred jointly with other venturers in relation to the joint venture;

(d) any income from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture; and

(e) any expenses which it has incurred in respect of its interest in the joint venture, for example, those related to financing the venturer's interest in the assets and selling its share of the output.

Because the assets, liabilities, income and expenses are already recognised in the separate financial statements of the venturer, and consequently in its consolidated financial statements, no adjustments or other consolidation procedures are required in respect of these items when the venturer presents consolidated financial statements.

20. The treatment of jointly controlled assets reflects the substance and economic reality and, usually, the legal form of the joint venture. Separate

accounting records for the joint venture itself may be limited to those expenses incurred in common by the venturers and ultimately borne by the venturers according to their agreed shares. Financial statements may not be prepared for the joint venture, although the venturers may prepare accounts for internal management reporting purposes so that they may assess the performance of the joint venture.

Jointly Controlled Entities

21. A jointly controlled entity is a joint venture which involves the establishment of a corporation, partnership or other entity in which each venturer has an interest. The entity operates in the same way as other enterprises, except that a contractual arrangement between the venturers establishes joint control over the economic activity of the entity.

22. A jointly controlled entity controls the assets of the joint venture, incurs liabilities and expenses and earns income. It may enter into contracts in its own name and raise finance for the purposes of the joint venture activity. Each venturer is entitled to a share of the results of the jointly controlled entity, although some jointly controlled entities also involve a sharing of the output of the joint venture.

23. An example of a jointly controlled entity is when two enterprises combine their activities in a particular line of business by transferring the relevant assets and liabilities into a jointly controlled entity. Another example is when an enterprise commences a business in a foreign country in conjunction with the government or other agency in that country, by establishing a separate entity which is jointly controlled by the enterprise and the government or agency.

24. Many jointly controlled entities are similar to those joint ventures referred to as jointly controlled operations or jointly controlled assets. For example, the venturers may transfer a jointly controlled asset, such as an oil pipeline, into a jointly controlled entity. Similarly, the venturers may contribute, into a jointly controlled entity, assets which will be operated jointly. Some jointly controlled operations also involve the establishment of a jointly controlled entity to deal with particular aspects of the activity, for example, the design, marketing, distribution or after-sales service of the product.

25. A jointly controlled entity maintains its own accounting records and prepares and presents financial statements in the same way as other enterprises in conformity with the requirements applicable to that jointly controlled entity.

Separate Financial Statements of a Venturer

26. In a venturer's separate financial statements, interest in a jointly controlled entity should be accounted for as an investment in accordance with Accounting Standard (AS) 13, Accounting for Investments.

27. 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.

Consolidated Financial Statements of a Venturer

28. 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; 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) 13, Accounting for Investments.

Explanation:

The period of time, which is considered as near future for the purposes of this Standard primarily depends on the facts and circumstances of each case. However, ordinarily, the meaning of the words 'near future' is considered as not more than twelve months from acquisition of relevant investments unless a longer period can be justified on the basis of facts

and circumstances of the case. The intention with regard to disposal of the relevant investment is considered at the time of acquisition of the investment. Accordingly, if the relevant investment is acquired without an intention to its subsequent disposal in near future, and subsequently, it is decided to dispose off the investment, such an investment is not excluded from application of the proportionate consolidation method, until the investment is actually disposed off. Conversely, if the relevant investment is acquired with an intention to its subsequent disposal in near future, however, due to some valid reasons, it could not be disposed off within that period, the same will continue to be excluded from application of the proportionate consolidation method, provided there is no change in the intention.

29. When reporting an interest in a jointly controlled entity in consolidated financial statements, it is essential that a venturer reflects the substance and economic reality of the arrangement, rather than the joint venture's particular structure or form. In a jointly controlled entity, a venturer has control over its share of future economic benefits through its share of the assets and liabilities of the venture. This substance and economic reality is reflected in the consolidated financial statements of the venturer when the venturer reports its interests in the assets, liabilities, income and expenses of the jointly controlled entity by using proportionate consolidation.

30. The application of proportionate consolidation means that the consolidated balance sheet of the venturer includes its share of the assets that it controls jointly and its share of the liabilities for which it is jointly responsible. The consolidated statement of profit and loss of the venturer includes its share of the income and expenses of the jointly controlled entity. Many of the procedures appropriate for the application of proportionate consolidation are similar to the procedures for the consolidation of investments in subsidiaries, which are set out in Accounting Standard (AS) 21, Consolidated Financial Statements.

31. For the purpose of applying proportionate consolidation, the venturer uses the consolidated financial statements of the jointly controlled entity.

32. Under proportionate consolidation, the venturer includes separate line items for its share of the assets, liabilities, income and expenses of the jointly controlled entity in its consolidated financial statements. For example, it shows its share of the inventory of the jointly controlled entity

separately as part of the inventory of the consolidated group; it shows its share of the fixed assets of the jointly controlled entity separately as part of the same items of the consolidated group.

Explanation:

While applying proportionate consolidation method, the venturer's share in the post-acquisition reserves of the jointly controlled entity is shown separately under the relevant reserves in the consolidated financial statements.

33. The financial statements of the jointly controlled entity used in applying proportionate consolidation are usually drawn up to the same date as the financial statements of the venturer. When the reporting dates are different, the jointly controlled entity often prepares, for applying proportionate consolidation, statements as at the same date as that of the venturer. When it is impracticable to do this, financial statements drawn up to different reporting dates may be used provided the difference in reporting dates is not more than six months. In such a case, adjustments are made for the effects of significant transactions or other events that occur between the date of financial statements of the jointly controlled entity and the date of the venturer's financial statements. The consistency principle requires that the length of the reporting periods, and any difference in the reporting dates, are consistent from period to period.

34. The venturer usually prepares consolidated financial statements using uniform accounting policies for the like transactions and events in similar circumstances. In case a jointly controlled entity uses accounting policies other than those adopted for the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to the financial statements of the jointly controlled entity when they are used by the venturer in applying proportionate consolidation. If it is not practicable to do so, that fact is disclosed together with the proportions of the items in the consolidated financial statements to which the different accounting policies have been applied.

35. While giving effect to proportionate consolidation, it is inappropriate to offset any assets or liabilities by the deduction of other liabilities or assets or any income or expenses by the deduction of other expenses or income, unless a legal right of set-off exists and the offsetting represents the expectation as to the realisation of the asset or the settlement of the liability.

PREVIOUS HOME NEXT

36. Any excess of the cost to the venturer of its interest in a jointly controlled entity over its share of net assets of the jointly controlled entity, at the date on which interest in the jointly controlled entity is acquired, is recognised as goodwill, and separately disclosed in the consolidated financial statements. When the cost to the venturer of its interest in a jointly controlled entity is less than its share of the net assets of the jointly controlled entity, at the date on which interest in the jointly controlled entity is acquired, the difference is treated as a capital reserve in the consolidated financial statements. Where the carrying amount of the venturer's interest in a jointly controlled entity is different from its cost, the carrying amount is considered for the purpose of above computations.

37. The losses pertaining to one or more investors in a jointly controlled entity may exceed their interests in the equity[2] of the jointly controlled entity. Such excess, and any further losses applicable to such investors, are recognised by the venturers in the proportion of their shares in the venture, except to the extent that the investors have a binding obligation to, and are able to, make good the losses. If the jointly controlled entity subsequently reports profits, all such profits are allocated to venturers until the investors' share of losses previously absorbed by the venturers has been recovered.

38. A venturer should discontinue the use of proportionate consolidation from the date that:

(a) it ceases to have joint control over a jointly controlled entity but retains, either in whole or in part, its interest in the entity; or

(b) the use of the proportionate consolidation is no longer appropriate because the jointly controlled entity operates under severe long-term restrictions that significantly impair its ability to transfer funds to the venturer.

39. 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,

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[2] Equity is the residual interest in the assets of an enterprise after deducting all its liabilities.

Consolidated 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) 13, Accounting for Investments, 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.

Transactions between a Venturer and Joint Venture

40. When a venturer contributes or sells assets to a joint venture, recognition of any portion of a gain or loss from the transaction should reflect the substance of the transaction. While the assets are retained by the joint venture, and provided the venturer has transferred the significant risks and rewards of ownership, the venturer should recognise only that portion of the gain or loss which is attributable to the interests of the other venturers. The venturer should recognise the full amount of any loss when the contribution or sale provides evidence of a reduction in the net realisable value of current assets or an impairment loss.

41. When a venturer purchases assets from a joint venture, the venturer should not recognise its share of the profits of the joint venture from the transaction until it resells the assets to an independent party. A venturer should recognise its share of the losses resulting from these transactions in the same way as profits except that losses should be recognised immediately when they represent a reduction in the net realisable value of current assets or an impairment loss.

42. To assess whether a transaction between a venturer and a joint venture provides evidence of impairment of an asset, the venturer determines the recoverable amount of the asset as per Accounting Standard on Impairment of Assets[3]. In determining value in use, future cash flows from the asset are estimated based on continuing use of the asset and its ultimate disposal by the joint venture.

43. In case of transactions between a venturer and a joint venture in the form of a jointly controlled entity, the requirements of paragraphs 41 and 42 should be applied only in the preparation and presentation of consolidated financial statements and not in the preparation and presentation of separate financial statements of the venturer.

44. In the separate financial statements of the venturer, the full amount of gain or loss on the transactions taking place between the venturer and the jointly controlled entity is recognised. However, while preparing the consolidated financial statements, the venturer's share of the unrealised gain or loss is eliminated. Unrealised losses are not eliminated, if and to the extent they represent a reduction in the net realisable value of current assets or an impairment loss. The venturer, in effect, recognises, in consolidated financial statements, only that portion of gain or loss which is attributable to the interests of other venturers.

Reporting Interests in Joint Ventures in the Financial Statements of an Investor

45. 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) 13, Accounting for Investments, Accounting Standard (AS) 21, Consolidated Financial Statements or Accounting Standard (AS) 23, Accounting for Investments in Associates in Consolidated Financial Statements, as appropriate.

46. In the separate financial statements of an investor, the interests in joint ventures should be accounted for in accordance with Accounting Standard (AS) 13, Accounting for Investments.

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[3] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

Operators of Joint Ventures

47. Operators or managers of a joint venture should account for any fees in accordance with Accounting Standard (AS) 9, Revenue Recognition.

48. One or more venturers may act as the operator or manager of a joint venture. Operators are usually paid a management fee for such duties. The fees are accounted for by the joint venture as an expense.

Disclosure

49. A venturer should disclose the information required by paragraphs 51, 52 and 53 in its separate financial statements as well as in consolidated financial statements.

50. A venturer should disclose the aggregate amount of the following contingent liabilities, unless the probability of loss is remote, separately from the amount of other contingent liabilities:

(a) any contingent liabilities that the venturer has incurred in relation to its interests in joint ventures and its share in each of the contingent liabilities which have been incurred jointly with other venturers;

(b) its share of the contingent liabilities of the joint ventures themselves for which it is contingently liable; and

(c) those contingent liabilities that arise because the venturer is contingently liable for the liabilities of the other venturers of a joint venture.

51. A venturer should disclose the aggregate amount of the following commitments in respect of its interests in joint ventures separately from other commitments:

(a) any capital commitments of the venturer in relation to its interests in joint ventures and its share in the capital commitments that have been incurred jointly with other venturers; and

(b) *its share of the capital commitments of the joint ventures themselves.*

52. A venturer should disclose a list of all joint ventures and description of interests in significant joint ventures. In respect of jointly controlled entities, the venturer should also disclose the proportion of ownership interest, name and country of incorporation or residence.

53. A venturer should disclose, in its separate financial statements, the aggregate amounts of each of the assets, liabilities, income and expenses related to its interests in the jointly controlled entities.

Accounting Standard (AS) 28

(issued 2002)

Impairment of Assets

Contents

Continued../..

Accounting Standard (AS) 28
(issued 2002)

Impairment of Assets

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

Objective

The objective of this Standard is to prescribe the procedures that an enterprise applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and this Standard requires the enterprise to recognise an impairment loss. This Standard also specifies when an enterprise should reverse an impairment loss and it prescribes certain disclosures for impaired assets.

Scope

1. This Standard should be applied in accounting for the impairment of all assets, other than:

> ***(a) inventories (see AS 2, Valuation of Inventories);***
>
> ***(b) assets arising from construction contracts (see AS 7, Construction Contracts);***

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

(c) financial assets[2], including investments that are included in the scope of AS 13, Accounting for Investments; and

(d) deferred tax assets (see AS 22, Accounting for Taxes on Income).

2. This Standard does not apply to inventories, assets arising from construction contracts, deferred tax assets or investments because existing Accounting Standards applicable to these assets already contain specific requirements for recognising and measuring the impairment related to these assets.

3. This Standard applies to assets that are carried at cost. It also applies to assets that are carried at revalued amounts in accordance with other applicable Accounting Standards. However, identifying whether a revalued asset may be impaired depends on the basis used to determine the fair value of the asset:

(a) if the fair value of the asset is its market value, the only difference between the fair value of the asset and its net selling price is the direct incremental costs to dispose of the asset:

(i) if the disposal costs are negligible, the recoverable amount of the revalued asset is necessarily close to, or greater than, its revalued amount (fair value). In this case, after the revaluation requirements have been applied, it is unlikely that the revalued asset is impaired and recoverable amount need not be estimated; and

(ii) if the disposal costs are not negligible, net selling price of the revalued asset is necessarily less than its fair value. Therefore, the revalued asset will be impaired if its value in use is less than its revalued amount (fair value). In this case, after the revaluation requirements have been applied, an enterprise applies this Standard to determine whether the asset may be impaired; and

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[2]A financial asset is any asset that is:

(a) cash;

(b) a contractual right to receive cash or another financial asset from another enterprise;

(c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

(d) an ownership interest in another enterprise.

(b) if the asset's fair value is determined on a basis other than its market value, its revalued amount (fair value) may be greater or lower than its recoverable amount. Hence, after the revaluation requirements have been applied, an enterprise applies this Standard to determine whether the asset may be impaired.

Definitions

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

4.1 Recoverable amount is the higher of an asset's net selling price and its value in use.

4.2 Value in use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.

Provided that in the context of Small and Medium-sized Companies and Small and Medium-sized Enterprises (SMEs) (Levels II and III non-corporate entities), as defined in Appendix 1 to this Compendium, the definition of the term 'value in use' would read as follows:

"Value in use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life, or a reasonable estimate thereof. "

Explantion:

The definition of the term 'value in use' in the proviso implies that instead of using the present value technique, a reasonable estimate of the 'value in use' can be made. Consequently, if an SMC/SME chooses to measure the 'value in use' by not using the present value technique, the relevant provisions of AS 28, such as discount rate etc., would not be applicable to such an SMC/SME.

4.3 Net selling price is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.

4.4 Costs of disposal are incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense.

4.5 An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.

4.6 Carrying amount is the amount at which an asset is recognised in the balance sheet after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.

4.7 Depreciation (Amortisation) is a systematic allocation of the depreciable amount of an asset over its useful life.[3]

4.8 Depreciable amount is the cost of an asset, or other amount substituted for cost in the financial statements, less its residual value.

4.9 Useful life is either:

(a) the period of time over which an asset is expected to be used by the enterprise; or

(b) the number of production or similar units expected to be obtained from the asset by the enterprise.

4.10 A cash generating unit is the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets.

4.11 Corporate assets are assets other than goodwill that contribute to the future cash flows of both the cash generating unit under review and other cash generating units.

4.12 An active market is a market where all the following conditions exist :

(a) the items traded within the market are homogeneous;

(b) willing buyers and sellers can normally be found at any time; and

(c) prices are available to the public.

[3] In the case of an intangible asset or goodwill, the term ‘amortisation’ is generally used instead of ‘depreciation’. Both terms have the same meaning.

Identifying an Asset that may be Impaired

5. An asset is impaired when the carrying amount of the asset exceeds its recoverable amount. Paragraphs 6 to 13 specify when recoverable amount should be determined. These requirements use the term 'an asset' but apply equally to an individual asset or a cash-generating unit.

6. An enterprise should assess at each balance sheet date whether there is any indication that an asset may be impaired. If any such indication exists, the enterprise should estimate the recoverable amount of the asset.

7. Paragraphs 8 to 10 describe some indications that an impairment loss may have occurred: if any of those indications is present, an enterprise is required to make a formal estimate of recoverable amount. If no indication of a potential impairment loss is present, this Standard does not require an enterprise to make a formal estimate of recoverable amount.

8. In assessing whether there is any indication that an asset may be impaired, an enterprise should consider, as a minimum, the following indications:

External sources of information

(a) during the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use;

(b) significant changes with an adverse effect on the enterprise have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the enterprise operates or in the market to which an asset is dedicated;

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

(d) the carrying amount of the net assets of the reporting enterprise is more than its market capitalisation;

Internal sources of information

(e) ***evidence is available of obsolescence or physical damage of an asset;***

(f) ***significant changes with an adverse effect on the enterprise have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include plans to discontinue or restructure the operation to which an asset belongs or to dispose of an asset before the previously expected date; and***

(g) ***evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.***

9. The list of paragraph 8 is not exhaustive. An enterprise may identify other indications that an asset may be impaired and these would also require the enterprise to determine the asset's recoverable amount.

10. Evidence from internal reporting that indicates that an asset may be impaired includes the existence of:

(a) cash flows for acquiring the asset, or subsequent cash needs for operating or maintaining it, that are significantly higher than those originally budgeted;

(b) actual net cash flows or operating profit or loss flowing from the asset that are significantly worse than those budgeted;

(c) a significant decline in budgeted net cash flows or operating profit, or a significant increase in budgeted loss, flowing from the asset; or

(d) operating losses or net cash outflows for the asset, when current period figures are aggregated with budgeted figures for the future.

11. The concept of materiality applies in identifying whether the recoverable amount of an asset needs to be estimated. For example, if previous calculations show that an asset's recoverable amount is

significantly greater than its carrying amount, the enterprise need not re-estimate the asset's recoverable amount if no events have occurred that would eliminate that difference. Similarly, previous analysis may show that an asset's recoverable amount is not sensitive to one (or more) of the indications listed in paragraph 8.

12. As an illustration of paragraph 11, if market interest rates or other market rates of return on investments have increased during the period, an enterprise is not required to make a formal estimate of an asset's recoverable amount in the following cases:

(a) if the discount rate used in calculating the asset's value in use is unlikely to be affected by the increase in these market rates. For example, increases in short-term interest rates may not have a material effect on the discount rate used for an asset that has a long remaining useful life; or

(b) if the discount rate used in calculating the asset's value in use is likely to be affected by the increase in these market rates but previous sensitivity analysis of recoverable amount shows that:

(i) it is unlikely that there will be a material decrease in recoverable amount because future cash flows are also likely to increase. For example, in some cases, an enterprise may be able to demonstrate that it adjusts its revenues to compensate for any increase in market rates; or

(ii) the decrease in recoverable amount is unlikely to result in a material impairment loss.

13. If there is an indication that an asset may be impaired, this may indicate that the remaining useful life, the depreciation (amortisation) method or the residual value for the asset need to be reviewed and adjusted under the Accounting Standard applicable to the asset, such as Accounting Standard (AS) 6, Depreciation Accounting[4], even if no impairment loss is recognised for the asset.

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[4] Amortisation (depreciation) of intangible assets is dealt with in AS 26, Intangible Assets.

Measurement of Recoverable Amount

14. This Standard defines recoverable amount as the higher of an asset's net selling price and value in use. Paragraphs 15 to 55 set out the requirements for measuring recoverable amount. These requirements use the term 'an asset' but apply equally to an individual asset or a cash-generating unit.

15. It is not always necessary to determine both an asset's net selling price and its value in use. For example, if either of these amounts exceeds the asset's carrying amount, the asset is not impaired and it is not necessary to estimate the other amount.

16. It may be possible to determine net selling price, even if an asset is not traded in an active market. However, sometimes it will not be possible to determine net selling price because there is no basis for making a reliable estimate of the amount obtainable from the sale of the asset in an arm's length transaction between knowledgeable and willing parties. In this case, the recoverable amount of the asset may be taken to be its value in use.

17. If there is no reason to believe that an asset's value in use materially exceeds its net selling price, the asset's recoverable amount may be taken to be its net selling price. This will often be the case for an asset that is held for disposal. This is because the value in use of an asset held for disposal will consist mainly of the net disposal proceeds, since the future cash flows from continuing use of the asset until its disposal are likely to be negligible.

18. Recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows from continuing use that are largely independent of those from other assets or groups of assets. If this is the case, recoverable amount is determined for the cash-generating unit to which the asset belongs (see paragraphs 63 to 86), unless either:

(a) the asset's net selling price is higher than its carrying amount; or

(b) the asset's value in use can be estimated to be close to its net selling price and net selling price can be determined.

19. In some cases, estimates, averages and simplified computations may provide a reasonable approximation of the detailed computations illustrated in this Standard for determining net selling price or value in use.

Net Selling Price

20. The best evidence of an asset's net selling price is a price in a binding sale agreement in an arm's length transaction, adjusted for incremental costs that would be directly attributable to the disposal of the asset.

21. If there is no binding sale agreement but an asset is traded in an active market, net selling price is the asset's market price less the costs of disposal. The appropriate market price is usually the current bid price. When current bid prices are unavailable, the price of the most recent transaction may provide a basis from which to estimate net selling price, provided that there has not been a significant change in economic circumstances between the transaction date and the date at which the estimate is made.

22. If there is no binding sale agreement or active market for an asset, net selling price is based on the best information available to reflect the amount that an enterprise could obtain, at the balance sheet date, for the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the costs of disposal. In determining this amount, an enterprise considers the outcome of recent transactions for similar assets within the same industry. Net selling price does not reflect a forced sale, unless management is compelled to sell immediately.

23. Costs of disposal, other than those that have already been recognised as liabilities, are deducted in determining net selling price. Examples of such costs are legal costs, costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale. However, termination benefits and costs associated with reducing or reorganising a business following the disposal of an asset are not direct incremental costs to dispose of the asset.

24. Sometimes, the disposal of an asset would require the buyer to take over a liability and only a single net selling price is available for both the asset and the liability. Paragraph 76 explains how to deal with such cases.

Value in Use

25. Estimating the value in use of an asset involves the following steps:

(a) estimating the future cash inflows and outflows arising from continuing use of the asset and from its ultimate disposal; and

(b) applying the appropriate discount rate to these future cash flows.

Basis for Estimates of Future Cash Flows

26. In measuring value in use:

(a) cash flow projections should be based on reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the remaining useful life of the asset. Greater weight should be given to external evidence;

(b) cash flow projections should be based on the most recent financial budgets/forecasts that have been approved by management. Projections based on these budgets/forecasts should cover a maximum period of five years, unless a longer period can be justified; and

(c) cash flow projections beyond the period covered by the most recent budgets/forecasts should be estimated by extrapolating the projections based on the budgets/forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified. This growth rate should not exceed the long-term average growth rate for the products, industries, or country or countries in which the enterprise operates, or for the market in which the asset is used, unless a higher rate can be justified.

27. Detailed, explicit and reliable financial budgets/forecasts of future cash flows for periods longer than five years are generally not available. For this reason, management's estimates of future cash flows are based on the most recent budgets/forecasts for a maximum of five years. Management may use cash flow projections based on financial budgets/forecasts over a period longer than five years if management is confident that these projections are reliable and it can demonstrate its ability, based on past experience, to forecast cash flows accurately over that longer period.

28. Cash flow projections until the end of an asset's useful life are estimated by extrapolating the cash flow projections based on the financial budgets/forecasts using a growth rate for subsequent years. This rate is steady or declining, unless an increase in the rate matches objective information about

patterns over a product or industry lifecycle. If appropriate, the growth rate is zero or negative.

29. Where conditions are very favourable, competitors are likely to enter the market and restrict growth. Therefore, enterprises will have difficulty in exceeding the average historical growth rate over the long term (say, twenty years) for the products, industries, or country or countries in which the enterprise operates, or for the market in which the asset is used.

30. In using information from financial budgets/forecasts, an enterprise considers whether the information reflects reasonable and supportable assumptions and represents management's best estimate of the set of economic conditions that will exist over the remaining useful life of the asset.

Composition of Estimates of Future Cash Flows

31. Estimates of future cash flows should include:

(a) projections of cash inflows from the continuing use of the asset;

(b) projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset (including cash outflows to prepare the asset for use) and that can be directly attributed, or allocated on a reasonable and consistent basis, to the asset; and

(c) net cash flows, if any, to be received (or paid) for the disposal of the asset at the end of its useful life.

32. Estimates of future cash flows and the discount rate reflect consistent assumptions about price increases due to general inflation. Therefore, if the discount rate includes the effect of price increases due to general inflation, future cash flows are estimated in nominal terms. If the discount rate excludes the effect of price increases due to general inflation, future cash flows are estimated in real terms but include future specific price increases or decreases.

33. Projections of cash outflows include future overheads that can be attributed directly, or allocated on a reasonable and consistent basis, to the use of the asset.

PREVIOUS HOME NEXT

34. When the carrying amount of an asset does not yet include all the cash outflows to be incurred before it is ready for use or sale, the estimate of future cash outflows includes an estimate of any further cash outflow that is expected to be incurred before the asset is ready for use or sale. For example, this is the case for a building under construction or for a development project that is not yet completed.

35. To avoid double counting, estimates of future cash flows do not include:

(a) cash inflows from assets that generate cash inflows from continuing use that are largely independent of the cash inflows from the asset under review (for example, financial assets such as receivables); and

(b) cash outflows that relate to obligations that have already been recognised as liabilities (for example, payables, pensions or provisions).

36. Future cash flows should be estimated for the asset in its current condition. Estimates of future cash flows should not include estimated future cash inflows or outflows that are expected to arise from:

(a) a future restructuring to which an enterprise is not yet committed; or

(b) future capital expenditure that will improve or enhance the asset in excess of its originally assessed standard of performance.

37. Because future cash flows are estimated for the asset in its current condition, value in use does not reflect:

(a) future cash outflows or related cost savings (for example, reductions in staff costs) or benefits that are expected to arise from a future restructuring to which an enterprise is not yet committed; or

(b) future capital expenditure that will improve or enhance the asset in excess of its originally assessed standard of performance or the related future benefits from this future expenditure.

38. A restructuring is a programme that is planned and controlled by management and that materially changes either the scope of the business undertaken by an enterprise or the manner in which the business is conducted[5].

39. When an enterprise becomes committed to a restructuring, some assets are likely to be affected by this restructuring. Once the enterprise is committed to the restructuring, in determining value in use, estimates of future cash inflows and cash outflows reflect the cost savings and other benefits from the restructuring (based on the most recent financial budgets/forecasts that have been approved by management).

Illustration 5 given in the Illustrations attached to the Standard illustrates the effect of a future restructuring on a value in use calculation.

40. Until an enterprise incurs capital expenditure that improves or enhances an asset in excess of its originally assessed standard of performance, estimates of future cash flows do not include the estimated future cash inflows that are expected to arise from this expenditure (see Illustration 6 given in the Illustrations attached to the Standard).

41. Estimates of future cash flows include future capital expenditure necessary to maintain or sustain an asset at its originally assessed standard of performance.

42. Estimates of future cash flows should not include:

(a) cash inflows or outflows from financing activities; or

(b) income tax receipts or payments.

43. Estimated future cash flows reflect assumptions that are consistent with the way the discount rate is determined. Otherwise, the effect of some assumptions will be counted twice or ignored. Because the time value of money is considered by discounting the estimated future cash flows, these cash flows exclude cash inflows or outflows from financing activities. Similarly, since the discount rate is determined on a pre-tax basis, future cash flows are also estimated on a pre-tax basis.

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[5] See AS 29, *Provisions, Contingent liabilities and Contingent Assets,* for further explanations on 'restructuring'.

44. The estimate of net cash flows to be received (or paid) for the disposal of an asset at the end of its useful life should be the amount that an enterprise expects to obtain from the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the estimated costs of disposal.

45. The estimate of net cash flows to be received (or paid) for the disposal of an asset at the end of its useful life is determined in a similar way to an asset's net selling price, except that, in estimating those net cash flows:

(a) an enterprise uses prices prevailing at the date of the estimate for similar assets that have reached the end of their useful life and that have operated under conditions similar to those in which the asset will be used; and

(b) those prices are adjusted for the effect of both future price increases due to general inflation and specific future price increases (decreases). However, if estimates of future cash flows from the asset's continuing use and the discount rate exclude the effect of general inflation, this effect is also excluded from the estimate of net cash flows on disposal.

Foreign Currency Future Cash Flows

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

Discount Rate

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

48. A rate that reflects current market assessments of the time value of money and the risks specific to the asset is the return that investors would require if they were to choose an investment that would generate cash flows of amounts,

timing and risk profile equivalent to those that the enterprise expects to derive from the asset. This rate is estimated from the rate implicit in current market transactions for similar assets or from the weighted average cost of capital of a listed enterprise that has a single asset (or a portfolio of assets) similar in terms of service potential and risks to the asset under review.

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

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

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

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

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

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

(c) other market borrowing rates.

51. These rates are adjusted:

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

(b) to exclude risks that are not relevant to the projected cash flows.

Consideration is given to risks such as country risk, currency risk, price risk and cash flow risk.

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

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

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

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

Recognition and Measurement of Impairment Loss

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

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

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

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

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

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

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

Cash-Generating Units

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

Identification of the Cash-Generating Unit to Which an Asset Belongs

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

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

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

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

Example

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

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

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

Example

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

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

67. Cash inflows from continuing use are inflows of cash and cash equivalents received from parties outside the reporting enterprise. In identifying whether cash inflows from an asset (or group of assets) are largely independent of the cash inflows from other assets (or groups of assets), an enterprise considers various factors including how management monitors the enterprise's operations (such as by product lines, businesses, individual

locations, districts or regional areas or in some other way) or how management makes decisions about continuing or disposing of the enterprise's assets and operations. Illustation 1 in the Illustrations attached to the Standard illustrates identification of a cash-generating unit.

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

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

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

69. Even if part or all of the output produced by an asset or a group of assets is used by other units of the reporting enterprise (for example, products at an intermediate stage of a production process), this asset or group of assets forms a separate cash-generating unit if the enterprise could sell this output in an active market. This is because this asset or group of assets could generate cash inflows from continuing use that would be largely independent of the cash inflows from other assets or groups of assets. In using information based on financial budgets/forecasts that relates to such a cash-generating unit, an enterprise adjusts this information if internal transfer prices do not reflect management's best estimate of future market prices for the cash-generating unit's output.

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

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

Recoverable Amount and Carrying Amount of a Cash-Generating Unit

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

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

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

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

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

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

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

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

Example

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

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

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

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

Goodwill

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

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

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

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

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

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

(i) identify the smallest cash-generating unit that includes the cash-generating unit under review and to which the

carrying amount of goodwill can be allocated on a reasonable and consistent basis (the 'larger' cash-generating unit); and

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

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

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

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

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

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

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

Corporate Assets

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

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

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

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

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

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

Impairment Loss for a Cash-Generating Unit

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

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

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

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

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

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

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

(c) zero.

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

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

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

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

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

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

Example

A machine has suffered physical damage but is still working, although not as well as it used to. The net selling price of the machine is less than its carrying amount. The machine does not generate independent cash inflows from continuing use. The smallest identifiable group of assets that includes the machine and generates cash inflows from continuing use that are largely independent of the cash inflows from other assets is the production line to which the machine belongs. The recoverable amount of the production line shows that the production line taken as a whole is not impaired.

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

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

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

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

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

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

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

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

Reversal of an Impairment Loss

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

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

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

External sources of information

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

(b) significant changes with a favourable effect on the enterprise have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the enterprise operates or in the market to which the asset is dedicated;

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

Internal sources of information

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

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

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

97. If there is an indication that an impairment loss recognised for an asset may no longer exist or may have decreased, this may indicate that the remaining useful life, the depreciation (amortisation) method or the residual

value may need to be reviewed and adjusted in accordance with the Accounting Standard applicable to the asset, even if no impairment loss is reversed for the asset.

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

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

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

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

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

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

Reversal of an Impairment Loss for an Individual Asset

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

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

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

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

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

Reversal of an Impairment Loss for a Cash-Generating Unit

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

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

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

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

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

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

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

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

Reversal of an Impairment Loss for Goodwill

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

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

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

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

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

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

Impairment in case of Discontinuing Operations

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

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

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

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

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

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

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

and recognises resulting impairment losses or reversals of impairment losses in accordance with this Standard.

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

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

Disclosure

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

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

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

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

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

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

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

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

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

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

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

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

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

(c) for an individual asset:

(i) the nature of the asset; and

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

(d) for a cash-generating unit:

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

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

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

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

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

(g) if recoverable amount is value in use, the discount rate(s) used in the current estimate and previous estimate (if any) of value in use. Provided that if a Small and Medium-sized Company (SMC) or a Small and Medium-sized Enterprise (SME) (Level II or Level III non-corporate entity), as defined in Appendix 1 to the Compendium, chooses to measure the 'value in use' as per the proviso to paragraph 4.2 of the Standard, such an SMC/ SME need not disclose the information required by paragraph 121(g) of the Standard.

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

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

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

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

Transitional Provisions

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

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

Illustrations

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

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

Illustration 1 - Identification of Cash-Generating Units

The purpose of this Illustration is:

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

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

A - Retail Store Chain

Background

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

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

Analysis

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

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

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

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

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

B - Plant for an Intermediate Step in a Production Process

Background

A5. A significant raw material used for plant Y's final production is an intermediate product bought from plant X of the same enterprise. X's products are sold to Y at a transfer price that passes all margins to X. 80% of Y's final production is sold to customers outside of the reporting enterprise. 60% of X's final production is sold to Y and the remaining 40% is sold to customers outside of the reporting enterprise.

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

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

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

Analysis

Case 1

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

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

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

Case 2

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

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

(b) the two plants are managed together.

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

C - Single Product Enterprise

Background

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

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

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

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

Analysis

Case 1

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

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

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

Case 2

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

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

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

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

D - Magazine Titles

Background

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

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

Analysis

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

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

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

Background

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

What is the cash-generating unit of the building?

Analysis

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

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

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

In this illustration, tax effects are ignored.

Background and Calculation of Value in Use

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

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

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

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

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

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

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

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

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

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

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

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

Recognition and Measurement of Impairment Loss

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

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

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

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

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

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

[1] Based on management's best estimate of net cash flow projections (after the 40% cut).
[2] Based on an extrapolation from preceding year cash flow using declining growth rates.
[3] The present value factor is calculated as $k = 1/(1+a)^n$, where a = discount rate and n = period of discount.

PREVIOUS HOME NEXT

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

End of 20X4	*Goodwill*	*Identifiable assets*	*Total*
Historical cost	1,000	2,000	3,000
Accumulated depreciation/ amortisation (20X1-20X4)	(800)	(533)	(1,333)
Carrying amount	200	1,467	1,667
Impairment Loss	(200)	[illegible]7)	(307)
Carrying amount after impairment loss	0	1,360	1,360

Illustration 3 - Deferred Tax Effects

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

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

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

Illustration 4 - Reversal of an Impairment Loss

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

Background

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

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

Reversal of Impairment Loss

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

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

	Goodwill	*Identifiable assets*	*Total*
End of 20X4 (Example 2)			
Historical cost	1,000	2,000	3,000
Accumulated depreciation/ amortisation (4 years)	(800)	(533)	(1,333)
Impairment loss	(200)	(107)	(307)
Carrying amount after impairment loss	0	1,360	1,360
End of 20X6			
Additional depreciation			
(2 years)[(1)]	–	(247)	(247)
Carrying amount	0	1,113	1,113
Recoverable amount			1,710
Excess of recoverable amount over carrying amount			597

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

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

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

Schedule 2. Determination of the depreciated historical cost of the Country A identifiable assets at the end of 20X6 (Amount in Rs. lakhs)

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

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

End of 20X6	*Goodwill*	*Identifiable assets*	*Total*
Gross carrying amount	1,000	2,000	3,000
Accumulated depreciation/ amortisation	(800)	(780)	(1,580)
Accumulated impairment loss	(200)	(107)	(307)
Carrying amount	0	1,113	1,113
Reversal of impairment loss	0	87	87
Carrying amount after reversal of impairment loss	0	1,200	1,200

Illustration 5 - Treatment of a Future Restructuring

In this illustration, tax effects are ignored.

Background

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

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

A42. Management approved budgets reflect that:

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

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

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

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

At the End of 20X0

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

Year	*Future cash flows*	*Discounted at 14%*
20X1	300	263
20X2	280	215
20X3	420(1)	283
20X4	520(2)	308
20X5	350(2)	182
20X6	420(2)	191
20X7	480(2)	192
20X8	480(2)	168
20X9	460(2)	141
20X10	400(2)	108
Value in use		2,051

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

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

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

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

At the End of 20X1

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

At the End of 20X2

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

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

Year	*Future cash flows*	*Discounted at 14%*
20X3	420[(1)]	368
20X4	570[(2)]	439
20X5	380[(2)]	256
20X6	450[(2)]	266
20X7	510[(2)]	265
20X8	510[(2)]	232
20X9	480[(2)]	192
20X10	410[(2)]	144
Value in use		2,162

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

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

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

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

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

At the End of 20X3

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

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

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

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

Illustration 6 - Treatment of Future Capital Expenditure

In this illustration, tax effects are ignored.

Background

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

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

A52. Management approved budgets reflect that:

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

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

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

At the End of 20X0

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

Year	*Future cash flows*	*Discounted at 14%*
20X1	221.65	194.43
20X2	214.50	165.05
20X3	205.50	138.71
20X4	247.25(1)	146.39
20X5	253.25(2)	131.53
20X6	248.25(2)	113.10
20X7	241.23(2)	96.40
20X8	255.33(2)	89.51
20X9	242.34(2)	74.52
20X10	228.50(2)	61.64
Value in use		1,211.28

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

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

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

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

Years 20X1-20X3

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

At the End of 20X4

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

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

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

[1] Includes estimated benefits expected from the renewal of the engine reflected in management budgets.

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

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

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

[(1)] The value in use of the plane exceeds what its carrying amount would have been at depreciated historical cost. Therefore, the reversal is limited to an amount that does not result in the carrying amount of the plane exceeding depreciated historical cost.

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

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

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

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

In this illustration, tax effects are ignored.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Illustration 8 - Allocation of Corporate Assets

In this illustration tax effects are ignored.

Background

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

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

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

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

Identification of Corporate Assets

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

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

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

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

Allocation of Corporate Assets

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

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

End of 20X0	*A*	*B*	*C*	*Total*
Carrying amount	100	150	200	450
Useful life	10 years	20 years	20 years	
Weighting based on useful life	1		2	
Carrying amount after weighting	100	300	400	800
Pro-rata allocation of the building	12.5% (100/800)	37.5% (300/800)	50% (400/800)	100%
Allocation of the carrying amount of the building (based on pro-rata above)	19	56	75	150
Carrying amount (after allocation of the building)	119	206	275	600

Determination of Recoverable Amount

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

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

	A		B		C		M	
Year	*Future cash flows*	*Discount at 15%*	*Future cash flows*	*Discount at 15%*	*Future cash flows*	*Discount at 15%*	*Future cash flows*	*Discount at 15%*
1	2	3	4	5	6	7	8	9
1	18	16	9	8	10	9	39	34
2	31	23	16	12	20	15	72	54
3	37	24	24	16	34	22	105	69
4	42	24	29	17	44	25	128	73
5	47	24	32	16	51	25	143	71
6	52	22	33	14	56	24	155	67
7	55	21	34	13	60	22	162	61
8	55	18	35	11	63	21	166	54
9	53	15	35	10	65	18	167	48
10	48	12	35	9	66	16	169	42
11			36	8	66	14	132	28
12			35	7	66	12	131	25
13			35	6	66	11	131	21
14			33	5	65	9	128	18
15			30	4	62	8	122	15
16			26	3	60	6	115	12
17			22	2	57	5	108	10
18			18	1	51	4	97	8
19			14	1	43	3	85	6
20			10	1	35	2	71	4
Value in use		199		164		271		720[(1)]

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

PREVIOUS HOME NEXT

Calculation of Impairment Losses

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

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

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

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

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

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

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

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

End of 20X0	*A*	*B*	*C*	*Building*	*Research centre*	*M*
Carrying amount	100	150	200	150	50	650
Impairment loss arising from the 'bottom-up' test	–	(30)	(3)	(13)	–	(46)
Carrying amount after the 'bottom-up' test	100	120	197	137	50	604
Recoverable amount (Schedule 2)						720
Impairment loss arising from 'top-down' test						0

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

Accounting Standard (AS) 29
(issued 2003)

Provisions, Contingent Liabilities and Contingent Assets

Contents

Accounting Standard (AS) 29
(issued 2003)

Provisions, Contingent Liabilities and Contingent Assets

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

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

Objective

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

Scope

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

[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.

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

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

Explanation:

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

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

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

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

(d) ***those covered by another Accounting Standard.***

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

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

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

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

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

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

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

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

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

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

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

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

9. This Standard applies to provisions for restructuring (including discontinuing operations). Where a restructuring meets the definition of a

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

discontinuing operation, additional disclosures are required by AS 24, Discontinuing Operations.

Definitions

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

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

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

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

10.4 A contingent liability is:

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

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

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

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

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

10.6 Present obligation - an obligation is a present obligation if, based on

the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.

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

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

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

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

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

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

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

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

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

Recognition

Provisions

14. A provision should be recognised when:

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

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

(c) a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.

Present Obligation

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

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

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

Past Event

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

PREVIOUS HOME NEXT

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

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

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

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

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

Probable Outflow of Resources Embodying Economic Benefits

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

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

Reliable Estimate of the Obligation

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

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

Contingent Liabilities

26. An enterprise should not recognise a contingent liability.

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

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

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

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

Contingent Assets

30. An enterprise should not recognise a contingent asset.

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

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

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

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

Measurement

Best Estimate

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

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

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

Risks and Uncertainties

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

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

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

Future Events

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

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

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

Expected Disposal of Assets

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

45. Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an enterprise recognises gains on

expected disposals of assets at the time specified by the Accounting Standard dealing with the assets concerned.

Reimbursements

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

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

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

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

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

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

Changes in Provisions

52. Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow

of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.

Use of Provisions

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

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

Application of the Recognition and Measurement Rules

Future Operating Losses

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

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

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

Restructuring

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

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

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

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

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

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

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

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

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

(a) necessarily entailed by the restructuring; and

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

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

(a) retraining or relocating continuing staff;

(b) marketing; or

(c) investment in new systems and distribution networks.

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

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

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

Disclosure

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

(a) the carrying amount at the beginning and end of the period;

(b) additional provisions made in the period, including increases to existing provisions;

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

(d) unused amounts reversed during the period.

Provided that a Small and Medium-sized Company and a Small and Medium-sized Enterprise (Level II and Level III non-corperate entities), as defined in Appendix 1 to this Compendium, may not comply with paragraph 66 above.

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

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

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

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

Provided that a Small and Medium-sized Company and a Small and Medium-sized Enterprise (Level II and Level III non-coperate entities), as defined in Appendix 1 to this Compendium, may not comply with paragraph 67 above.

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

- ***(a) an estimate of its financial effect, measured under paragraphs 35-45;***
- ***(b) an indication of the uncertainties relating to any outflow; and***
- ***(c) the possibility of any reimbursement.***

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

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

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

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

Illustration A

Tables - Provisions, Contingent Liabilities and Reimbursements

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

Provisions and Contingent Liabilities

Where, as a result of past events, there may be an outflow of resources embodying future economic benefits in settlement of: (a) a present obligation the one whose existence at the balance sheet date is considered probable; or (b) a possible obligation the existence of which at the balance sheet date is considered not probable.		
There is a present obligation that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation.	**There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.**	**There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.**
A provision is recognised (paragraph 14). Disclosures are required for the provision (paragraphs 66 and 67).	No provision is recognised (paragraph 26). Disclosures are required for the contingent liability (paragraph 68).	No provision is recognised (paragraph 26). No disclosure is required (paragraph 68).

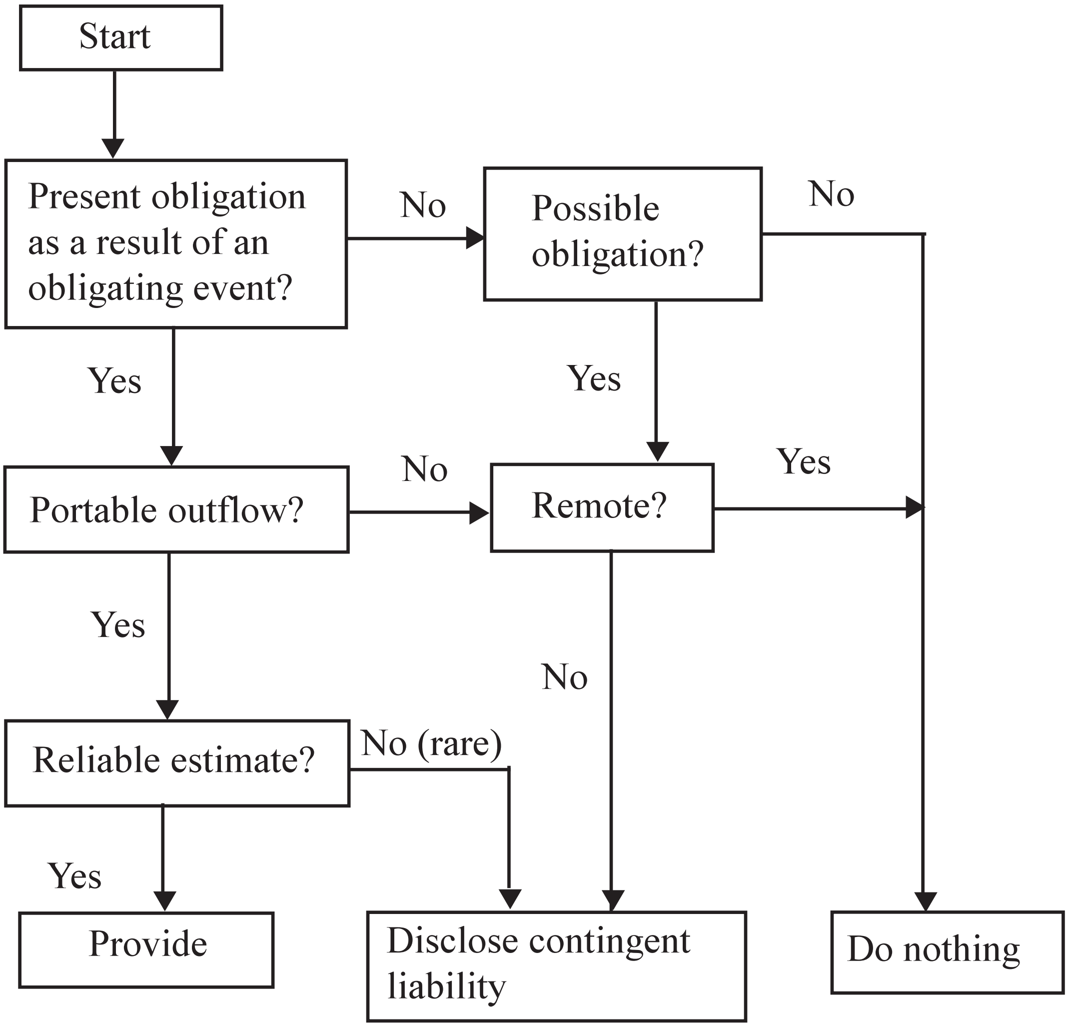
Reimbursements

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

Illustration B

Decision Tree

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



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

Illustration C

Illustrations: Recognition

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

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

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

Illustration 1: Warranties

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

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

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

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

Illustration 2: Contaminated Land - Legislation Virtually Certain to be Enacted

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

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

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

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

Illustration 3: Offshore Oilfield

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

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

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

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

Illustration 4: Refunds Policy

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

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

An outflow of resources embodying economic benefits in settlement - Probable, a proportion of goods are returned for refund (see paragraph 23).

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

Illustration 5: Legal Requirement to Fit Smoke Filters

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

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

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

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

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

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

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

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

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

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

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

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

Illustration 7: A Single Guarantee

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

(a) At 31 March 2005

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

An outflow of resources embodying economic benefits in settlement - No outflow of benefits is probable at 31 March 2005.

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

(b) At 31 March 2006

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

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

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

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

Illustration 8 : A Court Case

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

(a) At 31 March 2005

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

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

(b) At 31 March 2006

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

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

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

Illustration 9A: Refurbishment Costs - No Legislative Requirement

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

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

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

The cost of replacing the lining is not recognised because, at the balance sheet date, no obligation to replace the lining exists independently of the company's future actions - even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining.

Illustration 9B: Refurbishment Costs - Legislative Requirement

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

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

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

The costs of overhauling aircraft are not recognised as a provision for the same reasons as the cost of replacing the lining is not recognised as a provision in illustration 9A. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the enterprise's future actions - the enterprise could avoid the future expenditure by its future actions, for example by selling the aircraft.

Illustration 10: An Onerous Contract

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

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

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

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

Illustration D

Illustrations: Disclosure

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

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

Illustration 1 Warranties

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

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

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

Illustration 2 Disclosure Exemption

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

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

Appendix I to the Compendium of Accounting Standards (as on September 1, 2014)

Applicability of Accounting Standards to Various Entities

(including criteria for classification of entities)

Applicability of Accounting Standards to Companies

(I) Accounting Standards applicable to all companies in their entirety

AS 1 Disclosures of Accounting Policies

AS 2 Valuation of Inventories

AS 4 Contingencies and Events Occurring After the Balance Sheet Date

AS 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

AS 6 Depreciation Accounting

AS 7 Construction Contracts (revised 2002)

AS 9 Revenue Recognition

AS 10 Accounting for Fixed Assets

AS 11 The Effects of Changes in Foreign Exchange Rates (revised 2003)

AS 12 Accounting for Government Grants

AS 13 Accounting for Investments

AS 14 Accounting for Amalgamations

AS 16 Borrowing Costs

AS 18 Related Party Disclosures

AS 21 Consolidated Financial Statements

AS 22 Accounting for Taxes on Income

AS 23 Accounting for Investments in Associates in Consolidated Financial Statements

AS 24 Discontinuing Operations

AS 26 Intangible Assets

AS 27 Financial Reporting of Interest in Joint Ventures

(II) Exemptions or Relaxations for SMCs as defined in the Notification

(A) Accounting Standards not applicable to SMCs in their entirety:

AS 3 Cash Flow Statements.

AS 17 Segment Reporting

(B) Accounting Standards in respect of which relaxations from certain requirements have been given to SMCs:

(i) Accounting Standard (AS) 15, Employee Benefits (revised 2005)

(a) paragraphs 11 to 16 of the standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment for unused entitlement on leaving);

(b) paragraphs 46 and 139 of the Standard which deal with discounting of amounts that fall due more than 12 months after the balance sheet date;

(c) recognition and measurement principles laid down in paragraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such companies should actuarially determine and provide for the accrued liability in respect of defined benefit plans by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard. Such companies should disclose actuarial assumptions as per paragraph 120(l) of the Standard; and

(d) recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long-term employee benefits. However, such companies should actuarially determine and provide for the accrued liability in respect of other long-term employee benefits by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard.

(ii) AS 19, Leases

Paragraphs 22 (c),(e) and (f); 25 (a), (b) and (e); 37 (a) and (f); and 46 (b) and (d) relating to disclosures are not applicable to SMCs.

(iii) AS 20, Earnings Per Share

Disclosure of diluted earnings per share (both including and excluding extraordinary items) is exempted for SMCs.

(iv) AS 28, Impairment of Assets

SMCs are allowed to measure the 'value in use' on the basis of reasonable estimate thereof instead of computing the value in use by present value technique. Consequently, if an SMC chooses to measure the 'value in use' by not using the present value technique, the relevant provisions of AS 28, such as discount rate etc., would not be applicable to such an SMC. Further, such an SMC need not disclose the information required by paragraph 121(g) of the Standard.

(v) AS 29, Provisions, Contingent Liabilities and Contingent Assets

Paragraphs 66 and 67 relating to disclosures are not applicable to SMCs.

(C) AS 25, Interim Financial Reporting, does not require a company to present interim financial report. It is applicable only if a company is required or elects to prepare and present an interim financial report. Only certain Non-SMCs are required by the concerned regulators to present interim financial results, e.g, quarterly financial results required by the SEBI. Therefore, the recognition and measurement requirements contained in this Standard are applicable to those Non-SMCs for preparation of interim financial results.

(III) Applicability of Accounting Standards AS 30, AS 31 and AS 32 to Companies

(i) To the extent of accounting treatments covered by any of the existing notified accounting standards (eg. AS 11, AS 13, etc.), the existing accounting standards would continue to prevail over AS 30, *Financial Instruments: Recognition and Measurement.*

(ii) In cases where a relevant regulatory authority has prescribed specific regulatory requirements (eg. Loan impairment, investment classification or accounting for securitizations by the RBI, etc.), the prescribed regulatory requirements would continue to prevail over AS 30.

(iii) The preparers of the financial statements are encouraged to follow the principles enunciated in the accounting treatments contained in AS 30. The aforesaid is, however, subject to (i) and (ii) above.

The aforementioned clarifications regarding applicability of AS 30 would also be relevant to the existing AS 31, *Financial Instruments: Presentation* and AS 32, *Financial Instruments: Disclosures.*

Applicability of Accounting Standards to Non-corporate Entities

(I) Accounting Standards applicable to all Non-corporate Entities in their entirety (Level I, Level II and Level III)

AS 1 Disclosures of Accounting Policies

AS 2 Valuation of Inventories

AS 4 Contingencies and Events Occurring After the Balance Sheet Date

AS 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

AS 6 Depreciation Accounting

AS 7 Construction Contracts (revised 2002)

AS 9 Revenue Recognition

AS 10 Accounting for Fixed Assets

AS 11 The Effects of Changes in Foreign Exchange Rates (revised 2003)

AS 12 Accounting for Government Grants

AS 13 Accounting for Investments

AS 14 Accounting for Amalgamations

AS 16 Borrowing Costs

AS 22 Accounting for Taxes on Income

AS 26 Intangible Assets

(II) Exemptions or Relaxations for Non-corporate Entities falling in Level II and Level III (SMEs)

(A) Accounting Standards not applicable to Non-corporate Entities falling in Level II in their entirety:

AS 3 Cash Flow Statements

AS 17 Segment Reporting

(B) Accounting Standards not applicable to Non-corporate Entities falling in Level III in their entirety:

AS 3 Cash Flow Statements

AS 17 Segment Reporting

AS 18 Related Party Disclosures

AS 24 Discontinuing Operations

(C) Accounting Standards not applicable to all Non-corporate Entities since the relevant Regulators require compliance with them only by certain Level I entities:[2]

(i) AS 21, Consolidated Financial Statements

(ii) AS 23, Accounting for Investments in Associates in Consolidated Financial Statements

(iii) AS 27, Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements)

[2] AS 21, AS 23 and AS 27 (to the extent these standards relate to preparation of consolidated financial statements) are required to be complied with by a non-corporate entity if the non-corporate entity, pursuant to the requirements of a statute/regulator or voluntarily, prepares and presents consolidated financial statements.

(D) Accounting Standards in respect of which relaxations from certain requirements have been given to Non-corporate Entities falling in Level II and Level III (SMEs):

(i) Accounting Standard (AS) 15, Employee Benefits (revised 2005)

(1) Level II and Level III Non-corporate entities whose average number of persons employed during the year is 50 or more are exempted from the applicability of the following paragraphs:

(a) paragraphs 11 to 16 of the standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment for unused entitlement on leaving);

(b) paragraphs 46 and 139 of the Standard which deal with discounting of amounts that fall due more than 12 months after the balance sheet date;

(c) recognition and measurement principles laid down in paragraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such entities should actuarially determine and provide for the accrued liability in respect of defined benefit plans by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard. Such entities should disclose actuarial assumptions as per paragraph 120(l) of the Standard; and

(d) recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long-term employee benefits. However, such entities should actuarially determine and provide for the accrued liability in respect of other long-term employee benefits by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard.

(2) Level II and Level III Non-corporate entities whose average number of persons employed during the year is less than 50 are exempted from the applicability of the following paragraphs:

(a) paragraphs 11 to 16 of the standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment for unused entitlement on leaving);

(b) paragraphs 46 and 139 of the Standard which deal with discounting of amounts that fall due more than 12 months after the balance sheet date;

(c) recognition and measurement principles laid down in paragraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such entities may calculate and account for the accrued liability under the defined benefit plans by reference to some other rational method, e.g., a method based on the assumption that such benefits are payable to all employees at the end of the accounting year; and

(d) recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long-term employee benefits. Such entities may calculate and account for the accrued liability under the other long-term employee benefits by reference to some other rational method, e.g., a method based on the assumption that such benefits are payable to all employees at the end of the accounting year.

(ii) AS 19, Leases

Paragraphs 22 (c),(e) and (f); 25 (a), (b) and (e); 37 (a) and (f); and 46 (b) and (d) relating to disclosures are not applicable to non-corporate entities falling in Level II .

Paragraphs 22 (c),(e) and (f); 25 (a), (b) and (e); 37 (a), (f) and (g); and 46 (b), (d) and (e) relating to disclosures are not applicable to Level III entities.

(iii) AS 20, Earnings Per Share

Diluted earnings per share (both including and excluding extraordinary items) is not required to be disclosed by non-corporate entities falling in Level II and Level III and information required by paragraph 48(ii) of AS 20 is not required to be disclosed by Level III entities if this standard is applicable to these entities.

(iv) AS 28, Impairment of Assets

Non-corporate entities falling in Level II and Level III are allowed to measure the 'value in use' on the basis of reasonable estimate thereof instead of computing the value in use by present value technique. Consequently, if a non-corporate entity falling in Level II or Level III chooses to measure the 'value in use' by not using the present value technique, the relevant provisions of AS 28, such as discount rate etc., would not be applicable to such an entity. Further, such an entity need not disclose the information required by paragraph 121(g) of the Standard.

(v) AS 29, Provisions, Contingent Liabilities and Contingent Assets

Paragraphs 66 and 67 relating to disclosures are not applicable to non-corporate entities falling in Level II and Level III.

(E) AS 25, Interim Financial Reporting, does not require a non-corporate entity to present interim financial report. It is applicable only if a non-corporate entity is required or elects to prepare and present an interim financial report. Only certain Level I non-corporate entities are required by the concerned regulators to present interim financial results, e.g., quarterly financial results required by the SEBI. Therefore, the recognition and measurement requirements contained in this Standard are applicable to those Level I non-corporate entities for preparation of interim financial results.

(III) Applicability of Accounting Standards AS 30, AS 31 and AS 32 to Non-corporate Entities

(i) To the extent of accounting treatments covered by any of the existing accounting standards made mandatory by the ICAI (eg. AS 11, AS 13, etc.), the existing accounting standards would continue to prevail over AS 30, *Financial Instruments*: *Recognition and Measurement.*

(ii) In cases where a relevant regulatory authority has prescribed specific regulatory requirements (eg. Loan impairment, investment classification or accounting for securitizations by the RBI, etc.), the prescribed regulatory requirements would continue to prevail over AS 30.

(iii) The preparers of the financial statements are encouraged to follow the principles enunciated in the accounting treatments contained in AS 30. The aforesaid is, however, subject to (i) and (ii) above.

The aforementioned clarifications regarding applicability of AS 30 would also be relevant to the existing AS 31, *Financial Instruments: Presentation* and AS 32, *Financial Instruments: Disclosures.*

Criteria for classification of entities

Criteria for classification of companies under the Companies (Accounting Standards) Rules, 2006

Small and Medium-Sized Company (SMC) as defined in Clause 2(f) of the Companies (Accounting Standards) Rules, 2006:

(f) "Small and Medium Sized Company" (SMC) means, a company-

(i) whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

(ii) which is not a bank, financial institution or an insurance company;

(iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;

(iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and

(v) which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

Explanation: For the purposes of clause (f), a company shall qualify as a Small and Medium Sized Company, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

Non-SMCs

Companies not falling within the definition of SMC are considered as Non-SMCs.

Instructions

A. General Instructions

1. SMCs shall follow the following instructions while complying with Accounting Standards under these Rules:-

1.1 the SMC which does not disclose certain information pursuant to the exemptions or relaxations given to it shall disclose (by way of a note to its financial statements) the fact that it is an SMC and has complied with the Accounting Standards insofar as they are applicable to an SMC on the following lines:

"The Company is a Small and Medium Sized Company (SMC) as defined in the General Instructions in respect of Accounting Standards notified under the Companies Act, 1956. Accordingly, the Company has complied with the Accounting Standards as applicable to a Small and Medium Sized Company."

1.2 Where a company, being an SMC, has qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the corresponding period of the previous accounting period need not be revised merely by reason of its having ceased to be an SMC. The fact that the company was an SMC in the previous period and it had availed of the exemptions or relaxations available to SMCs shall be disclosed in the notes to the financial statements.

1.3 If an SMC opts not to avail of the exemptions or relaxations available to an SMC in respect of any but not all of the Accounting Standards, it shall disclose the standard(s) in respect of which it has availed the exemption or relaxation.

1.4 If an SMC desires to disclose the information not required to be disclosed pursuant to the exemptions or relaxations available to the SMCs, it shall disclose that information in compliance with the relevant accounting standard.

1.5 The SMC may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard:

Provided that such a partial exemption or relaxation and disclosure shall not be permitted to mislead any person or public.

B. Other Instructions

Rule 5 of the Companies (Accounting Standards) Rules, 2006, provides as below:

> "5. An existing company, which was previously not a Small and Medium Sized Company (SMC) and subsequently becomes an SMC, shall not be qualified for exemption or relaxation in respect of Accounting Standards available to an SMC until the company remains an SMC for two consecutive accounting periods."

Criteria for classification of non-corporate entities as decided by the Institute of Chartered Accountants of India

Level I Entities

Non-corporate Entities which fall in any one or more of the following categories, at the end of the relevant accounting period, are classified as Level I entities:

(i) Entities whose equity or debt securities are listed or are in the process of listing on any stock exchange, whether in India or outside India.

(ii) Banks (including co-operative banks), financial institutions or entities carrying on insurance business.

(iii) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees fifty crore in the immediately preceding accounting year.

(iv) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year.

(v) Holding and subsidiary entities of any one of the above.

Level II Entities (SMEs)

Non-corporate Entities which are not Level I entities but fall in any one or more of the following categories are classified as Level II entities:

(i) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees one crore but does not exceed rupees fifty crore in the immediately preceding accounting year.

(ii) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees one crore but not in excess of rupees ten crore at any time during the immediately preceding accounting year.

(iii) Holding and subsidiary entities of any one of the above.

Level III Entities (SMEs)

Non-corporate Entities which are not covered under Level I and Level II are considered as Level III entities.

Additional requirements

(1) An SME which does not disclose certain information pursuant to the exemptions or relaxations given to it should disclose (by way of a note to its financial statements) the fact that it is an SME and has complied with the Accounting Standards insofar as they are applicable to entities falling in Level II or Level III, as the case may be.

(2) Where an entity, being covered in Level II or Level III, had qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the corresponding period of the previous accounting period need not be revised merely by reason of its having ceased to be covered in Level II or Level III, as the case may be. The fact that the entity was covered in Level II or Level III, as the case may be, in the previous period and it had availed

of the exemptions or relaxations available to that Level of entities should be disclosed in the notes to the financial statements.

(3) Where an entity has been covered in Level I and subsequently, ceases to be so covered, the entity will not qualify for exemption/relaxation available to Level II entities, until the entity ceases to be covered in Level I for two consecutive years. Similar is the case in respect of an entity, which has been covered in Level I or Level II and subsequently, gets covered under Level III.

(4) If an entity covered in Level II or Level III opts not to avail of the exemptions or relaxations available to that Level of entities in respect of any but not all of the Accounting Standards, it should disclose the Standard(s) in respect of which it has availed the exemption or relaxation.

(5) If an entity covered in Level II or Level III desires to disclose the information not required to be disclosed pursuant to the exemptions or relaxations available to that Level of entities, it should disclose that information in compliance with the relevant Accounting Standard.

(6) An entity covered in Level II or Level III may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard:

Provided that such a partial exemption or relaxation and disclosure should not be permitted to mislead any person or public.

(7) In respect of Accounting Standard (AS) 15, *Employee Benefits*, exemptions/ relaxations are available to Level II and Level III entities, under two sub-classifications, viz., (i) entities whose average number of persons employed during the year is 50 or more, and (ii) entities whose average number of persons employed during the year is less than 50. The requirements stated in paragraphs (1) to (6) above, mutatis mutandis, apply to these sub-classifications.

Announcement of the Council regarding application of AS 30, *Financial Instruments: Recognition and Measurement.*

1 AS 30 was issued by the Institute of Chartered Accountants of India (ICAI) in 2007 but has not yet been notified by the Government under Section 211(3C) of the Companies Act, 1956. As per this standard;

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

2 AS 30 further states;

> *"From the date this Accounting Standard becomes recommendatory in nature, the following Guidance Notes issued by the Institute of Chartered Accountants of India, stand withdrawn:*
>
> *(i) Guidance Note on Guarantees & Counter Guarantees Given by the Companies.*
> *(ii) Guidance Note on Accounting for Investments in the Financial Statements of Mutual Funds.*
> *(iii) Guidance Note on Accounting for Securitisation.*
> *(iv) Guidance Note on Accounting for Equity Index and Equity Stock Futures and Options."*

3 Subsequent to the issuance of AS 30, the world witnessed financial crisis which raised issues with regard to accounting treatment of financial instruments. Accordingly, various accounting standards setting bodies including the ICAI examined these aspects. Insofar as International Accounting Standards Board is concerned certain modifications have been made in the corresponding International Accounting Standard, viz., IAS 39, *Financial Instruments: Recognition and Measurement.* The International Accounting Standards Board has also issued IFRS 9, *Financial Instruments,* which replaces certain requirements contained in IAS 39 and it is expected that ultimately the entire IAS 39 on which AS 30 is based is not expected to be replaced before June 30, 2011 as presently committed by IASB . Accordingly, AS 30 is not expected to continue in its present form including for those entities for which converged

Indian Accounting Standards will come into force from 1st April, 2011. In this changed scenario, the Council has reconsidered the matter regarding the status of the existing AS 30 and has decided to issue the following clarification for the guidance of the Members and others concerned.

4 It is clarified that in respect of the financial statements or other financial information for the accounting periods commencing on or after 1st April 2009 and ending on or before 31st March 2011, the status of AS 30 would be as below:

(i) To the extent of accounting treatments covered by any of the existing notified accounting standards (eg. AS 11, AS 13, etc.), the existing accounting standards would continue to prevail over AS 30.

(ii) In cases where a relevant regulatory authority has prescribed specific regulatory requirements (eg. Loan impairment, investment classification or accounting for securitizations by the RBI, etc.), the prescribed regulatory requirements would continue to prevail over AS 30.

(iii) The preparers of the financial statements are encouraged to follow the principles enunciated in the accounting treatments contained in AS 30. The aforesaid is, however, subject to (i) and (ii) above.

5 From 1st April 2011 onwards,

(i) The entities to which converged Indian Accounting Standards will be applied as per the roadmap issued by MCA, the Indian Accounting Standard (Ind AS) 39, Financial Instruments; Recognition and Measurement, will apply.

(ii) For entities other than those covered under paragraph 5(i) above, the status of AS 30 will continue as clarified in paragraph 4 above.

6 The abovementioned clarifications would also be relevant to the existing AS 31, *Financial Instruments: Presentation* and AS 32, *Financial Instruments: Disclosures* as well as for Ind AS 32, *Financial Instruments: Presentation* and Ind AS 107, *Financial Instruments: Disclosures*, after 1st April 2011 onwards.

Accounting Standard (AS) 30

Financial Instruments: Recognition and Measurement

Contents

PREVIOUS HOME NEXT

APPENDICES

A Application of the recognition and measurement principles prescribed in the Accounting Standard

Accounting Standard (AS) 30

Financial Instruments: Recognition and Measurement

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

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

(i) Whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

(ii) which is not a bank (including co-operative bank), financial institution or any entity carrying on insurance business;

(iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;

(iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and

(v) which is not a holding or subsidiary entity of an entity which is not a small and medium-sized entity.

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

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[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.

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.

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

(i) Guidance Note on Guarantees & Counter Guarantees Given by the Companies.

(ii) Guidance Note on Accounting for Investments in the Financial Statements of Mutual Funds.

(iii) Guidance Note on Accounting for Securitisation.

(iv) Guidance Note on Accounting for Equity Index and Equity Stock Futures and Options.

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

The following is the text of the Accounting Standard.

Objective

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

Scope

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

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

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

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

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

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[5] AS 32 *Financial Instruments: Disclosures* has been formulated and published elsewhere in this Compendium.

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

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

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

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

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

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

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

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

[8] *ibid.*

[9] *ibid.*

[10] *ibid.*

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

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

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

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

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

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

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

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

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

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

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

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

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* are used in this Standard with the meanings specified in paragraph 7 of AS 31. AS 31 defines the following terms:

- financial instrument
- financial asset

- financial liability
- equity instrument

and provides guidance on applying those definitions.

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

Definition of a Derivative

8.1 A <u>derivative</u> 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***

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

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

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

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

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

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

[14] AS 32 *Financial Instruments: Disclosures* has been formulated and published elsewhere in this Compendium.

(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 <u>financial guarantee contract</u> 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 <u>amortised cost of a financial asset or financial liability</u> 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 <u>effective interest method</u> is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.

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

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

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

8.12 A <u>regular way purchase or sale</u> 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 <u>Transaction costs</u> 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.

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

Definitions Relating to Hedge Accounting

8.14 A <u>firm commitment</u> 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 <u>forecast transaction</u> is an uncommitted but anticipated future transaction.

8.16 <u>Functional currency</u> is the currency of the primary economic environment in which the entity operates.

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

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

Embedded Derivatives

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

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

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

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

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

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

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

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

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

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

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

Recognition and Derecognition

Initial Recognition

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

Derecognition of a Financial Asset

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(a) the carrying amount and

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

should be recognised in the statement of profit and loss.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

34. If an entity's continuing involvement is in only a part of a financial asset (e.g., when an entity retains an option to repurchase part of a transferred asset, or retains a residual interest that does not result in the retention of substantially all the risks and rewards of ownership and the entity retains control), the entity allocates the previous carrying amount of the financial asset between the part it continues to recognise under continuing involvement,

and the part it no longer recognises on the basis of the relative fair values of those parts on the date of the transfer. For this purpose, the requirements of paragraph 28 apply. The difference between:

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

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

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

All Transfers

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

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

> ***(a)*** ***If the transferee has the right by contract or custom to sell or repledge the collateral, then the transferor should reclassify that asset in its balance sheet (e.g., as a loaned asset, pledged equity instruments or repurchase receivable) separately from other assets.***
>
> ***(b)*** ***If the transferee sells collateral pledged to it, it should recognise the proceeds from the sale and a liability measured at fair value for its obligation to return the collateral.***
>
> ***(c)*** ***If the transferor defaults under the terms of the contract and is no longer entitled to redeem the collateral, it should derecognise the collateral, and the transferee should recognise the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognise its obligation to return the collateral.***

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

Regular Way Purchase or Sale of a Financial Asset

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

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

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

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

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

Derecognition of a Financial Liability

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

44. An exchange between an existing borrower and lender of debt instruments with substantially different terms should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial

modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

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

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

Measurement

Initial Measurement of Financial Assets and Financial Liabilities

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

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

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

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

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

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

Subsequent Measurement of Financial Assets

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

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

(b) held-to-maturity investments;

(c) loans and receivables; and

(d) available-for-sale financial assets.

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

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

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

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

(c) investments in equity instruments that do not have a quoted market price in an active market and whose fair value can not be reliably measured and derivatives that are linked to 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.

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[16] AS 32 *Financial Instruments: Disclosures* has been formulated and published elsewhere in this Compendium.

Subsequent Measurement of Financial Liabilities

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

(a) financial liabilities at fair value through profit or loss. Such liabilities, including derivatives that are liabilities, should be measured at fair value other than a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured, which should be measured at cost.

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

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

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

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

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

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

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

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

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

Fair Value Measurement Considerations

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

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

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[17] AS 32 *Financial Instruments: Disclosures* has been formulated and published elsewhere in this Compendium.

PREVIOUS HOME NEXT

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

60. ***If,***

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

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

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

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

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

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

Gains and Losses

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

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

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

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

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

Impairment and Uncollectibility of Financial Assets

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

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

observable data that comes to the attention of the holder of the asset about the following loss events:

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

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

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

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

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

(f) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:

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

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

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

67. In addition to the types of events in paragraph 65, objective evidence of impairment for an investment in an equity instrument includes information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment

in which the issuer operates, and indicates that the cost of the investment in the equity instrument may not be recovered. A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment.

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

Financial Assets Carried at Amortised Cost

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

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

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

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

cost would have been had the impairment not been recognised at the date the impairment is reversed. The amount of the reversal should be recognised in the statement of profit and loss.

Short-term Receivables Carried at Original Invoice Amount

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

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

PREVIOUS HOME NEXT

group or divisions within an entity may enter into hedging transactions with other entities within the group or divisions within the entity, any such intragroup transactions are eliminated on consolidation. Therefore, such hedging transactions do not qualify for hedge accounting in the consolidated financial statements of the group. However, they may qualify for hedge accounting in the individual or separate financial statements of individual entities within the group or in segment reporting provided that they are external to the individual entity or segment that is being reported on.

Designation of Hedging Instruments

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

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

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

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

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

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

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

Hedged Items

Qualifying Items

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

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

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

Designation of Financial Items as Hedged Items

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

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

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 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 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 even if the hedged item is an available-for-sale financial asset.

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

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

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

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

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

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

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

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

(c) the entity revokes the designation.

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

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

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

Cash Flow Hedges

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Hedges of a Net Investment

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

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

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

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

Transitional Provisions

Designation and Measurement of Financial Assets and Financial Liabilities

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

Derecognition of Financial Assets and Financial Liabilities

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

116. The derecognition requirements in the Standard apply prospectively for transactions occurring on or after the date of this Standard becoming mandatory. This implies that if an entity has derecognised non-derivative financial assets or non-derivative financial liabilities under its previous accounting policy as a result of a transaction that occurred before the date of this

Standard becoming mandatory, it should not recognise those assets and liabilities under Accounting Standards (unless they qualify for recognition as a result of a later transaction or event). This, however, does not prohibit an entity from applying the derecognition requirements in the Standard retrospectively from a date of the entity's choosing, provided that the information needed to apply this Standard to financial assets and financial liabilities derecognised as a result of past transactions was obtained at the time of initially accounting for those transactions.

Hedge Accounting

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

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

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

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

Embedded Derivatives

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

Appendix A

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

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

Scope (paragraphs 2-6)

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

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

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

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

[21] A separate Accounting Standard on *Accounting and Reporting by Retirement Benefit Plan* will specify the requirements relating to accounting and reporting retirement by retirement benefit plans.

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

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

(a) Although a financial guarantee contract meets the definition of an insurance contract in Accounting Standard on *Insurance Contracts*[23]if the risk transferred is significant, the issuer applies this Standard. Nevertheless, if the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may chose to apply either this Standard or Accounting Standard on *Insurance Contracts*[24]to such financial guarantee contracts. If this Standard applies, paragraph 47 requires the issuer to recognise a financial guarantee contract initially at fair value. If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's length transaction, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary. Subsequently, unless the financial guarantee contract was designated at inception as at fair value through profit or loss or unless paragraphs 29–37 and A70–A75 apply (when a transfer of a financial asset does not qualify for derecognition or the continuing involvement approach applies), the issuer measures it at the higher of:

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

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

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

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[22] See footnote 20.

[23] *ibid*.

[24] *ibid*.

[25] *ibid*.

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

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

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

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

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

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

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

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[26] AS 9 is presently under revision.

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

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

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

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

Definitions (paragraphs 7 and 8)

Designation as at Fair Value through Profit or Loss

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

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

Paragraph 8.2(b)(i): Designation eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise

A15. Under this Standard, measurement of a financial asset or financial liability and classification of recognised changes in its value are determined by the item's classification and whether the item is part of a designated hedging relationship. Those requirements can create a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') when, for example, in the absence 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

[27] AS 5 is presently under revision.

would be measured at amortised cost (with changes in fair value not recognised). In such circumstances, an entity may conclude that its financial statements would provide more relevant information if both the asset and the liability were classified as at fair value through profit or loss.

A16. The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through profit or loss only if it meets the principle in paragraph 8.2(b)(i).

(a) An entity has liabilities whose cash flows are contractually based on the performance of assets that would otherwise be classified as available for sale. For example, an insurer may have liabilities containing a discretionary participation feature that pay benefits based on realised and/or unrealised investment returns of a specified pool of the insurer's assets. If the measurement of those liabilities reflects current market prices, classifying the assets as at fair value through profit or loss means that changes in the fair value of the financial assets are recognised in the statement of profit and loss in the same period as related changes in the value of the liabilities.

(b) An entity has liabilities under insurance contracts whose measurement incorporates current information (as permitted by Accounting Standard on *Insurance Contracts*[28]), and financial assets it considers related that would otherwise be classified as available for sale or measured at amortised cost.

(c) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other. However, only some of the instruments would be measured at fair value through profit or loss (i.e., derivatives, or instruments classified as held for trading). It may also be the case that the requirements for hedge accounting are not met, say, because the requirements for effectiveness in paragraph 98 are not met.

(d) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other and the entity does not qualify for hedge accounting because none of the instruments is a derivative. Furthermore, in the absence of hedge accounting there is a significant inconsistency in the recognition of gains and losses. For example:

(i) the entity has financed a portfolio of fixed rate assets that would otherwise be classified as available for sale by issuing fixed rate bonds/ debentures whose changes in fair value tend to offset each other. Reporting both the

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[28] A separate Accounting Standard on *Insurance Contracts*, which is being formulated, will specify the requirements relating to insurance contracts.

assets and the bonds/ debentures at fair value through profit or loss corrects the inconsistency that would otherwise arise from measuring the assets at fair value with changes reported in the appropriate equity account and the bonds/ debentures at amortised cost.

(ii) the entity has financed a specified group of loans by issuing traded bonds/ debentures whose changes in fair value tend to offset each other. If, in addition, the entity regularly buys and sells the bonds/ debentures but rarely, if ever, buys and sells the loans, reporting both the loans and the bonds/ debentures at fair value through profit or loss eliminates the inconsistency in the timing of recognition of gains and losses that would otherwise result 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[29]. An entity may apply the same accounting policy to other investments managed on a total return basis but over which its influence is insufficient for them to be within the scope of AS 23 or AS 27.

(b) The entity has financial assets and financial liabilities that share one or more risks and those risks are managed and evaluated on a fair value basis in accordance with a documented policy of 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

[29] It may be noted that AS 23 and AS 27, at present, do not make this exclusion from their scope. Limited Revisions have also been made to AS 23 and AS 27 to provide for the same.

the requirement of designation at initial recognition) an entity that designates financial instruments as at fair value through profit or loss on the basis of this condition should so designate all eligible financial instruments that are managed and evaluated together.

A22. Documentation of the entity's strategy need not be extensive but should be sufficient to demonstrate compliance with paragraph 8.2(b)(ii). Such documentation is not required for each individual item, but may be on a portfolio basis. For example, if the performance management system for a department—as approved by the entity's key management personnel, its board of directors or similar governing body or its chief executive officer—clearly demonstrates that its performance is evaluated on a total return basis, no further documentation is required to demonstrate compliance with paragraph 8.2(b)(ii).

Effective Interest Rate

A23. When calculating the effective interest rate, an entity should estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but should not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity should use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

A24. In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. Entities include such incurred credit losses in the estimated cash flows when computing the effective interest rate.

A25. When applying the effective interest method, an entity generally amortises any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the instrument. However, a shorter period is used if this is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate. This will be the case when the variable to which the fees, points paid or received, transaction costs, premiums or discounts relate is repriced to market rates before the expected maturity of the instrument. In such a case, the appropriate amortisation period is the period to the next such repricing date. For example, if a premium or discount on a floating rate instrument reflects interest that has accrued on the instrument since interest was last paid, or changes in market rates since the floating interest rate was reset to market rates, it will be amortised to the next date when the floating interest is reset to market rates. This is because the premium or discount relates to the period to the next interest reset date because, at that date, the variable to which the premium or discount relates (i.e., interest rates) is reset to market rates. If, however, the premium or discount results from a change in the credit spread over the floating rate specified in the instrument, or other variables that are not reset to market rates, it is amortised over the expected life of the instrument.

A26. For floating rate financial assets and floating rate financial liabilities, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. If a floating rate financial asset or floating rate financial liability is recognised initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability.

A27. If an entity revises its estimates of payments or receipts, the entity adjusts the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The adjustment is recognised as income or expense in the statement of profit and loss.

Derivatives

A28. Typical examples of derivatives are futures and forward, swap and option contracts. A derivative usually has a notional amount, which is an amount of currency, a number of shares, a number of units of weight or volume or other units specified in the contract. However, a derivative instrument does not require the holder or writer to invest or receive the notional amount at the inception of the contract. Alternatively, a derivative could require a fixed payment or payment of an amount that can change (but not proportionally with a change in the underlying) as a result of some future event that is unrelated to a notional amount. For example, a contract may require a fixed payment of 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 capitalised transaction costs in determining whether the carrying amount would be substantially recovered.

A39. A financial asset that is puttable (i.e., the holder has the right to require that the issuer repay or redeem the financial asset before maturity) cannot be classified as a held-to-maturity investment because paying for a put feature in a financial asset is inconsistent with expressing an intention to hold the financial asset until maturity.

A40. For most financial assets, fair value is a more appropriate measure than amortised cost. The held-to-maturity classification is an exception, but only if the entity has a positive intention and the ability to hold the investment to maturity. When an entity's actions cast doubt on its intention and ability to hold such investments to maturity, paragraph 8.3 precludes the use of the held-to-maturity classification for a reasonable period of time.

A41. A disaster scenario that is only remotely possible, such as a run on a bank or a similar situation affecting an insurer, is not something that is assessed by an entity in deciding whether it has the positive intention and ability to hold an investment to maturity.

A42. Sales before maturity could satisfy the condition in paragraph 8.3—and therefore not raise a question about the entity's intention to hold other investments to maturity—if they are attributable to any of the following:

(a) a significant deterioration in the issuer's creditworthiness. For example, a sale following a downgrade in a credit rating by an external rating agency would not necessarily raise a question about the entity's intention to hold other investments to maturity if the downgrade provides evidence of a significant deterioration in the issuer's creditworthiness judged by reference to the credit rating at initial recognition. Similarly, if an entity uses internal ratings for assessing exposures, changes in those internal ratings may help to identify issuers for which there has been a significant deterioration in creditworthiness, provided the entity's approach to assigning internal ratings and changes in those ratings give a consistent, reliable and objective measure of the credit quality of the issuers. If there is evidence that a financial asset is impaired (see paragraphs 64 and 65), the deterioration in creditworthiness is often regarded as significant.

(b) a change in tax law that eliminates or significantly reduces the tax-exempt status of interest on the held-to-maturity investment (but not a change in tax law that revises the marginal tax rates applicable to interest income).

(c) a major business combination or major disposition (such as a sale of a segment) that necessitates the sale or transfer of held-to-maturity investments to maintain the entity's existing interest rate risk position or credit risk policy (although the business combination is an event within the entity's control, the changes to its investment portfolio to maintain an interest rate risk position or credit risk policy may be consequential rather than anticipated).

(d) a change in statutory or regulatory requirements significantly modifying either what constitutes a permissible investment or the maximum level of particular types of investments, thereby causing an entity to dispose of a held-to-maturity investment.

(e) a significant increase in the industry's regulatory capital requirements that causes the entity to downsize by selling held-to-maturity investments.

(f) a significant increase in the risk weights of held-to-maturity investments used for regulatory risk-based capital purposes.

PREVIOUS HOME NEXT

A43. An entity does not have a demonstrated ability to hold to maturity an investment in a financial asset with a fixed maturity if:

(a) it does not have the financial resources available to continue to finance the investment until maturity; or

(b) it is subject to an existing legal or other constraint that could frustrate its intention to hold the financial asset to maturity. (However, an issuer's call option does not necessarily frustrate an entity's intention to hold a financial asset to maturity—see paragraph A38.)

A44. Circumstances other than those described in paragraphs A36-A43 can indicate that an entity does not have a positive intention or the ability to hold an investment to maturity.

A45. An entity assesses its intention and ability to hold its held-to-maturity investments to maturity not only when those financial assets are initially recognised, but also at each subsequent balance sheet date.

Loans and Receivables

A46. Any non-derivative financial asset with fixed or determinable payments (including loan assets, trade receivables, investments in debt instruments and deposits held in banks) could potentially meet the definition of loans and receivables. However, a financial asset that is quoted in an active market (such as a quoted debt instrument, see paragraph A90) does not qualify for classification as a loan or receivable. Financial assets that do not meet the definition of loans and receivables may be classified as held-to-maturity investments if they meet the conditions for that classification (see paragraphs 8.3 and A36-A45). On initial recognition of a financial asset that would otherwise be classified as a loan or receivable, an entity may designate it as a financial asset at fair value through profit or loss, or available for sale.

Embedded Derivatives (paragraphs 9-13)

A47. If a host contract has no stated or predetermined maturity and represents a residual interest in the net assets of an entity, then its economic characteristics and risks are those of an equity instrument, and an embedded derivative would need to possess equity characteristics related to the same entity to be regarded as closely related. If the host contract is not an equity instrument and meets the definition of a financial instrument, then its economic characteristics and risks are those of a debt instrument.

A48. An embedded non-option derivative (such as an embedded forward or swap) is separated from its host contract on the basis of its stated or implied substantive terms, so as to result in it having a fair value of zero at initial recognition. An embedded option-based derivative (such as an embedded put, call, cap, floor or swaption) is separated from its host contract on the basis of the stated terms of the option feature. The initial carrying amount of the host instrument is the residual amount after separating the embedded derivative.

A49. Generally, multiple embedded derivatives in a single instrument are treated as a single compound embedded derivative. However, embedded derivatives that are classified as equity (see AS 31, *Financial Instruments: Presentation* are accounted for separately from those classified as assets or liabilities. In addition, if an instrument has more than one embedded derivative and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other.

A50. The economic characteristics and risks of an embedded derivative are not closely related to the host contract (paragraph 10(a)) in the following examples. In these examples, assuming the conditions in paragraph 10(b) and (c) are met, an entity accounts for the embedded derivative separately from the host contract.

(a) A put option embedded in an instrument that enables the holder to require the issuer to reacquire the instrument for an amount of cash or other assets that varies on the basis of the change in an equity or commodity price or index is not closely related to a host debt instrument.

(b) A call option embedded in an equity instrument that enables the issuer to reacquire that equity instrument at a specified price is not closely related to the host equity instrument from the perspective of the holder (from the issuer's perspective, the call option is an equity instrument provided it meets the conditions for that classification under AS 31, in which case it is excluded from the scope of this Standard).

(c) An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension. If an entity issues a debt instrument and the holder of that debt instrument writes a call option on the debt instrument to a third party, the issuer regards the call option as extending the term to maturity of the debt instrument provided the issuer can be required to participate in or facilitate the remarketing of the debt instrument as a result of the call option being exercised.

(d) Equity-indexed interest or principal payments embedded in a host debt instrument or insurance contract—by which the amount of interest or principal is indexed to the value of equity instruments—are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.

(e) Commodity-indexed interest or principal payments embedded in a host debt instrument or insurance contract—by which the amount of interest or principal is indexed to the price of a commodity (such as gold)—are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.

(f) An equity conversion feature embedded in a convertible debt instrument is not closely related to the host debt instrument from the perspective of the holder of the instrument (from the issuer's perspective, the equity conversion option is an equity instrument and excluded from the scope of this Standard provided it meets the conditions for that classification under AS 31).

(g) A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless the option's exercise price is approximately equal on each exercise date to the amortised cost of the host debt instrument or the carrying amount of the host insurance contract. From the perspective of the issuer of a convertible debt instrument with an embedded call or put option feature, the assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element under AS 31.

(h) Credit derivatives that are embedded in a host debt instrument and allow one party (the 'beneficiary') to transfer the credit risk of a particular reference asset, which it may not own, to another party (the 'guarantor') are not closely related to the host debt instrument. Such credit derivatives allow the guarantor to assume the credit risk associated with the reference asset without directly owning it.

A51. An example of a hybrid instrument is a financial instrument that gives the holder a right to put the financial instrument back to the issuer in exchange for an amount of cash or other financial assets that varies on the basis of the change in an equity or commodity index that may increase or decrease (a 'puttable instrument'). Unless the issuer on initial recognition designates the puttable instrument as a financial liability at fair value through profit or loss, it is required to separate an embedded derivative (i.e., the indexed principal payment) under paragraph 10 because the host contract is a debt instrument under paragraph A47 and the indexed principal payment is not closely related to a host debt instrument under paragraph A50(a). Because the principal payment can increase and decrease, the embedded derivative is a non-option derivative whose value is indexed to the underlying variable.

A52. In the case of a puttable instrument that can be put back at any time for cash equal to a proportionate share of the net asset value of an entity (such as units of an open-ended mutual fund or some unit-linked investment products), the effect of separating an embedded derivative and accounting for each component is to measure the combined instrument at the redemption amount that is payable at the balance sheet date if the holder exercised its right to put the instrument back to the issuer.

A53. The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract in the following examples. In these examples, an entity does not account for the embedded derivative separately from the host contract.

(a) An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt contract or insurance contract is closely related to the host contract unless the combined instrument can be settled in such a way that the holder would not recover substantially all of its recognised investment or the embedded derivative could at least double the holder's initial rate of return on the host contract and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract.

(b) An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the contract is issued, and the cap or floor is not leveraged in relation to the host contract. Similarly, provisions included in a contract to purchase or sell an asset (e.g., a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money at inception and are not leveraged.

(c) An embedded foreign currency derivative that provides a stream of principal or interest payments that are denominated in a foreign currency and is embedded in a host debt instrument (e.g., a dual currency bond) is closely related to the host debt instrument. Such a derivative is not separated from the host instrument because AS 11 requires foreign currency gains and losses on monetary items to be recognised in the statement of profit and loss.

(d) An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument (such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:

  (i) the functional currency of any substantial party to that contract;

  (ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or

  (iii) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (e.g., a relatively stable and liquid currency that is commonly used in local business transactions or external trade).

(e) An embedded prepayment option in an interest-only or principal-only strip is closely related to the host contract provided the host contract (i) initially resulted from separating the right to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative, and (ii) does not contain any terms not present in the original host debt contract.

(f) An embedded derivative in a host lease contract is closely related to the host contract if the embedded derivative is (i) an inflation-related index such as an index of lease payments to a consumer price index (provided that the lease is not leveraged and the index relates to inflation in the entity's own economic environment), (ii) contingent rentals based on related sales or (iii) contingent rentals based on variable interest rates.

(g) A unit-linking feature embedded in a host financial instrument or host insurance contract is closely related to the host instrument or host contract if the unit-denominated payments are measured at current unit values that reflect the fair values of the assets of the fund. A unit-linking feature is a contractual term that requires payments denominated in units of an internal or external investment fund.

(h) A derivative embedded in an insurance contract is closely related to the host insurance contract if the embedded derivative and host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately (i.e., without considering the host contract).

Instruments containing Embedded Derivatives

A54. When an entity becomes a party to a hybrid (combined) instrument that contains one or more embedded derivatives, paragraph 10 requires the entity to identify any such embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently. These requirements can be more complex, or result in less reliable measures, than measuring the entire instrument at fair value through profit or loss. For that reason this Standard permits the entire instrument to be designated as at fair value through profit or loss.

A55. Such designation may be used whether paragraph 10 requires the embedded derivatives to be separated from the host contract or prohibits such separation**.** However, paragraph 11 would not justify designating the hybrid (combined) instrument as at fair value through profit or loss in the cases set out in paragraph 11(a) and (b) because doing so would not reduce complexity or increase reliability.

PREVIOUS HOME NEXT

Reassessment of Embedded Derivatives

A56. An entity should assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity first becomes a party to the contract. Subsequent reassessment is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract, in which case reassessment is required. An entity determines whether a modification to cash flows is significant by considering the extent to which the expected future cash flows associated with the embedded derivative, the host contract or both have changed and whether the change is significant relative to the previously expected cash flows on the contract.

Recognition and Derecognition (paragraphs 14-46)

Initial Recognition (paragraph 14)

A57. As a consequence of the principle in paragraph 14, an entity recognises all of its contractual rights and obligations under derivatives in its balance sheet as assets and liabilities, respectively, except for derivatives that prevent a transfer of financial assets from being accounted for as a sale (see paragraph A72). If a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset (see paragraph A73).

A58. The following are examples of applying the principle in paragraph 14:

(a) unconditional receivables and payables are recognised as assets or liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash.

(b) assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognised until at least one of the parties has performed under the agreement. For example, an entity that receives a firm order does not generally recognise an asset (and the entity that places the order does not recognise a liability) at the time of the commitment but, rather, delays recognition until the ordered goods or services have been shipped, delivered or rendered. If a firm commitment to buy or sell non-financial items is within the scope of this Standard under paragraphs 4-6, its net fair value is recognised as an asset or liability on the commitment date (see (c) below). In addition, if a previously unrecognised firm commitment is designated as a hedged item in a fair value hedge, any change in the net fair value attributable to the hedged risk is recognised as an asset or liability after the inception of the hedge (see paragraphs 104 and 105).

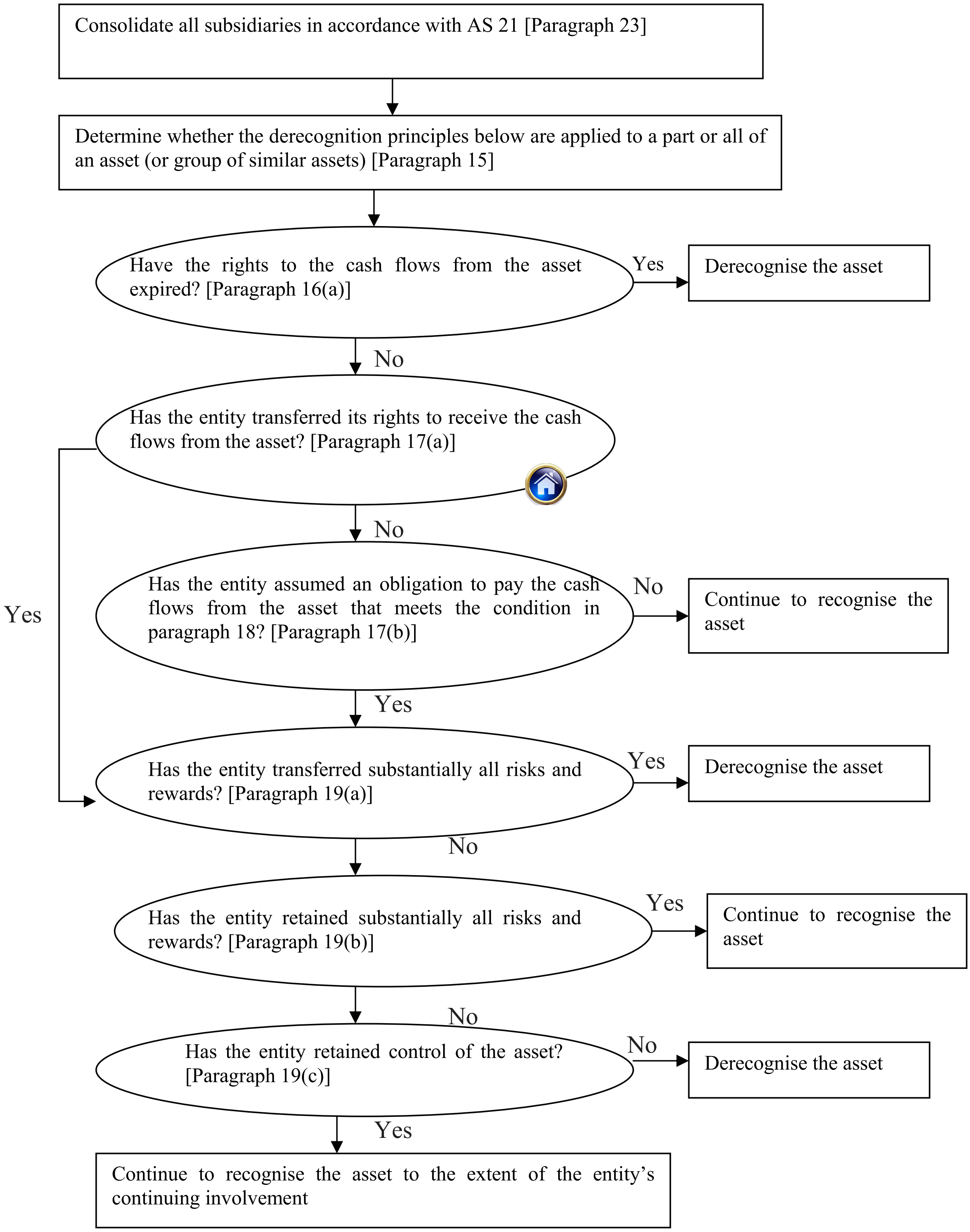
(c) a forward contract that is within the scope of this Standard (see paragraphs 2-6) is recognised as an asset or a liability on the commitment date, rather than on the date on which settlement takes place. When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero. If the net fair value of the right and obligation is not zero, the contract is recognised as an asset or liability.

(d) option contracts that are within the scope of this Standard (see paragraphs 2-6) are recognised as assets or liabilities when the holder or writer becomes a party to the contract.

(e) planned future transactions, no matter how likely, are not assets and liabilities because the entity has not become a party to a contract.

Derecognition of a Financial Asset (paragraphs 15-37)

A59. The following flow chart illustrates the evaluation of whether and to what extent a financial asset is derecognised.



Arrangements under which an entity retains the contractual rights to receive the cash flows of a financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients (paragraph 17(b))

A60. The situation described in paragraph 17(b) (when an entity retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients) occurs, for example, if the entity is a special purpose entity or trust, and issues to investors beneficial interests in the underlying financial assets that it owns and provides servicing of those financial assets. In that case, the financial assets qualify for derecognition if the conditions in paragraphs 18 and 19 are met.

A61. In applying paragraph 18, the entity could be, for example, the originator of the financial asset, or it could be a group that includes a consolidated special purpose entity that has acquired the financial asset and passes on cash flows to unrelated third party investors.

Evaluation of the transfer of risks and rewards of ownership (paragraph 19)

A62. Examples of when an entity has transferred substantially all the risks and rewards of ownership are:

(a) an unconditional sale of a financial asset;

(b) a sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase; and

(c) sale of a financial asset together with a put or call option that is deeply out of the money (i.e., an option that is so far out of the money it is highly unlikely to go into the money before expiry).

A63. Examples of when an entity has retained substantially all the risks and rewards of ownership are:

(a) a sale and repurchase transaction (e.g., REPO transactions) where the repurchase price is a fixed price or the sale price plus a lender's return;

(b) a securities lending agreement;

(c) a sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity;

(d) a sale of a financial asset together with a deep in-the-money put or call option (i.e., an option that is so far in the money that it is highly unlikely to go out of the money before expiry); and

(e) a sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.

A64. If an entity determines that as a result of the transfer, it has transferred substantially all the risks and rewards of ownership of the transferred asset, it does not recognise the transferred asset again in a future period, unless it reacquires the transferred asset in a new transaction.

Evaluation of the transfer of control

A65. An entity has not retained control of a transferred asset if the transferee has the practical ability to sell the transferred asset. An entity has retained control of a transferred asset if the transferee does not have the practical ability to sell the transferred asset. A transferee has the practical ability to sell the transferred asset if it is traded in an active market because the transferee could repurchase the transferred asset in the market if it needs to return the asset to the entity. For example, a transferee may have the practical ability to sell a transferred asset if the transferred asset is subject to an option that allows the entity to repurchase it, but the transferee can readily obtain the transferred asset in the market if the option is exercised. A transferee does not have the practical ability to sell the transferred asset if the entity retains such an option and the transferee cannot readily obtain the transferred asset in the market if the entity exercises its option.

A66. The transferee has the practical ability to sell the transferred asset only if the transferee can sell the transferred asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without imposing additional restrictions on the transfer. The critical question is what the transferee is able to do in practice, not what contractual rights the transferee has concerning what it can do with the transferred asset or what contractual prohibitions exist. In particular:

(a) a contractual right to dispose of the transferred asset has little practical effect if there is no market for the transferred asset; and

(b) an ability to dispose of the transferred asset has little practical effect if it cannot be exercised freely. For that reason:

 (i) the transferee's ability to dispose of the transferred asset must be independent of the actions of others (i.e., it must be a unilateral ability); and

 (ii) the transferee must be able to dispose of the transferred asset without needing to attach restrictive conditions or 'strings' to the transfer (e.g., conditions about how a loan asset is serviced or an option giving the transferee the right to repurchase the asset).

A67. That the transferee is unlikely to sell the transferred asset does not, of itself, mean that the transferor has retained control of the transferred asset. However, if a put option or guarantee constrains the transferee from selling the transferred asset, then the transferor has retained control of the transferred asset. For example, if a put option or guarantee is sufficiently valuable it constrains the transferee from selling the transferred asset because the transferee would, in practice, not sell the transferred asset to a third party without attaching a similar option or other restrictive conditions. Instead, the transferee would hold the transferred asset so as to obtain payments under the guarantee or put option. Under these circumstances the transferor has retained control of the transferred asset.

Transfers that Qualify for Derecognition

A68. An entity may retain the right to a part of the interest payments on transferred assets as compensation for servicing those assets. The part of the interest payments that the entity would give up upon termination or transfer of the servicing contract is allocated to the servicing asset or servicing liability. The part of the interest payments that the entity would not give up is an interest-only strip receivable. For example, if the entity would not give up any interest upon termination or transfer of the servicing contract, the entire interest spread is an interest-only strip receivable. For the purposes of applying paragraph 27, the fair values of the servicing asset and interest-only strip receivable are used to allocate the carrying amount of the receivable between the part of the asset that is derecognised and the part that continues to be recognised. If there is no servicing fee specified or the fee to be received is not expected to compensate the entity adequately for performing the servicing, a liability for the servicing obligation is recognised at fair value.

A69. In estimating the fair values of the part that continues to be recognised and the part that is derecognised for the purposes of applying paragraph 27, an entity applies the fair value measurement requirements in paragraphs 53-55 and A88-A102 in addition to paragraph 28.

Transfers that Do Not Qualify for Derecognition

A70. The following is an application of the principle outlined in paragraph 29. If a guarantee provided by the entity for default losses on the transferred asset prevents a transferred asset from being derecognised because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the transferred asset continues to be recognised in its entirety and the consideration received is recognised as a liability.

Continuing Involvement in Transferred Assets

A71. The following are examples of how an entity measures a transferred asset and the associated liability under paragraph 30.

All assets

(a) If a guarantee provided by an entity to pay for default losses on a transferred asset prevents the transferred asset from being derecognised to the extent of the continuing involvement, the transferred asset at the date of the transfer is measured at the lower of (i) the carrying amount of the asset and (ii) the maximum amount of the consideration received in the transfer that the entity could be required to repay ('the guarantee amount'). The associated liability is initially measured at the guarantee amount plus the fair value of the guarantee (which is normally the consideration received for the guarantee). Subsequently, the initial fair value of the guarantee is recognised in the statement of profit and loss on a time proportion basis (see AS 9 (revised)[30]) and the carrying value of the asset is reduced by any impairment losses.

Assets measured at amortised cost

(b) If a put option obligation written by an entity or call option right held by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at amortised cost, the associated liability is measured at its cost (i.e., the consideration received) adjusted for the amortisation of any difference between that cost and the amortised cost of the transferred asset at the expiration date of the option. For example, assume that the amortised cost and carrying amount of the asset on the date of the transfer is 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

[30] AS 9 is presently under revision.

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) 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) A*mortising interest rate swaps.* An entity may transfer to a transferee a fixed rate financial asset that is paid off over time, and enter into an amortising interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount. If the notional amount of the swap amortises so that it equals the principal amount of the transferred financial asset outstanding at any point in time, the swap would generally result in the entity retaining substantial prepayment risk, in which case the entity either continues to recognise all of the transferred asset or continues to recognise the transferred asset to the extent of its continuing involvement. Conversely, if the amortisation of the notional amount of the swap is not linked to the principal amount outstanding of the transferred asset, such a swap would not result in the entity retaining prepayment risk on the asset. Hence, it would not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on interest payments being made on the transferred asset and the swap does not result in the entity retaining any other significant risks and rewards of ownership on the transferred asset.

A75. This paragraph illustrates the application of the continuing involvement approach when the entity's continuing involvement is in a part of a financial asset.

Assume an entity has a portfolio of prepayable loans whose coupon and effective interest rate is 10 per cent and whose principal amount and amortised cost is 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.

PREVIOUS HOME NEXT

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 A95). However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated, using a valuation technique (see paragraphs A93-A99). For example, the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset.

A84. If an entity originates a loan that bears an off-market interest rate (e.g., 5 per cent when the market rate for similar loans is 8 per cent), and receives an up-front fee as compensation, the entity recognises the loan at its fair value, i.e., net of the fee it receives. The entity accretes the discount to the statement of profit and loss using the effective interest rate method.

Example Illustrating Paragraph A84

Entity S lends 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 entity also considers the other relevant factors, if any, in determination of fair value of a financial instrument.

Gains and Losses (paragraphs 61-63)

A103. An entity applies AS 11 to financial assets and financial liabilities that are monetary items in accordance with AS 11 and denominated in a foreign currency. Under AS 11, any foreign exchange gains and losses on monetary assets and monetary liabilities are recognised in the statement of profit and loss. An exception is a monetary item that is designated as a hedging instrument in either a cash flow hedge (see paragraphs 106-112) or a hedge of a net investment in a non-integral foreign operation (see paragraph 113). For the purpose of recognising foreign exchange gains and losses under AS 11, a monetary available-for-sale financial asset is treated as if it were carried at amortised cost in the foreign currency. Accordingly, for such a financial asset, exchange differences resulting from changes in amortised cost are recognised in the statement of profit and loss and other changes in carrying amount are recognised in accordance with paragraph 61(b). For available-for-sale financial assets that are not monetary items under AS 11 (for example, equity instruments), the gain or loss including any related foreign exchange component is recognised directly in the appropriate equity account under paragraph 61(b). If there is a hedging relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in the foreign currency component of those financial instruments are recognised in the statement of profit and loss.

Impairment and Uncollectibility of Financial Assets (paragraphs 64-79)

Financial Assets Carried at Amortised Cost (paragraphs 69-71)

A104. Impairment of a financial asset carried at amortised cost is measured using the financial instrument's original effective interest rate because discounting at the current market rate of interest would, in effect, impose fair value measurement on financial assets that are otherwise measured at amortised cost. If the terms of a loan, receivable or held-to-maturity investment are renegotiated or otherwise modified because of financial difficulties of the borrower or issuer, impairment is measured using the original effective interest rate before the modification of terms. Cash flows relating to short-term receivables are not discounted if the effect of discounting is immaterial. If a loan, receivable or held-to-maturity investment has a variable interest rate, the discount rate for measuring any impairment loss under paragraph 69 is the current effective interest rate(s) determined under the contract. As a practical expedient, a creditor may measure impairment of a financial asset carried at amortised cost on the basis of an instrument's fair value using an observable market price. The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

A105. The process for estimating impairment considers all credit exposures, not only those of low credit quality. For example, if an entity uses an internal credit grading system it considers all credit grades, not only those reflecting a severe credit deterioration.

A106. Uncertainties surrounding the amount to be recognised as impairment loss are dealt with by various means according to the circumstances. The process for estimating the amount of an impairment loss may result either in a single amount or in a range of possible amounts. In the latter case, the entity recognises an impairment loss equal to the best estimate within the range taking into account all relevant information available before the financial statements are issued about conditions existing at the balance sheet date. In a range of possible outcomes, the best estimate of loss is determined by using 'expected value' statistical method of valuation which weighs all possible outcomes by their associated probabilities. Under this method, the best estimate of loss will be different depending on whether the probability of a loss of a given amount is, for example, 60 per cent or 90 per cent. Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the mid-point of the range is used as the best estimate.

A107. For the purpose of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics that are indicative of the debtors' ability to pay all amounts due according to the contractual terms (for example, on the basis of a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status and other relevant factors). The characteristics chosen are relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated. However, loss probabilities and other loss statistics differ at a group level between (a) assets that have been individually evaluated for impairment and found not to be impaired and (b) assets that have not been individually evaluated for impairment with the result that a different amount of impairment may be required. If an entity does not have a group of assets with similar risk characteristics, it does not make the additional assessment.

A108. Impairment losses recognised on a group basis represent an interim step pending the identification of impairment losses on individual assets in the group of financial assets that are collectively assessed for impairment. As soon as information is available that specifically identifies losses on individually impaired assets in a group, those assets are removed from the group.

A109. Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group. Entities that have no entity-specific loss experience or insufficient experience, use peer group experience for comparable groups of financial assets. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. Estimates of changes in future cash flows reflect and are directionally consistent with changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of incurred losses in the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

A110. As an example of applying paragraph A109, an entity may determine, on the basis of historical experience, that one of the main causes of default on credit card loans is the death of the borrower. The entity may observe that the death rate is unchanged from one year to the next. On this basis, the entity concludes that some of the borrowers in its group of credit card loans may have died in that year, indicating that an impairment loss has occurred on those loans, even if, at the year-end, the entity is not yet aware which specific borrowers have died. It would be appropriate for an impairment loss to be recognised for these 'incurred but not reported' losses. However, it would not be appropriate to recognise an impairment loss for deaths that are expected to occur in a future period, because the necessary loss event (the death of the borrower) has not yet occurred.

A111. When using historical loss rates in estimating future cash flows, it is important that information about historical loss rates is applied to groups that are defined in a manner consistent with the groups for which the historical loss rates were observed. Therefore, the method used should enable each group to be associated with information about past loss experience in groups of assets with similar credit risk characteristics and relevant observable data that reflect current conditions.

A112. Formula-based approaches or statistical methods may be used to determine impairment losses in a group of financial assets (e.g., for smaller balance loans) as long as they are consistent with the requirements in paragraphs 69-71 and A107-A111. Any model used would incorporate the effect of the time value of money, consider the cash flows for all of the remaining life of an asset (not only the next year), consider the age of the loans within the portfolio and not give rise to an impairment loss on initial recognition of a financial asset.

Interest Income After Impairment Recognition

A113. Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is thereafter recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

Hedging (paragraphs 80-113)

Hedging Instruments (paragraphs 81-86)

Qualifying Instruments (paragraphs 81 and 82)

A114. The potential loss on an option that an entity writes could be significantly greater than the potential gain in value of a related hedged item. In other words, a written option is not effective in reducing the profit or loss exposure of a hedged item. Therefore, a written option does not qualify as a hedging instrument unless it is designated as an offset to a purchased option, including one that is embedded in another financial instrument (for example, a written call option used to hedge a callable liability). In contrast, a purchased option has potential gains equal to or greater than losses and therefore has the potential to reduce profit or loss exposure from changes in fair values or cash flows. Accordingly, it can qualify as a hedging instrument.

A115. A held-to-maturity investment carried at amortised cost may be designated as a hedging instrument in a hedge of foreign currency risk.

A116. An investment in an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured or a derivative that is linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 51(c) and 52) cannot be designated as a hedging instrument.

A117. An entity's own equity instruments are not financial assets or financial liabilities of the entity and therefore cannot be designated as hedging instruments.

Hedged Items (paragraphs 87-94)

Qualifying Items (paragraphs 87-89)

A118. A firm commitment to acquire a business in a business combination cannot be a hedged item, except for foreign exchange risk, because the other risks being hedged cannot be specifically identified and measured. These other risks are general business risks.

A119. An investment accounted for using the equity method of accounting or using the proportionate consolidation cannot be a hedged item in a fair value hedge because the equity method and the proportionate consolidation recognises in the consolidated statement of profit and loss the investor's share of the associate's profit or loss and the venturer's share of the jointly controlled entity's profit or loss, respectively, rather than changes in the investment's fair value. For a similar reason, an investment in a consolidated subsidiary cannot be a hedged item in a fair value hedge because consolidation recognises in the consolidated statement of profit and loss the subsidiary's profit or loss, rather than changes in the investment's fair value. A hedge of a net investment in a foreign operation is different because it is a hedge of the foreign currency exposure, not a fair value hedge of the change in the value of the investment.

A120. Paragraph 89 states that in consolidated financial statements the foreign currency risk of a highly probable forecast intragroup transaction may qualify as a hedged item in a cash flow hedge, provided the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss. For this purpose an entity can be a parent, subsidiary, associate, joint venture or branch. If the foreign currency risk of a forecast intragroup transaction does not affect consolidated profit or loss, the intragroup transaction cannot qualify as a hedged item. This is usually the case for royalty payments, interest payments or management charges between members of the same group unless there is a related external transaction. However, when the foreign currency risk of a forecast intragroup transaction will affect consolidated profit or loss, the intragroup transaction can qualify as a hedged item. An example is forecast sales or purchases of inventories between members of the same group if there is an onward sale of the inventory to a party external to the group. Similarly, a forecast intragroup sale of plant and equipment from the group entity that manufactured it to a group entity that will use the plant and equipment in its operations may affect consolidated profit or loss. This could occur, for example, because the plant and equipment will be depreciated by the purchasing entity and the amount initially recognised for the plant and equipment may change if the forecast intragroup transaction is denominated in a currency other than the functional currency of the purchasing entity.

A121. If a hedge of a forecast intragroup transaction qualifies for hedge accounting, any gain or loss that is recognised directly in the appropriate equity account in accordance with paragraph 106(a) should be reclassified into, i.e., recognised in, the statement of profit and loss in the same period or periods during which the foreign currency risk of the hedged transaction affects consolidated profit or loss.

Designation of Financial Items as Hedged Items (paragraphs 90 and 91)

A122. If a portion of the cash flows of a financial asset or financial liability is designated as the hedged item, that designated portion must be less than the total cash flows of the asset or liability. For example, in the case of a liability whose effective interest rate is below LIBOR, an entity cannot designate (a) a portion of the liability equal to the principal amount plus interest at LIBOR and (b) a negative residual portion. However, the entity may designate all of the cash flows of the entire financial asset or financial liability as the hedged item and hedge them for only one particular risk (e.g., only for changes that are attributable to changes in LIBOR). For example, in the case of a financial liability whose effective interest rate is 100 basis points below LIBOR, an entity can designate as the hedged item the entire liability (i.e., principal plus interest at LIBOR minus 100 basis points) and hedge the change in the fair value or cash flows of that entire liability that is attributable to changes in LIBOR. The entity may also choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph A124.

A123. In addition, if a fixed rate financial instrument is hedged some time after its origination and interest rates have changed in the meantime, the entity can designate a portion equal to a benchmark rate that is higher than the contractual rate paid on the item. The entity can do so provided that the benchmark rate is less than the effective interest rate calculated on the assumption that the entity had purchased the instrument on the day it first designates the hedged item. For example, assume an entity originates a fixed rate financial asset of 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[31] will be recognised in the statement of profit and loss as the difference between the change in fair value referred to in (g) and that referred to in (h).

A140. This approach is described in more detail below. The approach is applied only to a fair value hedge of the interest rate risk associated with a portfolio of financial assets or financial liabilities.

A141. The portfolio identified in paragraph A139(a) could contain assets and liabilities. Alternatively, it could be a portfolio containing only assets, or only liabilities. The portfolio is used to determine the amount of the assets or liabilities the entity wishes to hedge. However, the portfolio is not itself designated as the hedged item.

A142. In applying paragraph A139(b), the entity determines the expected repricing date of an item as the earlier of the dates when that item is expected to mature or to reprice to market rates. The expected repricing dates are estimated at the inception of the hedge and throughout the term of the hedge, based on historical experience and other available information, including information and expectations regarding prepayment rates, interest rates and the interaction between them. Entities that have no entity-specific experience or insufficient experience use peer group experience for comparable financial instruments. These estimates are reviewed periodically and updated in the light of experience. In the case of a fixed rate item that is prepayable, the expected repricing date is the date on which the item is expected to prepay unless it reprices to market rates on an earlier date. For a group of similar items, the analysis into time periods based on expected repricing dates may take the form of allocating a percentage of the group, rather than individual items, to each time period. An entity may apply other methodologies for such allocation purposes. For example, it may use a prepayment rate multiplier for allocating amortising loans to time periods based on expected repricing dates.

[31] The same materiality considerations apply in this context as apply throughout Accounting Standards.

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)[32]. The designation is expressed as an 'amount of a currency' (e.g., an amount of dollars, euro, pounds or rand) rather than as individual assets. It follows that all of the assets (or liabilities) from which the hedged amount is drawn—i.e., all of the 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[33] specifies that the fair value of a financial liability with a demand feature (such as demand deposits and some types of time deposits) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid, such an item cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the holder can demand payment. In the above example, the hedged position is an amount of assets. Hence, such liabilities are not a part of the designated hedged item, but are used by the entity to determine the amount of the asset that is designated as being hedged. If the position the entity wished to hedge was an amount of liabilities, the amount representing the designated hedged item must be drawn from fixed rate liabilities other than liabilities that the entity can be required to repay in an earlier time period, and the percentage measure used for assessing hedge effectiveness in accordance with paragraph A151(b) would be calculated as a percentage of these other liabilities. For example, assume that an entity estimates that in a particular repricing time period it has fixed rate liabilities of 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[34] 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:

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[32] The Standard permits an entity to designate any amount of the available qualifying assets or liabilities, i.e., in this example any amount of assets between Rs. 0 and Rs. 100.

[33] See Paragraph 52.

[34] Rs. 30 / (Rs. 100 – Rs. 40) = 50 per cent

(a) which assets and liabilities are to be included in the portfolio hedge and the basis to be used for removing them from the portfolio.

(b) how the entity estimates repricing dates, including what interest rate assumptions underlie estimates of prepayment rates and the basis for changing those estimates. The same method is used for both the initial estimates made at the time an asset or liability is included in the hedged portfolio and for any later revisions to those estimates.

(c) the number and duration of repricing time periods.

(d) how often the entity will test effectiveness and which of the two methods in paragraph A151 it will use.

(e) the methodology used by the entity to determine the amount of assets or liabilities that are designated as the hedged item and, accordingly, the percentage measure used when the entity tests effectiveness using the method described in paragraph A151(b).

(f) when the entity tests effectiveness using the method described in paragraph A151(b), whether the entity will test effectiveness for each repricing time period individually, for all time periods in aggregate, or by using some combination of the two.

The policies specified in designating and documenting the hedging relationship should be in accordance with the entity's risk management procedures and objectives. Changes in policies should not be made arbitrarily. They should be justified on the basis of changes in market conditions and other factors and be founded on and consistent with the entity's risk management procedures and objectives.

A145. The hedging instrument referred to in paragraph A139(e) may be a single derivative or a portfolio of derivatives all of which contain exposure to the hedged interest rate risk designated in paragraph A139(d) (e.g., a portfolio of interest rate swaps all of which contain exposure to LIBOR). Such a portfolio of derivatives may contain offsetting risk positions. However, it may not include written options or net written options, because the Standard[35] does not permit such options to be designated as hedging instruments (except when a written option is designated as an offset to a purchased option). If the hedging instrument hedges the amount designated in paragraph A139(c) for more than one repricing time period, it is allocated to all of the time periods that it hedges. However, the whole of the hedging instrument must be allocated to those repricing time periods because the Standard[36] does not permit a hedging relationship to be designated for only a portion of the time period during which a hedging instrument remains outstanding.

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[35] See paragraphs 86 and A114

[36] See paragraph 84

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[37] should be identified and recognised in the statement of profit and loss.

A150. Generally, the effectiveness of the hedge will be improved:

(a) if the entity schedules items with different prepayment characteristics in a way that takes account of the differences in prepayment behaviour.

(b) when the number of items in the portfolio is larger. When only a few items are contained in the portfolio, relatively high ineffectiveness is likely if one of the items prepays earlier or later than expected. Conversely, when the portfolio contains many items, the prepayment behaviour can be predicted more accurately.

(c) when the repricing time periods used narrower (e.g., 1-month as opposed to 3-month repricing time periods). Narrower repricing time periods reduces the effect of any mismatch between the repricing and payment dates (within the repricing time period) of the hedged item and those of the hedging instrument.

(d) the greater the frequency with which the amount of the hedging instrument is adjusted to reflect changes in the hedged item (e.g., because of changes in prepayment expectations).

A151. An entity tests effectiveness periodically. If estimates of repricing dates change between one date on which an entity assesses effectiveness and the next, it should calculate the amount of effectiveness either:

(a) as the difference between the change in the fair value of the hedging instrument (see paragraph A139(h)) and the change in the value of the entire hedged item that is attributable to changes in the hedged interest rate (including the effect that changes in the hedged interest rate have on the fair value of any embedded prepayment option); or

(b) using the following approximation. The entity:

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[37] The same materiality considerations apply in this context as apply throughout Accounting Standards.

(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)[38] 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[39] on 1 January 20x7 to pay a fixed rate

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[38] In this Example principal cash flows have been scheduled into time periods but the related interest cash flows have been included when calculating the change in the fair value of the hedged item. Other methods of scheduling assets and liabilities are also possible. Also, in this Example, monthly repricing time periods have been used. An entity may choose narrower or wider time periods.

[39] The Example uses a swap as the hedging instrument. An entity may use forward rate agreements or other derivatives as hedging instruments.

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.

IE12. The fair value of the designated interest rate swap with a notional principal of Rs. 20 million is (Rs. 47,408)[40] (the swap is a liability).

IE13. Entity A computes the change in the fair value of the hedged item, taking into account the change in estimated prepayments, as follows.

(a) First, it calculates the percentage of the initial estimate of the assets in the time period that was hedged. This is 20 per cent (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[41] 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)[42]		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.

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[40] See paragraph IE8.

[41] i.e., Rs. 20,047,408 – Rs. 20,000,000. See paragraph IE7.

[42] This Example does not show how amounts of interest income and interest expense are calculated.

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 $8^{1}/_{3}$ per cent of the entire portfolio of assets. Because the assets were allocated into time periods by allocating a percentage of the assets (rather than individual assets) into each time period, Entity A determines that it cannot ascertain into which specific time periods the sold assets were scheduled. Hence it uses a systematic and rational basis of allocation. Based on the fact that it sold a representative selection of the assets in the portfolio, Entity A allocates the sale proportionately over all time periods.

IE17. On this basis, Entity A computes that it has sold $8^{1}/_{3}$ per cent of the assets allocated to the three-month time period, i.e., Rs. 8 million ($8^{1}/_{3}$ per cent of Rs. 96 million). The proceeds received are Rs. 8,018,400, equal to the fair value of the assets[43]. On derecognition of the assets, Entity A also removes from the separate balance sheet line item an amount that represents the change in the fair value of the hedged assets that it has now sold. This is $8^{1}/_{3}$ per cent of the total line item balance of 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.

[43] The amount realised on sale of the asset is the fair value of a prepayable asset, which is less than the fair value of the equivalent non-prepayable asset shown in paragraph IE7.

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.[44] 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.[45]

IE21. As at 1 February 20x7 and after accounting for the sale of assets, the separate balance sheet line item is Rs. 41,718 (Rs. 45,511 – Rs. 3,793), which represents the cumulative change in fair value of Rs. 17.6[46] 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.[47] The remaining separate balance sheet line item of Rs. 22,755[48] relates to an amount of assets that Entity A still holds but is no longer hedging. Accordingly Entity A amortises this amount over the remaining life of the time period, i.e., it amortises 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)[49] (the swap is a liability). Also,

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[44] Rs. 47,408 x 40 per cent

[45] The entity could instead enter into an offsetting swap with a notional principal of Rs. 12 million to adjust its position and designate as the hedging instrument all Rs. 20 million of the existing swap and all Rs. 12 million of the new offsetting swap.

[46] Rs. 19.2 million – ($8^1/_3$ % x Rs. 19.2 million)

[47] Rs. 41,718 x (Rs. 8 million / Rs. 17.6 million)

[48] Rs. 41,718 – Rs. 18,963

[49] Rs. 23,795 [see paragraph IE8] x (Rs. 8 million / Rs. 20 million)

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[50].

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[51]

To recognise the amortisation charge for the period.

[50] Rs. 20,023,795 [see paragraph IE7] x (Rs. 8 million / Rs. 20 million)

[51] Rs. 22,755 / 2

End of month 3

IE27. During the third month there is no further change in the amount of assets or liabilities in the three-month time period. On 31 March 20x7 the assets and the swap mature and all balances are recognised in the statement of profit and loss.

IE28. Entity A makes the following accounting entries relating to this time period:

Dr	Cash	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.

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[52]

To recognise the amortisation charge for the period.

[52] Rs. 22,755 / 2

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)

Appendix C

Guidance on Implementing
AS 30, *Financial Instruments: Recognition and Measurement*

SECTION A: SCOPE

A.1 Practice of settling net: forward contract to purchase a commodity

A.2 Option to put a non-financial asset

SECTION B: DEFINITIONS

B.1 Definition of a financial instrument: gold bullion

B.2 Definition of a derivative: examples of derivatives and underlyings

B.3 Definition of a derivative: settlement at a future date, interest rate swap with net or gross settlement

B.4 Definition of a derivative: prepaid interest rate swap (fixed rate payment obligation prepaid at inception or subsequently)

B.5 Definition of a derivative: prepaid pay-variable, receive-fixed interest rate swap

B.6 Definition of a derivative: offsetting loans

B.7 Definition of a derivative: option not expected to be exercised

B.8 Definition of a derivative: foreign currency contract based on sales volume

B.9 Definition of a derivative: prepaid forward

B.10 Definition of a derivative: initial net investment

B.11 Definition of held for trading: portfolio with a recent actual pattern of short-term profit taking

B.12 Definition of held for trading: balancing a portfolio

B.13 Definition of held-to-maturity financial assets: index-linked principal

B.14 Definition of held-to-maturity financial assets: index-linked interest

B.15 Definition of held-to-maturity financial assets: sale following rating downgrade

B.16 Definition of held-to-maturity financial assets: permitted sales

B.17 Definition of held-to-maturity investments: sales in response to entity- specific capital requirements

B.18 Definition of held-to-maturity financial assets: pledged collateral, repurchase agreements (REPOs) and securities lending agreements

B.19 Definition of held-to-maturity financial assets: 'tainting'

B.20 Definition of held-to-maturity investments: sub-categorisation for the purpose of applying the 'tainting' rule

B.21 Definition of held-to-maturity investments: application of the 'tainting' rule on consolidation

B.22 Definition of loans and receivables: equity instrument

B.23 Definition of loans and receivables: bank deposits in other banks

B.24 Definition of amortised cost: perpetual debt instruments with fixed or market-based variable rate

B.25 Definition of amortised cost: perpetual debt instruments with decreasing interest rate

B.26 Example of calculating amortised cost: financial asset

B.27 Example of calculating amortised cost: debt instruments with stepped interest payments

B.28 Regular way contracts: no established market

B.29 Regular way contracts: forward contract

B.30 Regular way contracts: which customary settlement provisions apply?

B.31 Regular way contracts: share purchase by call option

B.32 Recognition and derecognition of financial liabilities using trade date or settlement date accounting

SECTION C: EMBEDDED DERIVATIVES

C.1 Embedded derivatives: separation of host debt instrument

C.2 Embedded derivatives: separation of embedded option

C.3 Embedded derivatives: accounting for a convertible bond

C.4 Embedded derivatives: equity kicker

C.5 Embedded derivatives: debt or equity host contract

C.6 Embedded derivatives: synthetic instruments

C.7 Embedded derivatives: purchases and sales contracts in foreign currency instruments

C.8 Embedded foreign currency derivatives: unrelated foreign currency provision

C.9 Embedded foreign currency derivatives: currency of international commerce

C.10 Embedded derivatives: holder permitted, but not required, to settle without recovering substantially all of its recognised investment

C.11 Embedded derivatives: reliable determination of fair value

SECTION D: RECOGNITION AND DERECOGNITION

D.1 Initial Recognition

D.1.1 Recognition: cash collateral

D.2 Regular Way Purchase or Sale of a Financial Asset

D.2.1 Trade date vs. settlement date: Amounts to be recorded for a purchase

D.2.2 Trade date vs. settlement date: Amounts to be recorded for a sale

D.2.3 Settlement date accounting: exchange of non-cash financial assets

SECTION E: MEASUREMENT

E.1 Initial Measurement of Financial Assets and Financial Liabilities

E.1.1 Initial measurement: transaction costs

E.2 Fair Value Measurement Considerations

E.2.1 Fair value measurement considerations for investment funds

E.2.2 Fair value measurement: large holding

E.3 Gains and Losses

E.3.1 Available-for-sale financial assets: exchange of shares

E.3.2 AS 30 and AS 11 – Available-for-sale financial assets: separation of currency component

E.3.3 AS 30 and AS 11 – Exchange differences arising on translation of foreign entities: equity or income?

E.3.4 AS 30 and AS 11 – Interaction between AS 30 and AS 11

E.4 Impairment and Uncollectibility of Financial Assets

E.4.1 Objective evidence of impairment

E.4.2 Impairment: future losses

E.4.3 Assessment of impairment: principal and interest

E.4.4 Assessment of impairment: fair value hedge

E.4.5 Impairment: provision matrix

E.4.6 Impairment: excess losses

E.4.7 Recognition of impairment on a portfolio basis

E.4.8 Impairment: recognition of collateral

E.4.9 Impairment of non-monetary available-for-sale financial asset

E.4.10 Impairment: whether the available-for-sale reserve in equity can be negative

SECTION F: HEDGING

F.1 Hedging Instruments

F.1.1 Hedging the fair value exposure of a bond denominated in a foreign currency

F.1.2 Hedging with a non-derivative financial asset or liability

F.1.3 Hedge accounting: use of written options in combined hedging instruments

F.1.4 Internal hedges

F.1.5 Offsetting internal derivative contracts used to manage interest rate risk

F.1.6 Offsetting internal derivative contracts used to manage foreign currency risk

F.1.7 Internal derivatives: examples of applying Question F.1.6

F.1.8 Combination of written and purchased options

F.1.9 Delta-neutral hedging strategy

F.1.10 Hedging instrument: out of the money put option

F.1.11 Hedging instrument: proportion of the cash flows of a cash instrument

F.1.12 Hedges of more than one type of risk

F.1.13 Hedging instrument: dual foreign currency forward exchange contract

F.1.14 Concurrent offsetting swaps and use of one as a hedging instrument

F.2 Hedged Items

F.2.1 Whether a derivative can be designated as a hedged item

F.2.2 Cash flow hedge: anticipated issue of fixed rate debt

F.2.3 Hedge accounting: unrecognised assets

F.2.4 Hedge accounting: hedging of future foreign currency revenue streams

F.2.5 Cash flow hedges: 'all in one' hedge

F.2.6 Hedge relationships: entity-wide risk

F.2.7 Cash flow hedge: forecast transaction related to an entity's equity

F.2.8 Hedge accounting: risk of a transaction not occurring

F.4 Hedge Effectiveness

F.4.1 Hedging on an after-tax basis

F.4.2 Hedge effectiveness: assessment on cumulative basis

F.4.3 Hedge effectiveness: counterparty credit risk

F.4.4 Hedge effectiveness: effectiveness tests

F.4.5 Hedge effectiveness: less than 100 per cent offset

F.4.6 Assuming perfect hedge effectiveness

F.5 Cash Flow Hedges

F.5.1 Hedge accounting: non-derivative monetary asset or non-derivative monetary liability used as a hedging instrument

F.5.2 Cash flow hedges: performance of hedging instrument (1)

F.5.3 Cash flow hedges: performance of hedging instrument (2)

F.5.4 Cash flow hedges: forecast transaction occurs before the specified period

F.5.5 Cash flow hedges: measuring effectiveness for a hedge of a forecast transaction in a debt instrument

F.5.6 Cash flow hedges: firm commitment to purchase inventory in a foreign currency

F.6 Hedging: Other Issues

F.6.1 Hedge accounting: management of interest rate risk in financial institutions

F.6.2 Hedge accounting considerations when interest rate risk is managed on a net basis

F.6.3 Illustrative example of applying the approach in Question F.6.2

F.6.4 Hedge accounting: premium or discount on forward exchange contract

F.6.5 AS 30 and AS 11 – Fair value hedge of asset measured at cost

SECTION G: OTHER

G.1 Disclosure of changes in fair value

G.2 AS 30 and AS 3 – Hedge accounting: cash flow statements

Guidance on Implementing
AS 30, *Financial Instruments: Recognition and Measurement*

This guidance accompanies, but is not part of, AS 30.

Section A: Scope

A.1 Practice of settling net: forward contract to purchase a commodity

Entity XYZ enters into a fixed price forward contract to purchase one million kilograms of copper in accordance with its expected usage requirements. The contract permits XYZ to take physical delivery of the copper at the end of twelve months or to pay or receive a net settlement in cash, based on the change in fair value of copper. Is the contract accounted for as a derivative?

While such a contract meets the definition of a derivative, it is not necessarily accounted for as a derivative. The contract is a derivative instrument because there is no initial net investment, the contract is based on the price of copper, and it is to be settled at a future date. However, if XYZ intends to settle the contract by taking delivery and has no history for similar contracts of settling net in cash or of taking delivery of the copper and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin, the contract is not accounted for as a derivative under AS 30. Instead, it is accounted for as an executory contract.

A.2 Option to put a non-financial asset

Entity XYZ owns an office building. XYZ enters into a put option with an investor that permits XYZ to put the building to the investor for Rs. 150 million. The current value of the building is Rs. 175million. The option expires in five years. The option, if exercised, may be settled through physical delivery or net cash, at XYZ's option. How do both XYZ and the investor account for the option?

XYZ's accounting depends on XYZ's intention and past practice for settlement. Although the contract meets the definition of a derivative, XYZ does not account for it as a derivative if XYZ intends to settle the contract by delivering the building if XYZ exercises its option and there is no past practice of settling net (paragraph 4 and Appendix A paragraph A29 of AS 30).

The investor, however, cannot conclude that the option was entered into to meet the investor's expected purchase, sale or usage requirements because the investor does not have the ability to require delivery (paragraph 6 of AS 30.). In addition, the option may be settled net in cash. Therefore, the investor has to account for the contract as a derivative. Regardless of past practices, the investor's intention does not affect whether settlement is by delivery or in cash. The investor has written an option, and a written option in which the holder has a choice of physical settlement or net cash settlement can never satisfy the normal delivery requirement for the exemption from AS 30 because the option writer does not have the ability to require delivery.

However, if the contract were a forward contract rather than an option, and if the contract required physical delivery and the reporting entity had no past practice of settling net in cash or of taking delivery of the building and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin, the contract would not be accounted for as a derivative.

Section B: Definitions

B.1 Definition of a financial instrument: gold bullion

Is gold bullion a financial instrument (like cash) or is it a commodity?

It is a commodity. Although bullion is highly liquid, there is no contractual right to receive cash or another financial asset inherent in bullion.

B.2 Definition of a derivative: examples of derivatives and underlyings

What are examples of common derivative contracts and the identified underlying?

AS 30 defines a derivative as follows:

"A <u>derivative</u> is a financial instrument or other contract within the scope of this Standard with all three of the following characteristics:

> ***(a)*** ***its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying');***
>
> ***(b)*** ***it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and***
>
> ***(c)*** ***it is settled at a future date."***

Type of Contract	**Main Pricing-Settlement Variable (Underlying Variable)**
Interest Rate Swap	Interest rates
Currency Swap (Foreign Exchange Swap)	Currency rates
Commodity Swap	Commodity prices
Equity Swap	Equity prices (equity of another entity)
Credit Swap	Credit rating, credit index or credit price
Total Return Swap	Total fair value of the reference asset and interest rates
Purchased or Written Treasury Bond Option (call or put)	Interest rates
Purchased or Written Currency Option (call or put)	Currency rates
Purchased or Written Commodity Option (call or put)	Commodity prices
Currency Futures	Currency rates
Commodity Futures	Commodity prices
Interest Rate Forward Linked to Government Debt (Treasury Forward)	Interest rates
Currency Forward	Currency rates
Commodity Forward	Commodity prices
Equity Forward	Equity prices (equity of another entity)

The above list provides examples of contracts that normally qualify as derivatives under AS 30. The list is not exhaustive. Any contract that has an underlying may be a derivative. Moreover, even if an instrument meets the definition of a derivative contract, special provisions of AS 30 may apply, for example, if it is a weather derivative (see Appendix A paragraph A1 of AS 30.) or a contract to buy or sell a non-financial item such as commodity (see paragraph 4 and Appendix A paragraph A29 of AS 30.). Therefore, an entity must evaluate the contract to determine whether the other characteristics of a derivative are present and whether special provisions apply.

B.3 Definition of a derivative: settlement at a future date, interest rate swap with net or gross settlement

For the purpose of determining whether an interest rate swap is a derivative financial instrument under AS 30, does it make a difference whether the parties pay the interest payments to each other (gross settlement) or settle on a net basis?

No. The definition of a derivative does not depend on gross or net settlement.

To illustrate: Entity ABC enters into an interest rate swap with a counterparty (XYZ) that requires ABC to pay a fixed rate of 8 per cent and receive a variable amount based on three-month LIBOR, reset on a quarterly basis. The fixed and variable amounts are determined based on a Rs. 100 million notional amount. ABC and XYZ do not exchange the notional amount. ABC pays or receives a net cash amount each quarter based on the difference between 8 per cent and three-month LIBOR. Alternatively, settlement may be on a gross basis.

The contract meets the definition of a derivative regardless of whether there is net or gross settlement because its value changes in response to changes in an underlying variable (LIBOR), there is no initial net investment, and settlements occur at future dates.

B.4 Definition of a derivative: prepaid interest rate swap (fixed rate payment obligation prepaid at inception or subsequently)

If a party prepays its obligation under a *pay-fixed, receive-variable* interest rate swap at inception, is the swap a derivative financial instrument?

Yes.

To illustrate: Entity S enters into a Rs. 100 million notional amount five-year pay-fixed, receive-variable interest rate swap with Counterparty C. The interest rate of the variable part of the swap is reset on a quarterly basis to three-month LIBOR. The interest rate of the fixed part of the swap is 10 per cent per year. Entity S prepays its fixed obligation under the swap of Rs. 50 million (Rs. 100 million x 10 per cent x 5 years) at inception, discounted using market interest rates, while retaining the right to receive interest payments on the Rs. 100 million reset quarterly based on three-month LIBOR over the life of the swap.

The initial net investment in the interest rate swap is significantly less than the notional amount on which the variable payments under the variable leg will be calculated. The contract requires an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, such as a variable rate bond. Therefore, the contract fulfils the "no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors" provision of AS 30. Even though Entity S has no future performance obligation, the ultimate settlement of the contract is at a future date and the value of the contract changes in response to changes in the LIBOR index. Accordingly, the contract is regarded as a derivative contract.

Would the answer change if the fixed rate payment obligation is prepaid subsequent to initial recognition?

If the fixed leg is prepaid during the term, that would be regarded as a termination of the old swap and an origination of a new instrument that is evaluated under AS 30.

B.5 Definition of a derivative: prepaid pay-variable, receive-fixed interest rate swap

If a party prepays its obligation under a pay-variable, receive-fixed interest rate swap at inception of the contract or subsequently, is the swap a derivative financial instrument?

No. A prepaid pay-variable, receive-fixed interest rate swap is not a derivative if it is prepaid at inception and it is no longer a derivative if it is prepaid after inception because it provides a return on the prepaid (invested) amount comparable to the return on a debt instrument with fixed cash flows. The prepaid amount fails the "no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors" criterion of a derivative.

To illustrate: Entity S enters into a Rs. 100 million notional amount five-year pay-variable, receive-fixed interest rate swap with Counterparty C. The variable leg of the swap is reset on a quarterly basis to three-month LIBOR. The fixed interest payments under the swap are calculated as 10 per cent times the swap's notional amount, i.e., Rs. 10 million per year. Entity S prepays its obligation under the variable leg of the swap at inception at current market rates, while retaining the right to receive fixed interest payments of 10 per cent on Rs. 100 million per year.

The cash inflows under the contract are equivalent to those of a financial instrument with a fixed annuity stream since Entity S knows it will receive Rs. 10 million per year over the life of the swap. Therefore, all else being equal, the initial investment in the contract should equal that of other financial instruments that consist of fixed annuities. Thus, the initial net investment in the pay-variable, receive-fixed interest rate swap is equal to the investment required in a non-derivative contract that has a similar response to changes in market conditions. For this reason, the instrument fails the "no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors" criterion of AS 30. Therefore, the contract is not accounted for as a derivative under AS 30. By discharging the obligation to pay variable interest rate payments, Entity S in effect provides a loan to Counterparty C.

B.6 Definition of a derivative: offsetting loans

Entity A makes a five-year fixed rate loan to Entity B, while B at the same time makes a five-year variable rate loan for the same amount to A. There are no transfers of principal at inception of the two loans, since A and B have a netting agreement. Is this a derivative under AS 30?

Yes. This meets the definition of a derivative (that is to say, there is an underlying variable, no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and future settlement). The contractual effect of the loans is the equivalent of an interest rate swap arrangement with no initial net investment. Non-derivative transactions are aggregated and treated as a derivative when the transactions result, in substance, in a derivative. Indicators of this would include:

- they are entered into at the same time and in contemplation of one another
- they have the same counterparty
- they relate to the same risk
- there is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.

The same answer would apply if Entity A and Entity B did not have a netting agreement, because the definition of a derivative instrument in paragraph 8.1 of AS 30 does not require net settlement.

B.7 Definition of a derivative: option not expected to be exercised

The definition of a derivative in paragraph 8.1 of AS 30 requires that the instrument "is settled at a future date". Is this criterion met even if an option is expected not to be exercised, for example, because it is out of the money?

Yes. An option is settled upon exercise or at its maturity. Expiry at maturity is a form of settlement even though there is no additional exchange of consideration.

B.8 Definition of a derivative: foreign currency contract based on sales volume

Entity XYZ, whose functional currency is the Indian Rupees, sells products in France denominated in Euro. XYZ enters into a contract with an investment bank to convert Euro

to Indian Rupees at a fixed exchange rate. The contract requires XYZ to remit Euro based on its sales volume in France in exchange for Indian Rupees at a fixed exchange rate of 55.00. Is that contract a derivative?

Yes. The contract has two underlying variables (the foreign exchange rate and the volume of sales), no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and a payment provision. AS 30 does not exclude from its scope derivatives that are based on sales volume.

B.9 Definition of a derivative: prepaid forward

An entity enters into a forward contract to purchase shares in one year at the forward price. It prepays at inception based on the current price of the shares. Is the forward contract a derivative?

No. The forward contract fails the "no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors" test for a derivative.

To illustrate: Entity XYZ enters into a forward contract to purchase one million equity shares of T in one year. The current market price of T is Rs. 50 per share; the one-year forward price of T is Rs. 55 per share. XYZ is required to prepay the forward contract at inception with a Rs. 50 million payment. The initial investment in the forward contract of Rs. 50 million is less than the notional amount applied to the underlying, one million shares at the forward price of Rs. 55 per share, i.e., Rs. 55 million. However, the initial net investment approximates the investment that would be required for other types of contracts that would be expected to have a similar response to changes in market factors because T's shares could be purchased at inception for the same price of Rs. 50. Accordingly, the prepaid forward contract does not meet the initial net investment criterion of a derivative instrument.

B.10 Definition of a derivative: initial net investment

Many derivative instruments, such as futures contracts and exchange traded written options, require margin accounts. Is the margin account part of the initial net investment?

No. The margin account is not part of the initial net investment in a derivative instrument. Margin accounts are a form of collateral for the counterparty or clearing house and may take the form of cash, securities or other specified assets, typically liquid assets. Margin accounts are separate assets that are accounted for separately.

B.11 Definition of held for trading: portfolio with a recent actual pattern of short-term profit taking

The definition of a financial asset or financial liability held for trading states that "a financial asset or financial liability is classified as held for trading if it is … part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit taking". What is a 'portfolio' for the purposes of applying this definition?

Although the term 'portfolio' is not explicitly defined in AS 30, the context in which it is used suggests that a portfolio is a group of financial assets or financial liabilities that are managed as part of that group (paragraph 8.2 of AS 30). If there is evidence of a recent actual pattern of short-term profit taking on financial instruments included in such a portfolio, those financial instruments qualify as held for trading even though an individual financial instrument may in fact be held for a longer period of time.

B.12 Definition of held for trading: balancing a portfolio

Entity A has an investment portfolio of debt and equity instruments. The documented portfolio management guidelines specify that the equity exposure of the portfolio should be limited to between 30 and 50 per cent of total portfolio value. The investment manager of the portfolio is authorised to balance the portfolio within the designated guidelines by buying and selling equity and debt instruments. Is Entity A permitted to classify the instruments as available for sale?

It depends on Entity A's intentions and past practice. If the portfolio manager is authorised to buy and sell instruments to balance the risks in a portfolio, but there is no intention to trade and there is no past practice of trading for short-term profit, the instruments can be classified as available for sale. If the portfolio manager actively buys and sells instruments to generate short-term profits, the financial instruments in the portfolio are classified as held for trading.

B.13 Definition of held-to-maturity financial assets: index-linked principal

Entity A purchases a five-year equity-index-linked note with an original issue price of Rs. 10 at a market price of Rs. 12 at the time of purchase. The note requires no interest payments before maturity. At maturity, the note requires payment of the original issue price of Rs. 10 plus a supplemental redemption amount that depends on whether a specified share price index exceeds a predetermined level at the maturity date. If the share index does not exceed or is equal to the predetermined level, no supplemental redemption amount is paid. If the share index exceeds the predetermined level, the supplemental redemption amount equals the product of 1.15 and the difference between the level of the share index at maturity and the level of the share index when the note was issued divided

by the level of the share index at the time of issue. Entity A has the positive intention and ability to hold the note to maturity. Can Entity A classify the note as a held-to-maturity investment?

Yes. The note can be classified as a held-to-maturity investment because it has a fixed payment of Rs. 10 and fixed maturity and Entity A has the positive intention and ability to hold it to maturity (paragraph 8.3 of AS 30). However, the equity index feature is a call option not closely related to the debt host, which must be separated as an embedded derivative under paragraph 10 of AS 30. The purchase price of Rs. 12 is allocated between the host debt instrument and the embedded derivative. For example, if the fair value of the embedded option at acquisition is Rs. 4, the host debt instrument is measured at Rs. 8 on initial recognition. In this case, the discount of Rs. 2 that is implicit in the host bond (principal of Rs. 10 minus the original carrying amount of Rs. 8) is amortised to the statement of profit and loss over the term to maturity of the note using the effective interest method.

B.14 Definition of held-to-maturity financial assets: index-linked interest

Can a bond with a fixed payment at maturity and a fixed maturity date be classified as a held-to-maturity investment if the bond's interest payments are indexed to the price of a commodity or equity, and the entity has the positive intention and ability to hold the bond to maturity?

Yes. However, the commodity-indexed or equity-indexed interest payments result in an embedded derivative that is separated and accounted for as a derivative at fair value (paragraph 10 of AS 30). Paragraph 12 of AS 30 is not applicable since it should be straightforward to separate the host debt investment (the fixed payment at maturity) from the embedded derivative (the index-linked interest payments).

B.15 Definition of held-to-maturity financial assets: sale following rating downgrade

Would a sale of a held-to-maturity investment following a downgrade of the issuer's credit rating by a rating agency raise a question about the entity's intention to hold other investments to maturity?

Not necessarily. A downgrade is likely to indicate a decline in the issuer's creditworthiness. AS 30 specifies that a sale due to a significant deterioration in the issuer's creditworthiness could satisfy the condition in AS 30 and therefore not raise a question about the entity's intention to hold other investments to maturity. However, the deterioration in creditworthiness must be significant judged by reference to the credit rating at initial recognition. Also, the rating downgrade must not have been reasonably anticipated when the entity classified the investment as held to maturity in order to meet the condition in AS 30. A credit downgrade of a notch within a class or from one rating class to the immediately lower rating class could often be regarded as reasonably anticipated. If the rating downgrade in combination with other information provides evidence of impairment, the deterioration in creditworthiness often would be regarded as significant.

B.16 Definition of held-to-maturity financial assets: permitted sales

Would sales of held-to-maturity financial assets due to a change in management compromise the classification of other financial assets as held to maturity?

Yes. A change in management is not identified under Appendix A paragraph A42 of AS 30 as an instance where sales or transfers from held-to-maturity do not compromise the classification as held to maturity. Sales in response to such a change in management would, therefore, call into question the entity's intention to hold investments to maturity.

To illustrate: Entity X has a portfolio of financial assets that is classified as held to maturity. In the current period, at the direction of the Board of Directors, the senior management team has been replaced. The new management wishes to sell a portion of the held-to-maturity financial assets in order to carry out an expansion strategy designated and approved by the Board. Although the previous management team had been in place since the entity's inception and Entity X had never before undergone a major restructuring, the sale nevertheless calls into question Entity X's intention to hold remaining held-to-maturity financial assets to maturity.

B.17 Definition of held-to-maturity investments: sales in response to entity-specific capital requirements

In some cases, a regulator may set *entity-specific* capital requirements that are based on an assessment of the risk in that particular entity. Appendix A paragraph A42(e) of AS 30 indicates that an entity that sells held-to-maturity investments in response to an unanticipated significant increase by the regulator in the *industry's* capital requirements may do so under AS 30 without necessarily raising a question about its intention to hold other investments to maturity. Would sales of held-to-maturity investments that are due to a significant increase in *entity-specific* capital requirements imposed by regulators (i.e., capital requirements applicable to a particular entity, but not to the industry) raise such doubt?

Yes, such sales 'taint' the entity's intention to hold other financial assets as held to maturity unless it can be demonstrated that the sales fulfil the condition in paragraph 8.3 of AS 30in that they result from an increase in capital requirements, which is an isolated event that is beyond the entity's control, is non-recurring and could not have been reasonably anticipated by the entity.

B.18 Definition of held-to-maturity financial assets: pledged collateral, repurchase agreements (REPOs) and securities lending agreements

An entity cannot have a demonstrated ability to hold to maturity an investment if it is subject to a constraint that could frustrate its intention to hold the financial asset to maturity. Does this mean that a debt instrument that has been pledged as collateral or transferred to another party under a REPO or securities lending transaction, and continues to be recognised cannot be classified as a held-to-maturity investment?

No. An entity's intention and ability to hold debt instruments to maturity is not necessarily constrained if those instruments have been pledged as collateral or are subject to a repurchase agreement or securities lending agreement. However, an entity does not have the positive intention and ability to hold the debt instruments until maturity if it does not expect to be able to maintain or recover access to the instruments.

B.19 Definition of held-to-maturity financial assets: 'tainting'

In response to unsolicited tender offers, Entity A sells a significant amount of financial assets classified as held to maturity on economically favourable terms. Entity A does not classify any financial assets acquired after the date of the sale as held to maturity. However, it does not reclassify the remaining held-to-maturity investments since it maintains that it still intends to hold them to maturity. Is Entity A in compliance with AS 30?

No. Whenever a sale or transfer of more than an insignificant amount of financial assets classified as held to maturity (HTM) results in the conditions in paragraph 8.3 and Appendix A paragraph A42 of AS 30 not being satisfied, no instruments should be classified in that category. Accordingly, any remaining HTM assets are reclassified as available-for-sale financial assets. The reclassification is recorded in the reporting period in which the sales or transfers occurred and is accounted for as a change in classification under paragraph 57 of AS 30. Paragraph 8.3 of AS 30makes it clear that at least two full financial years must pass before an entity can again classify financial assets as HTM.

B.20 Definition of held-to-maturity investments: sub-categorisation for the purpose of applying the 'tainting' rule

Can an entity apply the conditions for held-to-maturity classification in paragraph 8.3 of AS 30 separately to different categories of held-to-maturity financial assets, such as debt instruments denominated in Indian Rupees and debt instruments denominated in a Foreign Currency?

No. The ‘tainting rule’ in paragraph 8.3 of AS 30 is clear. If an entity has sold or reclassified more than an insignificant amount of held-to-maturity investments, it cannot classify any financial assets as held-to-maturity financial assets.

B.21 Definition of held-to-maturity investments: application of the ‘tainting’ rule on consolidation

Can an entity apply the conditions in paragraph 8.3 of AS 30 separately to held-to-maturity financial assets held by different entities in a consolidated group, for example, if those group entities are in different countries with different legal or economic environments?

No. If an entity has sold or reclassified more than an insignificant amount of investments classified as held-to-maturity in the consolidated financial statements, it cannot classify any financial assets as held-to-maturity financial assets in the consolidated financial statements unless the conditions in paragraph 8.3 of AS 30 are met.

B.22 Definition of loans and receivables: equity instrument

Can an equity instrument, such as a preference share, with fixed or determinable payments be classified within loans and receivables by the holder?

Yes. If a non-derivative equity instrument, such as a preference share, is required to be recorded as a liability by the issuer as per the relevant Accounting Standard, and it has fixed or determinable payments and is not quoted in an active market, it can be classified within loans and receivables by the holder, provided the definition is otherwise met. Paragraphs 31-46 of AS 31 provide guidance about the classification of a financial instrument as a liability or as equity from the perspective of the issuer of a financial instrument. If an instrument meets the definition of an equity instrument under AS 31, it cannot be classified within loans and receivables by the holder.

B.23 Definition of loans and receivables: banks’ deposits in other banks

Banks make term deposits with the Reserve Bank of India or other banks. Sometimes, the proof of deposit (such as certificate of deposit/ receipt) is negotiable, sometimes not. Even if negotiable, the depositor bank may or may not intend to sell it. Would such a deposit fall within loans and receivables under paragraph 8.4 of AS 30?

Such a deposit meets the definition of loans and receivables, whether or not the proof of deposit is negotiable, unless the depositor bank intends to sell the instrument immediately or in the near term, in which case the deposit is classified as a financial asset held for trading.

B.24 Definition of amortised cost: perpetual debt instruments with fixed or market-based variable rate

Sometimes entities purchase or issue debt instruments that are required to be measured at amortised cost and in respect of which the issuer has no obligation to repay the principal amount. Interest may be paid either at a fixed rate or at a variable rate. Would the difference between the initial amount paid or received and zero ('the maturity amount') be amortised immediately on initial recognition for the purpose of determining amortised cost if the rate of interest is fixed or specified as a market-based variable rate?

No. Since there are no repayments of principal, there is no amortisation of the difference between the initial amount and the maturity amount if the rate of interest is fixed or specified as a market-based variable rate. Because interest payments are fixed or market-based and will be paid in perpetuity, the amortised cost (the present value of the stream of future cash payments discounted at the effective interest rate) equals the principal amount in each period (paragraph 8.7 of AS 30).

B.25 Definition of amortised cost: perpetual debt instruments with decreasing interest rate

If the stated rate of interest on a perpetual debt instrument decreases over time, would amortised cost equal the principal amount in each period?

No. From an economic perspective, some or all of the interest payments are repayments of the principal amount. For example, the interest rate may be stated as 16 per cent for the first ten years and as zero per cent in subsequent periods. In that case, the initial amount is amortised to zero over the first ten years using the effective interest method, since a portion of the interest payments represents repayments of the principal amount. The amortised cost is zero after year 10 because the present value of the stream of future cash payments in subsequent periods is zero (there are no further cash payments of either principal or interest in subsequent periods).

B.26 Example of calculating amortised cost: financial asset

Financial assets that are excluded from fair valuation and have a fixed maturity should be measured at amortised cost. How is amortised cost calculated?

Under AS 30, amortised cost is calculated using the effective interest method. The effective interest rate inherent in a financial instrument is the rate that exactly discounts the estimated cash flows associated with the financial instrument through the expected life of the instrument or, where appropriate, a shorter period to the net carrying amount at initial recognition. The computation includes all fees and points paid or received that are an integral part of the effective interest rate, directly attributable transaction costs and all other premiums or discounts.

The following example illustrates how amortised cost is calculated using the effective interest method. Entity A purchases a debt instrument with five years remaining to maturity for its fair value of Rs. 1,000 (including transaction costs). The instrument has a principal amount of Rs. 1,250 and carries fixed interest of 4.7 per cent that is paid annually (Rs. 1,250 x 4.7 per cent = Rs. 59 per year). The contract also specifies that the borrower has an option to prepay the instrument and that no penalty will be charged for prepayment. At inception, the entity expects the borrower not to prepay.

It can be shown that in order to allocate interest receipts and the initial discount over the term of the debt instrument at a constant rate on the carrying amount, they must be accrued at the rate of 10 per cent annually. The table below provides information about the amortised cost, interest income and cash flows of the debt instrument in each reporting period.

Year	**(a) Amortised cost at the beginning of the year**	**(b = a 10%) Interest income**	**(c) Cash flows**	**(d = a + b - c) Amortised cost at the end of the year**
20x6	1,000	100	59	1,041
20x7	1,041	104	59	1,086
20x8	1,086	109	59	1,136
20x9	1,136	113	59	1,190
20y0	1,190	119	1,250+59	-

On the first day of 20x8, the entity revises its estimate of cash flows. It now expects that 50 per cent of the principal will be prepaid at the end of 20x8 and the remaining 50 per cent at the end of 20y0. In accordance with Appendix A paragraph A27 of AS 30, the opening balance of the debt instrument in 20x8 is adjusted. The adjusted amount is calculated by discounting the amount the entity expects to receive in 20x8 and subsequent years using the original effective interest rate (10 per cent). This results in the new opening balance in 20x8 of Rs. 1,138. The adjustment of Rs. 52 (Rs. 1,138 – Rs. 1,086) is recorded in the statement of profit and loss in 20x8. The table below provides information about the amortised cost, interest income and cash flows as they would be adjusted taking into account the change in estimate.

Year	(a) Amortised cost at the beginning of the year	(b = a x 10%) Interest income	(c) Cash flows	(d = a + b - c) Amortised cost at the end of the year
20x6	1,000	100	59	1,041
20x7	1,041	104	59	1,086
20x8	1,086+52	114	625+59	568
20x9	568	57	30	595
20y0	595	60	625+30	-

If the debt instrument becomes impaired, say, at the end of 20x9, the impairment loss is calculated as the difference between the carrying amount (Rs. 595) and the present value of estimated future cash flows discounted at the original effective interest rate (10 per cent).

B.27 Example of calculating amortised cost: debt instruments with stepped interest payments

Sometimes entities purchase or issue debt instruments with a predetermined rate of interest that increases or decreases progressively ('stepped interest') over the term of the debt instrument. If a debt instrument with stepped interest and no embedded derivative is issued at Rs. 1,250 and has a maturity amount of Rs. 1,250, would the amortised cost equal Rs. 1,250 in each reporting period over the term of the debt instrument?

No. Although there is no difference between the initial amount and maturity amount, an entity uses the effective interest method to allocate interest payments over the term of the debt instrument to achieve a constant rate on the carrying amount (paragraph 8.9 of AS 30 and Appendix A paragraphs A23-A27).

The following example illustrates how amortised cost is calculated using the effective interest method for an instrument with a predetermined rate of interest that increases or decreases over the term of the debt instrument ('stepped interest').

On 1 January 20x6, Entity A issues a debt instrument for a price of Rs. 1,250. The principal amount is Rs. 1,250 and the debt instrument is repayable on 31 December 20y0. The rate of interest is specified in the debt agreement as a percentage of the principal amount as follows: 6.0 per cent in 20x6 (Rs. 75), 8.0 per cent in 20x7 (Rs. 100), 10.0 per cent in 20x8 (Rs. 125), 12.0 per cent in 20x9 (Rs. 150), and 16.4 per cent in 20y0 (Rs. 205). In this case, the interest rate that exactly discounts the stream of future cash payments through maturity is 10 per cent. Therefore, cash interest payments are reallocated over the term of the debt instrument for the purposes of determining amortised cost in each period. In each period, the amortised cost at the beginning of the period is multiplied by the effective interest rate of 10 per cent and added to the amortised cost. Any cash payments in the period are deducted from the resulting number. Accordingly, the amortised cost in each period is as follows:

Year	(a) Amortised cost at the beginning of the year	*(b= a x 10%)* Interest income	(c) Cash flows	*(d = a+b-c)* Amortised cost at the end of the year
20x6	1,250	125	75	1,300
20x7	1,300	130	100	1,330
20x8	1,330	133	125	1,338
20x9	1,338	134	150	1,322
20y0	1,322	133	1,250+205	-

B.28 Regular way contracts: no established market

Can a contract to purchase a financial asset be a regular way contract if there is no established market for trading such a contract?

Yes. Paragraph 8.12 of AS 30 refers to terms that require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned. Marketplace, as that term is used in paragraph 8.12 of AS 30, is not limited to a formal stock exchange or organised over-the-counter market. Rather, it means the environment in which the financial asset is customarily exchanged. An acceptable timeframe would be the period reasonably and customarily required for the parties to complete the transaction and prepare and execute closing documents.

For example, a market for private issue financial instruments can be a marketplace.

B.29 Regular way contracts: forward contract

Entity ABC enters into a forward contract to purchase one million of M's equity shares in two months for Rs. 10 per share. The contract is with an individual and is not an exchange-traded contract. The contract requires ABC to take physical delivery of the shares and pay the counterparty Rs. 10 million in cash. M's shares trade in an active public market at an average of 100,000 shares a day. Regular way delivery is three days. Is the forward contract regarded as a regular way contract?

No. The contract must be accounted for as a derivative because it is not settled in the way established by regulation or convention in the marketplace concerned.

B.30 Regular way contracts: which customary settlement provisions apply?

If an entity's financial instruments trade in more than one active market, and the settlement provisions differ in the various active markets, which provisions apply in assessing whether a contract to purchase those financial instruments is a regular way contract?

The provisions that apply are those in the market in which the purchase actually takes place. To illustrate: Entity XYZ purchases one million shares of Entity ABC on a Stock Exchange, for example, through a broker. The settlement date of the contract is six business days later. Trades for equity shares on the Stock Exchange customarily settle in three business days. Because the trade settles in six business days, it does not meet the exemption as a regular way trade.

However, if XYZ did the same transaction on a foreign exchange that has a customary settlement period of six business days, the contract would meet the exemption for a regular way trade.

B.31 Regular way contracts: share purchase by call option

Entity A purchases a call option in a public market permitting it to purchase 100 shares of Entity XYZ at any time over the next three months at a price of Rs. 100 per share. If Entity A exercises its option, it has 14 days to settle the transaction according to regulation or convention in the options market. XYZ shares are traded in an active public market that requires three-day settlement. Is the purchase of shares by exercising the option a regular way purchase of shares?

Yes. The settlement of an option is governed by regulation or convention in the marketplace for options and, therefore, upon exercise of the option it is no longer accounted for as a derivative because settlement by delivery of the shares within 14 days is a regular way transaction.

B.32 Recognition and derecognition of financial liabilities using trade date or settlement date accounting

AS 30 has special rules about recognition and derecognition of financial assets using trade date or settlement date accounting. Do these rules apply to transactions in financial instruments that are classified as financial liabilities, such as transactions in deposit liabilities and trading liabilities?

No. AS 30 does not contain any specific requirements about trade date accounting and settlement date accounting in the case of transactions in financial instruments that are classified as financial liabilities. Therefore, the general recognition and derecognition requirements in paragraph 14 and paragraph 43 of AS 30 apply. Paragraph 14 of AS 30 states that financial liabilities are recognised on the date the entity "becomes a party to the contractual provisions of the instrument". Such contracts generally are not recognised unless one of the parties has performed or the contract is a derivative contract not exempted from the scope of AS 30. Paragraph 43 of AS 30 specifies that financial liabilities are derecognised only when they are extinguished, i.e., when the obligation specified in the contract is discharged or cancelled or expires.

Section C: Embedded Derivatives

C.1 Embedded derivatives: separation of host debt instrument

If an embedded non-option derivative is required to be separated from a host debt instrument, how are the terms of the host debt instrument and the embedded derivative identified? For example, would the host debt instrument be a fixed rate instrument, a variable rate instrument or a zero coupon instrument?

The terms of the host debt instrument reflect the stated or implied substantive terms of the hybrid instrument. In the absence of implied or stated terms, the entity makes its own judgement of the terms. However, an entity may not identify a component that is not specified or may not establish terms of the host debt instrument in a manner that would result in the separation of an embedded derivative that is not already clearly present in the hybrid instrument, that is to say, it cannot create a cash flow that does not exist. For example, if a five-year debt instrument has fixed interest payments of Rs. 40,000 annually and a principal payment at maturity of Rs. 1,000,000 multiplied by the change in an equity price index, it would be inappropriate to identify a floating rate host contract and an embedded equity swap that has an offsetting floating rate leg in lieu of identifying a fixed rate host. In that example, the host contract is a fixed rate debt instrument that pays Rs. 40,000 annually because there are no floating interest rate cash flows in the hybrid instrument.

In addition, the terms of an embedded non-option derivative, such as a forward or swap, must be determined so as to result in the embedded derivative having a fair value of zero at the inception of the hybrid instrument. If it were permitted to separate embedded non-option derivatives on other terms, a single hybrid instrument could be decomposed into an infinite variety of combinations of host debt instruments and embedded derivatives, for example, by separating embedded derivatives with terms that create leverage, asymmetry or some other risk exposure not already present in the hybrid instrument. Therefore, it is inappropriate to separate an embedded non-option derivative on terms that result in a fair value other than zero at the inception of the hybrid instrument. The determination of the terms of the embedded derivative is based on the conditions existing when the financial instrument was issued.

C.2 Embedded derivatives: separation of embedded option

The response to Question C.1 states that the terms of an embedded non-option derivative should be determined so as to result in the embedded derivative having a fair value of zero at the initial recognition of the hybrid instrument. When an embedded option-based derivative is separated, must the terms of the embedded option be determined so as to result in the embedded derivative having either a fair value of zero or an intrinsic value of zero (that is to say, be at the money) at the inception of the hybrid instrument?

No. The economic behaviour of a hybrid instrument with an option-based embedded derivative depends critically on the strike price (or strike rate) specified for the option feature in the hybrid instrument, as discussed below. Therefore, the separation of an option-based embedded derivative (including any embedded put, call, cap, floor, caption, floortion or swaption feature in a hybrid instrument) should be based on the stated terms of the option feature documented in the hybrid instrument. As a result, the embedded derivative would not necessarily have a fair value or intrinsic value equal to zero at the initial recognition of the hybrid instrument.

If an entity were required to identify the terms of an embedded option-based derivative so as to achieve a fair value of the embedded derivative of zero, the strike price (or strike rate) generally would have to be determined so as to result in the option being infinitely out of the money. This would imply a zero probability of the option feature being exercised. However, since the probability of the option feature in a hybrid instrument being exercised generally is not zero, it would be inconsistent with the likely economic behaviour of the hybrid instrument to assume an initial fair value of zero. Similarly, if an entity was required to identify the terms of an embedded option-based derivative so as to achieve an intrinsic value of zero for the embedded derivative, the strike price (or strike rate) would have to be assumed to equal the price (or rate) of the underlying variable at the initial recognition of the hybrid instrument. In this case, the fair value of the option would consist only of time value. However, such an assumption would not be consistent with the likely economic behaviour of the hybrid instrument, including the probability of the option feature being exercised, unless the agreed strike price was indeed equal to the price (or rate) of the underlying variable at the initial recognition of the hybrid instrument.

The economic nature of an option-based embedded derivative is fundamentally different from a forward-based embedded derivative (including forwards and swaps), because the terms of a forward are such that a payment based on the difference between the price of the underlying and the forward price will occur at a specified date, while the terms of an option are such that a payment based on the difference between the price of the underlying and the strike price of the option may or may not occur depending on the relationship between the agreed strike price and the price of the underlying at a specified date or dates in the future. Adjusting the strike price of an option-based embedded derivative, therefore, alters the nature of the hybrid instrument. On the other hand, if the terms of a non-option embedded derivative in a host debt instrument were determined so as to result in a fair value of any amount other than zero at the inception of the hybrid instrument, that amount would essentially represent a borrowing or lending. Accordingly, as discussed in the answer to Question C.1, it is not appropriate to separate a non-option embedded derivative in a host debt instrument on terms that result in a fair value other than zero at the initial recognition of the hybrid instrument.

C.3 Embedded derivatives: accounting for a convertible bond

What is the accounting treatment of an investment in a bond (financial asset) that is convertible into shares of the issuing entity or another entity before maturity?

An investment in a convertible bond that is convertible before maturity generally cannot be classified as a held-to-maturity investment because that would be inconsistent with paying for the conversion feature—the right to convert into equity shares before maturity.

An investment in a convertible bond can be classified as an available-for-sale financial asset provided it is not purchased for trading purposes. The equity conversion option is an embedded derivative.

If the bond is classified as available for sale (i.e., fair value changes recognised directly in the appropriate equity account until the bond is sold), the equity conversion option (the embedded derivative) is separated. The amount paid for the bond is split between the debt instrument without the conversion option and the equity conversion option. Changes in the fair value of the equity conversion option are recognised in the statement of profit and loss unless the option is part of a cash flow hedging relationship.

If the convertible bond is measured at fair value with changes in fair value recognised in the statement of profit and loss, separating the embedded derivative from the host bond is not permitted.

C.4 Embedded derivatives: equity kicker

In some instances, venture capital entities providing subordinated loans agree that if and when the borrower lists its shares on a stock exchange, the venture capital entity is entitled to receive shares of the borrowing entity free of charge or at a very low price (an 'equity kicker') in addition to interest and repayment of principal. As a result of the equity kicker feature, the interest on the subordinated loan is lower than it would otherwise be. Assuming that the subordinated loan is not measured at fair value with changes in fair value recognised in the statement of profit and loss (paragraph 10(c) of AS 30), does the equity kicker feature meet the definition of an embedded derivative even though it is contingent upon the future listing of the borrower?

Yes. The economic characteristics and risks of an equity return are not closely related to the economic characteristics and risks of a host debt instrument (paragraph 10(a) of AS 30). The equity kicker meets the definition of a derivative because it has a value that changes in response to the change in the price of the shares of the borrower, it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and it is settled at a future date (paragraphs 10(b) and 8.1(a) of AS 30). The equity kicker feature meets the definition of a derivative even though the right to receive shares is contingent upon the future listing of the borrower. Appendix A paragraph A28 of AS 30 states that a derivative could require a payment as a result of some future event that is unrelated to a notional amount. An equity kicker feature is similar to such a derivative except that it does not give a right to a fixed payment, but an option right, if the future event occurs.

C.5 Embedded derivatives: debt or equity host contract

Entity A purchases a five-year 'debt' instrument issued by Entity B with a principal amount of Rs. 1 million that is indexed to the share price of Entity C. At maturity, Entity A will receive from Entity B the principal amount plus or minus the change in the fair value of 10,000 shares of Entity C. The current share price is Rs. 110. No separate interest payments are made by Entity B. The purchase price is Rs. 1 million. Entity A classifies the debt instrument as available for sale. Entity A concludes that the instrument is a hybrid instrument with an embedded derivative because of the equity-indexed principal. For the purposes of separating an embedded derivative, is the host contract an equity instrument or a debt instrument?

The host contract is a debt instrument because the hybrid instrument has a stated maturity, *i.e.*, it does not meet the definition of an equity instrument (paragraphs 7 and 32 of AS 31). It is accounted for as a zero coupon debt instrument. Thus, in accounting for the host instrument, Entity A imputes interest on Rs. 1 million over five years using the applicable market interest rate at initial recognition. The embedded non-option derivative is separated so as to have an initial fair value of zero (see Question C.1).

C.6 Embedded derivatives: synthetic instruments

Entity A acquires a five-year floating rate debt instrument issued by Entity B. At the same time, it enters into a five-year pay-variable, receive-fixed interest rate swap with Entity C. Entity A regards the combination of the debt instrument and swap as a synthetic fixed rate instrument and classifies the instrument as a held-to-maturity investment, since it has the positive intention and ability to hold it to maturity. Entity A contends that separate accounting for the swap is inappropriate since Appendix A paragraph A53(a) of AS 30 requires an embedded derivative to be classified together with its host instrument if the derivative is linked to an interest rate that can change the amount of interest that would otherwise be paid or received on the host debt contract. Is the entity's analysis correct?

No. Embedded derivative instruments are terms and conditions that are included in non-derivative host contracts. It is generally inappropriate to treat two or more separate financial instruments as a single combined instrument ('synthetic instrument' accounting) for the purpose of applying AS 30. Each of the financial instruments has its own terms and conditions and each may be transferred or settled separately. Therefore, the debt instrument and the swap are classified separately. The transactions described here differ from the transactions discussed in Question B.6, which had no substance apart from the resulting interest rate swap.

C.7 Embedded derivatives: purchases and sales contracts in foreign currency instruments

A supply contract provides for payment in a currency other than (a) the functional currency of either party to the contract, (b) the currency in which the product is routinely denominated in commercial transactions around the world and (c) the currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place. Is there an embedded derivative that should be separated under AS 30?

Yes. To illustrate: an Indian entity agrees to sell oil to an entity in France. The oil contract is denominated in Swiss francs, although oil contracts are routinely denominated in US dollars in commercial transactions around the world, and Indian Rupees are commonly used in contracts to purchase or sell non-financial items in India. Neither entity carries out any significant activities in Swiss francs. In this case, the Indian entity regards the supply contract as a host contract with an embedded foreign currency forward to purchase Swiss francs. The French entity regards the supply contact as a host contract with an embedded foreign currency forward to sell Swiss francs. Each entity includes fair value changes on the currency forward in the statement of profit and loss unless the reporting entity designates it as a cash flow hedging instrument, if appropriate.

C.8 Embedded foreign currency derivatives: unrelated foreign currency provision

Entity A, which measures items in its financial statements on the basis of the Rupees (its functional currency), enters into a contract with Entity B, which has the Norwegian krone as its functional currency, to purchase oil in six months for 1,000 US dollars. The host oil contract is not within the scope of AS 30 because it was entered into and continues to be for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (paragraph 4 and Appendix A paragraph A29 of AS 30). The oil contract includes a leveraged foreign exchange provision that states that the parties, in addition to the provision of, and payment for, oil will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a

notional amount of 100,000 US dollars. Under paragraph 10 of AS 30, is that embedded derivative (the leveraged foreign exchange provision) regarded as closely related to the host oil contract?

No, that leveraged foreign exchange provision is separated from the host oil contract because it is not closely related to the host oil contract (Appendix A paragraph A53(d) of AS 30).

The payment provision under the host oil contract of 1,000 US dollars can be viewed as a foreign currency derivative because the US dollar is neither Entity A's nor Entity B's functional currency. This foreign currency derivative would not be separated because it follows from Appendix A paragraph A53(d) of AS 30 that a crude oil contract that requires payment in US dollars is not regarded as a host contract with a foreign currency derivative.

The leveraged foreign exchange provision that states that the parties will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars is in addition to the required payment for the oil transaction. It is unrelated to the host oil contract and therefore separated from the host oil contract and accounted for as an embedded derivative under paragraph 10 of AS 30.

C.9 Embedded foreign currency derivatives: currency of international commerce

Appendix A paragraph A53(d) of AS 30 refers to the currency in which the price of the related goods or services is routinely denominated in commercial transactions around the world. Could it be a currency that is used for a certain product or service in commercial transactions within the local area of one of the substantial parties to the contract?

No. The currency in which the price of the related goods or services is routinely denominated in commercial transactions around the world is only a currency that is used for similar transactions all around the world, not just in one local area. For example, if cross-border transactions in natural gas in North America are routinely denominated in US dollars and such transactions are routinely denominated in Euro in Europe, neither the US dollar nor the Euro is a currency in which the goods or services is routinely denominated in commercial transactions around the world.

C.10 Embedded derivatives: holder permitted, but not required, to settle without recovering substantially all of its recognised investment

If the terms of a combined instrument permit, but do not require, the holder to settle the combined instrument in a manner that causes it not to recover substantially all of its recognised investment and the issuer does not have such a right (for example, a puttable

debt instrument), does the contract satisfy the condition in Appendix A paragraph A53(a) of AS 30 that the holder would not recover substantially all of its recognised investment?

No. The condition that "the holder would not recover substantially all of its recognised investment" is not satisfied if the terms of the combined instrument permit, but do not require, the investor to settle the combined instrument in a manner that causes it not to recover substantially all of its recognised investment and the issuer has no such right. Accordingly, an interest-bearing host contract with an embedded interest rate derivative with such terms is regarded as closely related to the host contract. The condition that "the holder would not recover substantially all of its recognised investment" applies to situations in which the holder can be forced to accept settlement at an amount that causes the holder not to recover substantially all of its recognised investment.

C.11 Embedded derivatives: reliable determination of fair value

If an embedded derivative that is required to be separated cannot be reliably measured because it will be settled by an unquoted equity instrument whose fair value cannot be reliably measured, is the embedded derivative measured at cost?

No. In this case, the entire combined contract is treated as a financial instrument held for trading (paragraph 12 of AS 30). If the fair value of the combined instrument can be reliably measured, the combined contract is measured at fair value. The entity might conclude, however, that the equity component of the combined instrument may be sufficiently significant to preclude it from obtaining a reliable estimate of the entire instrument. In that case, the combined instrument is measured at cost less impairment.

Section D: Recognition and Derecognition

D.1 Initial Recognition

D.1.1 Recognition: cash collateral

Entity B transfers cash to Entity A as collateral for another transaction with Entity A (for example, a securities borrowing transaction). The cash is not legally segregated from Entity A's assets. Should Entity A recognise the cash collateral it has received as an asset?

Yes. The ultimate realisation of a financial asset is its conversion into cash and, therefore, no further transformation is required before the economic benefits of the cash transferred by Entity B can be realised by Entity A. Therefore, Entity A recognises the cash as an asset and a payable to Entity B while Entity B derecognises the cash and recognises a receivable from Entity A.

D.2 Regular Way Purchase or Sale of a Financial Asset

D.2.1 Trade date vs. settlement date: Amounts to be recorded for a purchase

How are the trade date and settlement date accounting principles in the Standard applied to a purchase of a financial asset?

The following example illustrates the application of the trade date and settlement date accounting principles in the Standard for a purchase of a financial asset. On 29 December 20x7, an entity commits itself to purchase a financial asset for Rs. 1,000, which is its fair value on commitment (trade) date. Transaction costs are immaterial. On 31 December 20x7 (financial year-end) and on 4 January 20x8 (settlement date) the fair value of the asset is Rs. 1,002 and Rs. 1,003, respectively. The amounts to be recorded for the asset will depend on how it is classified and whether trade date or settlement date accounting is used, as shown in the two tables below.

SETTLEMENT DATE ACCOUNTING			
Balances	**Held-to-Maturity Investments Carried at Amortised Cost**	**Available-for- Sale Assets Remeasured to Fair Value with Changes in the Appropriate Equity Account**	**Assets at Fair Value through Profit or Loss Remeasured to Fair Value with Changes in the Statement of Profit and Loss**
29 December 20x7			
Financial asset	-	-	-
Financial liability	-	-	-
31 December 20x7			
Receivable	-	2	2
Financial asset	-	-	-
Financial liability	-	-	-
Appropriate Equity Account (fair value adjustment)	-	(2)	-
Retained earnings (through statement of profit and loss)	-	-	(2)

PREVIOUS HOME NEXT

4 January 20x8			
Receivable	-	-	-
Financial asset	1,000	1,003	1,003
Financial liability	-	-	-
Appropriate Equity Account (fair value adjustment)	-	(3)	-
Retained earnings (through statement of profit and loss)	-	-	(3)

TRADE DATE ACCOUNTING			
Balances	**Held-to-Maturity Investments Carried at Amortised Cost**	**Available-for- Sale Assets Remeasured to Fair Value with Changes in the Appropriate Equity Account**	**Assets at Fair Value through Profit or Loss Remeasured to Fair Value with Changes in the Statement of Profit or and Loss**
29 December 20x7			
Financial asset	1,000	1,000	1,000
Financial liability	(1,000)	(1,000)	(1,000)
31 December 20x7			
Receivable	-	-	-
Financial asset	1,000	1,002	1,002
Financial liability	(1,000)	(1,000)	(1,000)
Appropriate Equity Account (fair value adjustment)	-	(2)	-
Retained earnings (through statement of profit and loss)	-	-	(2)
4 January 20x8			
Receivable	-	-	-
Financial asset	1,000	1,003	1,003
Financial liability	-	-	-
Appropriate Equity Account (fair value adjustment)	-	(3)	-
Retained earnings (through statement of profit and loss)	-	-	(3)

Note: When an entity applies the trade date accounting, it is not required to mark the investment to market on the settlement date. However, only with a view to present the comparative results of two methods, viz., the trade date accounting and the settlement date accounting, on the settlement date, the concerned investment has been marked to market on the settlement date in examples D.2.1 to D.2.3.

D.2.2 Trade date vs. settlement date: Amounts to be recorded for a sale

How are the trade date and settlement date accounting principles in the Standard applied to a sale of a financial asset?

The following example illustrates the application of the trade date and settlement date accounting principles in the Standard for a sale of a financial asset. On 29 December 20x8 (trade date) an entity enters into a contract to sell a financial asset for its current fair value of Rs. 1,010. The asset was acquired one year earlier for Rs. 1,000 and its amortised cost is Rs. 1,000. On 31 December 20x8 (financial year-end), the fair value of the asset is Rs. 1,012. On 4 January 20x9 (settlement date), the fair value is Rs. 1,013. The amounts to be recorded will depend on how the asset is classified and whether trade date or settlement date accounting is used as shown in the two tables below (any interest that might have accrued on the asset is disregarded).

A change in the fair value of a financial asset that is sold on a regular way basis is not recorded in the financial statements between trade date and settlement date even if the entity applies settlement date accounting because the seller's right to changes in the fair value ceases on the trade date.

SETTLEMENT DATE ACCOUNTING			
Balances	**Held-to-Maturity Investments Carried at Amortised Cost**	**Available-for-Sale Assets Remeasured to Fair Value with Changes in the Appropriate Equity Account**	**Assets at Fair Value through Profit or Loss Remeasured to Fair Value with Changes in the Statement of Profit or and Loss**
29 December 20x8			
Receivable	-	-	-
Financial asset	1,000	1,010	1,010
Appropriate Equity Account (fair value adjustment)	-	10	-
Retained earnings (through statement of profit and loss)	-	-	10
31 December 20x8			
Receivable	-	-	-
Financial asset	1,000	1,010	1,010
Appropriate Equity Account (fair value adjustment)	-	10	-
Retained earnings (through statement of profit and loss)	-	-	10

PREVIOUS HOME NEXT

4 January 20x9			
Appropriate Equity Account (fair value adjustment)	-	-	-
Retained earnings (through statement of profit and loss)	10	10	10

TRADE DATE ACCOUNTING			
Balances	**Held-to-Maturity Investments Carried at Amortised Cost**	**Available-for- Sale Assets Remeasured to Fair Value with Changes in the Appropriate Equity Account**	**Assets at Fair Value through Profit or Loss Remeasured to Fair Value with Changes in the Statement of Profit and Loss**
29 December 20x8			
Receivable	1,010	1,010	1,010
Financial asset	-	-	-
Appropriate Equity Account (fair value adjustment)	-	-	-
Retained earnings (through statement of profit and loss)	10	10	10
31 December 20x8			
Receivable	1,010	1,010	1,010
Financial asset	-	-	-
Appropriate Equity Account (fair value adjustment)	-	-	-
Retained earnings (through statement of profit and loss)	10	10	10
4 January 20x9			
Appropriate equity account (fair value adjustment)	-	-	-
Retained earnings (through statement of profit and loss)	10	10	10

D.2.3 Settlement date accounting: exchange of non-cash financial assets

If an entity recognises sales of financial assets using settlement date accounting, would a change in the fair value of a financial asset to be received in exchange for the non-cash financial asset that is sold be recognised in accordance with paragraph 63 of AS30?

It depends. Any change in the fair value of the financial asset to be received would be accounted for under paragraph 63 of AS30 if the entity applies settlement date accounting for that category of financial assets. However, if the entity classifies the financial asset to be received in a category for which it applies trade date accounting, the asset to be received is recognised on the trade date as described in paragraph 41 of AS30. In that case, the entity recognises a liability of an amount equal to the carrying amount of the financial asset to be delivered on settlement date.

To illustrate: on 29 December 20x8 (trade date) Entity A enters into a contract to sell Note Receivable A, which is classified under the category 'Held-to-Maturity (HTM) Investments' and, therefore, carried at amortised cost, in exchange for Bond B, which will be classified as held for trading and measured at fair value. Both assets have a fair value of Rs. 1,010 on 29 December, while the amortised cost of Note Receivable A is Rs. 1,000. Entity A uses settlement date accounting for loans and receivables and trade date accounting for assets held for trading. On 31 December 20x8 (financial year-end), the fair value of Note Receivable A is Rs. 1,012 and the fair value of Bond B is Rs. 1,009. On 4 January 20x9, the fair value of Note Receivable A is Rs. 1,013 and the fair value of Bond B is Rs. 1,007. The following entries are made:

29 December 20x8

Dr	Bond B	Rs. 1,010	
	Cr Payable		Rs. 1,010

31 December 20x8

Dr	Trading loss	Re. 1	
	Cr Bond B		Re. 1

4 January 20x9

Dr	Payable	Rs. 1,010	
Dr	Trading loss	Rs. 2	
	Cr Note Receivable A		Rs. 1,000
	Cr Bond B		Rs. 2
	Cr Realisation gain		Rs. 10

Section E: Measurement

E.1 Initial Measurement of Financial Assets and Financial Liabilities

E.1.1 Initial measurement: transaction costs

Paragraph 47 of AS 30, *inter alia*, prescribes accounting for transaction costs upon initial measurement of financial assets and financial liabilities. How should the requirements of this paragraph regarding transaction costs be applied in practice?

For financial assets, incremental costs that are directly attributable to the acquisition of the asset, for example fees and commissions, are added to the amount originally recognised. For financial liabilities, directly related costs of issuing debt are deducted from the amount of debt originally recognised. For financial instruments that are measured at fair value through profit or loss and short-term receivables and payables (see paragraph 47(b) of AS 30), transaction costs are not added to the fair value measurement at initial recognition.

For financial instruments that are carried at amortised cost, such as held-to-maturity investments, loans and receivables (except short-term receivables), and financial liabilities that are not at fair value through profit or loss (except short-term payables), transaction costs are included in the calculation of amortised cost using the effective interest method and, in effect, amortised through profit or loss over the life of the instrument.

For available-for-sale financial assets, transaction costs are recognised in the appropriate equity account as part of a change in fair value at the next remeasurement. If an available-for-sale financial asset has fixed or determinable payments and does not have an indefinite life, the transaction costs are amortised to the statement of profit and loss using the effective interest method. If an available-for-sale financial asset does not have fixed or determinable payments and has an indefinite life, the transaction costs are recognised in the statement of profit and loss when the asset is derecognised or becomes impaired.

Transaction costs expected to be incurred on transfer or disposal of a financial instrument are not included in the measurement of the financial instrument.

E.2 Fair Value Measurement Considerations

E.2.1 Fair value measurement considerations for investment funds

Appendix A paragraph A91 of AS 30 states that the current bid price is usually the appropriate price to be used in measuring the fair value of an asset held. The rules applicable to some investment funds require net asset values to be reported to investors on the basis of mid-market prices. In these circumstances, would it be appropriate for an investment fund to measure its assets on the basis of mid-market prices?

No. The existence of regulations that require a different measurement for specific purposes does not justify a departure from the general requirement in Appendix A paragraph A91 of AS 30 to use the current bid price in the absence of a matching liability position. In its financial statements, an investment fund measures its assets at current bid prices. In reporting its net asset value to investors, an investment fund may wish to provide a reconciliation between the fair values recognised on its balance sheet and the prices used for the net asset value calculation.

E.2.2 Fair value measurement: large holding

Entity A holds 15 per cent of the share capital in Entity B. The shares are publicly traded in an active market. The currently quoted price is Rs. 100. Daily trading volume is 0.1 per cent of outstanding shares. Because Entity A believes that the fair value of the Entity B shares it owns, if sold as a block, is greater than the quoted market price, Entity A obtains several independent estimates of the price it would obtain if it sells its holding. These estimates indicate that Entity A would be able to obtain a price of Rs. 105, *i.e.*, a 5 per cent premium above the quoted price. Which figure should Entity A use for measuring its holding at fair value?

Under Appendix A paragraph A90 of AS 30, a published price quotation in an active market is the best estimate of fair value. Therefore, Entity A uses the published price quotation (Rs. 100). Entity A cannot depart from the quoted market price solely because independent estimates indicate that Entity A would obtain a higher (or lower) price by selling the holding as a block.

E.3 Gains and Losses

E.3.1 Available-for-sale financial assets: exchange of shares

Entity A holds a small number of shares in Entity B. The shares are classified as available for sale. On 20 December 20x6, the fair value of the shares is Rs. 120 and the cumulative gain recognised in the Investment Revaluation Reserve Account is Rs. 20. On the same day, Entity B is acquired by Entity C, a large public entity. As a result, Entity A receives shares in Entity C in exchange for those it had in Entity B of equal fair value. Under paragraph 61(b) of AS 30, should Entity A recognise the cumulative gain of Rs. 20 recognised in the Investment Revaluation Reserve Account in the statement of profit and loss?

Yes. The transaction qualifies for derecognition under AS 30. Paragraph 61(b) of AS 30 requires that the cumulative gain or loss that has been recognised in the Investment Revaluation Reserve Account on an available-for-sale financial asset be recognised in the statement of profit and loss when the asset is derecognised. In the exchange of shares, Entity A disposes of the shares it had in Entity B and receives shares in Entity C.

E.3.2 AS 30 and AS 11 – Available-for-sale financial assets: separation of currency component

For an available-for-sale monetary financial asset, the entity reports changes in the carrying amount relating to changes in foreign exchange rates in the statement of profit and loss in accordance with AS 11 and other changes in the carrying amount in the Investment Revaluation Reserve Account in accordance with AS 30. How is the cumulative gain or loss that is recognised in the Investment Revaluation Reserve Account determined?

It is the difference between the amortised cost (adjusted for impairment, if any) and fair value of the available-for-sale monetary financial asset in the functional currency of the reporting entity. For the purpose of applying AS 11, the asset is treated as an asset measured at amortised cost in the foreign currency.

To illustrate: on 31 December 20x7, Entity A acquires a bond denominated in a foreign currency (FC) for its fair value of FC 1,000. The bond has five years remaining to maturity and a principal amount of FC 1,250, carries fixed interest of 4.7 per cent that is paid annually (FC 1,250 X 4.7 per cent = FC 59 per year), and has an effective interest rate of 10 per cent. Entity A classifies the bond as available for sale, and thus recognises gains and losses in the Investment Revaluation Reserve Account. The entity's functional currency is its Indian currency (Rs.). The exchange rate is FC1 to Rs. 1.5 and the carrying amount of the bond is Rs. 1,500 (= FC 1,000 X 1.5).

Dr	Bond	Rs. 1,500	
	Cr Cash		Rs. 1,500

On 31 December 20x8, the foreign currency has appreciated and the exchange rate is FC1 to Rs. 2. The fair value of the bond is FC 1,060 and thus the carrying amount is Rs. 2,120 (= FC 1,060 X 2). The amortised cost is FC 1,041 (= Rs. 2,082). In this case, the cumulative gain or loss to be recognised directly in the Investment Revaluation Reserve Account is the difference between the fair value and the amortised cost on 31 December 20x8, i.e., Rs. 38 (= Rs. 2,120 – Rs. 2,082).

Interest received on the bond on 31 December 20x8 is FC 59 (= Rs. 118). Interest income determined in accordance with the effective interest method is FC 100 (=1,000 X 10 per cent). The average exchange rate during the year is FC1 to Rs. 1.75. For the purpose of this question, it is assumed that the use of the average exchange rate provides a reliable approximation of the spot rates applicable to the accrual of interest income during the year (AS 11.). Thus, reported interest income is Rs. 175 (= FC100 X 1.75) including accretion of the initial discount of Rs. 72 (= [FC100 – FC59] X 1.75). Accordingly, the exchange difference on the bond that is recognised in the statement of profit and loss is Rs. 510 (= Rs. 2,082 – Rs. 1,500 – Rs. 72). Also, there is an exchange gain on the interest receivable for the year of Rs. 15 (= FC 59 X [2.00 – 1.75]).

Dr	Bond	Rs. 620	
Dr	Cash	Rs. 118	
	Cr Interest income		Rs. 175
	Cr Exchange gain		Rs. 525
	Cr Investment Revaluation Reserve Account		Rs. 38

On 31 December 20x9, the foreign currency has appreciated further and the exchange rate is FC1 to Rs. 2.50. The fair value of the bond is FC 1,070 and thus the carrying amount is Rs. 2,675 (= FC 1,070 X 2.50). The amortised cost is FC1,086 (= Rs. 2,715). The cumulative gain or loss to be recognised directly in the Investment Revaluation Reserve Account is the difference between the fair value and the amortised cost on 31 December 20x9, i.e. negative Rs. 40 (= Rs. 2,675 –

Rs. 2,715). Thus, there is a debit to the Investment Revaluation Reserve Account equal to the change in the difference during 20x9 of Rs. 78 (= Rs. 40 + Rs. 38).

Interest received on the bond on 31 December 20x9 is FC 59 (= Rs. 148). Interest income determined in accordance with the effective interest method is FC104 (= FC 1,041 X 10 per cent). The average exchange rate during the year is FC1 to Rs. 2.25. For the purpose of this question, it is assumed that the use of the average exchange rate provides a reliable approximation of the spot rates applicable to the accrual of interest income during the year (AS 11.). Thus, recognised interest income is Rs. 234 (= FC104 X 2.25) including accretion of the initial discount of Rs. 101 (= [FC104 – FC59] X 2.25). Accordingly, the exchange difference on the bond that is recognised in the statement of profit and loss is Rs. 532 (= Rs. 2,715 – Rs. 2,082 – Rs. 101). Also, there is an exchange gain on the interest receivable for the year of Rs. 15 (= FC59 X [2.50 – 2.25]).

Dr	Bond	Rs. 555	
Dr	Cash	Rs. 148	
Dr	Investment Revaluation Reserve Account	Rs. 78	
	Cr Interest income		Rs. 234
	Cr Exchange gain		Rs. 547

E.3.3 AS 30 and AS 11 – Exchange differences arising on translation of non-integral foreign operations: foreign currency translation reserve or income?

AS 11 states that all exchange differences resulting from translating the financial statements of a non-integral foreign operation should be accumulated in the foreign currency translation reserve until disposal of the net investment. This would include exchange differences arising from financial instruments carried at fair value, which would include both financial assets classified as at fair value through profit or loss and financial assets that are available for sale.

Paragraph 61 of AS 30 requires that changes in fair value of financial assets classified as at fair value through profit or loss should be recognised in the statement of profit and loss and changes in fair value of available-for-sale investments should be reported in the appropriate equity account.

If the non-integral foreign operation is a subsidiary whose financial statements are consolidated with those of its parent, in the consolidated financial statements how are paragraph 61 of AS 30 and AS 11 applied?

AS 30 applies in the accounting for financial instruments in the financial statements of a non-integral foreign operation and AS 11 applies in translating the financial statements of a non-integral foreign operation for incorporation in the financial statements of the reporting entity.

To illustrate: Entity A is domiciled in India and its functional currency and reporting currency are the Indian Rupees (Rs.)). A has a foreign subsidiary (Entity B) in Country Y whose functional currency is the local currency of Country Y (LCY). B is the owner of a debt instrument, which is held for trading and therefore carried at fair value under AS 30.

In B's financial statements for year 20x6, the fair value and carrying amount of the debt instrument is LCY 100 in the local currency of Country Y. In A's consolidated financial statements, the asset is translated into the Indian Rupees at the spot exchange rate applicable at the balance sheet date (2.00). Thus, the carrying amount is Rs. 200 (= LCY 100 x 2.00) in the consolidated financial statements.

At the end of year 20x7, the fair value of the debt instrument has increased to LCY 110 in the local currency of Country Y. B recognises the trading asset at LCY 110 in its balance sheet and recognises a fair value gain of LCY 10 in its statement of profit and loss. During the year, the spot exchange rate has increased from 2.00 to 3.00 resulting in an increase in the fair value of the instrument from Rs. 200 to Rs. 330 (= LCY 110 x 3.00) in the Indian Rupees. Therefore, Entity A recognises the trading asset at Rs. 330 in its consolidated financial statements.

Entity A translates the statement of profit and loss of B "at the exchange rates at the dates of the transactions" (AS 11). Since the fair value gain has accrued through the year, A uses the average rate as a practical approximation ([3.00 + 2.00] / 2 = 2.50, in accordance with AS 11). Therefore, while the fair value of the trading asset has increased by Rs. 130 (= Rs. 330 - Rs. 200), Entity A recognises only Rs. 25 (= LCY10 x 2.5) of this increase in the consolidated statement of profit and loss to comply with AS 11. The resulting exchange difference, *i.e.*, the remaining increase in the fair value of the debt instrument (Rs. 130 – Rs. 25 = Rs. 105), is accumulated in the foreign currency translation reserve until the disposal of the net investment in the non-integral foreign operation in accordance with AS 11.

E.3.4 AS 30 and AS 11 – Interaction between AS 30 and AS 11

AS 30 includes requirements about the measurement of financial assets and financial liabilities and the recognition of gains and losses on remeasurement in the statement of profit and loss. AS 11 includes rules about the reporting of foreign currency items and the recognition of exchange differences in the statement of profit and loss. In what order are AS 11 and AS 30 applied?

Balance sheet

Generally, the measurement of a financial asset or financial liability at fair value, cost or amortised cost is first determined in the foreign currency in which the item is denominated in accordance with AS 30. Then, the foreign currency amount is translated into the functional currency using the closing rate or a historical rate in accordance with AS 11 (Appendix A paragraph A103 of AS 30). For example, if a monetary financial asset (such as a debt instrument) is carried at amortised cost under AS 30, amortised cost is calculated in the currency of denomination of that financial asset. Then, the foreign currency amount is recognised using the closing rate in the entity's financial statements (AS 11). That applies regardless of whether a monetary item is measured at cost, amortised cost or fair value in the foreign currency (AS 11). A non-monetary financial asset (such as an investment in an equity instrument) is translated using the closing rate if it is carried at fair value in the foreign currency (AS 11) and at a historical rate if it is not carried at fair value under AS 30 because its fair value cannot be reliably measured (AS 11and paragraph 51(c) of AS 30).

As an exception, if the financial asset or financial liability is designated as a hedged item in a fair value hedge of the exposure to changes in foreign currency rates under AS 30, the hedged item is remeasured for changes in foreign currency rates even if it would otherwise have been recognised using a historical rate under AS 11 (paragraph 99 of AS 30), i.e., the foreign currency amount is recognised using the closing rate. This exception applies to non-monetary items that are carried in terms of historical cost in the foreign currency and are hedged against exposure to foreign currency rates (AS 11).

Statement of profit and loss

The recognition of a change in the carrying amount of a financial asset or financial liability in the statement of profit and loss depends on a number of factors, including whether it is an exchange difference or other change in carrying amount, whether it arises on a monetary item (for example, most debt instruments) or non-monetary item (such as most equity investments), whether the associated asset or liability is designated as a cash flow hedge of an exposure to changes in foreign currency rates, and whether it results from translating the financial statements of a foreign operation. The issue of recognising changes in the carrying amount of a financial asset or financial liability held by a non-integral foreign operation is addressed in a separate question (see Question E.3.3).

Any exchange difference arising on recognising a *monetary item* at a rate different from that at which it was initially recognised during the period, or recognised in previous financial statements, is recognised in the statement of profit and loss or in the foreign currency translation reserve in accordance with AS 11 (Appendix A paragraph A103 of AS 30 and AS 11), unless the monetary item is designated as a cash flow hedge of a highly probable forecast transaction in foreign currency, in which case the requirements for recognition of gains and losses on cash flow hedges in AS 30 apply (paragraph 106 of AS 30). Differences arising from recognising a monetary item at a foreign currency amount different from that at which it was previously recognised are accounted for in a similar manner, since all changes in the carrying amount relating to foreign currency movements should be treated consistently. All other changes in the balance sheet measurement of a monetary item are recognised in the statement of profit and loss or in the appropriate equity account, say, Investment Revaluation Reserve Account, in accordance with AS 30. For example, although an entity recognises gains and losses on available-for-sale monetary financial assets in the equity account (paragraph 61(b) of AS 30), the entity nevertheless recognises the changes in the carrying amount relating to changes in foreign exchange rates in the statement of profit and loss (AS 11).

Any changes in the carrying amount of a *non-monetary item* are recognised in the statement of profit and loss or in the equity account in accordance with AS 30 (Appendix A paragraph A103 of AS 30). For example, for available-for-sale financial assets the entire change in the carrying amount, including the effect of changes in foreign currency rates, is reported in the equity account. If the non-monetary item is designated as a cash flow hedge of an unrecognised firm commitment or a highly probable forecast transaction in foreign currency, the requirements for recognition of gains and losses on cash flow hedges in AS 30 apply (paragraph 106 of AS 30).

When some portion of the change in carrying amount is recognised in an appropriate equity account and some portion is recognised in the statement of profit and loss, for example, if the amortised cost of a foreign currency bond classified as available for sale has increased in foreign currency (resulting in a gain in the statement of profit and loss) but its fair value has decreased in the functional currency (resulting in a loss in the foreign currency translation reserve), an entity cannot offset those two components for the purposes of determining gains or losses that should be recognised in the statement of profit and loss or in the equity account.

E.4 Impairment and Uncollectibility of Financial Assets

E.4.1 Objective evidence of impairment

Does AS 30 require that an entity be able to identify a single, distinct past causative event to conclude that it is probable that an impairment loss on a financial asset has been incurred?

No. Paragraph 65 of AS 30 states "It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment." Also, paragraph 66 of AS 30 states that "a downgrade of an entity's credit rating is not, by itself, evidence of impairment, although it may be evidence of impairment when considered with other available information". Other factors that an entity considers in determining whether it has objective evidence that an impairment loss has been incurred include information about the debtors' or issuers' liquidity, solvency and business and financial risk exposures, levels of and trends in delinquencies for similar financial assets, national and local economic trends and conditions, and the fair value of collateral and guarantees. These and other factors may, either individually or taken together, provide sufficient objective evidence that an impairment loss has been incurred in a financial asset or group of financial assets.

E.4.2 Impairment: future losses

Does AS 30 permit the recognition of an impairment loss through the establishment of an allowance for future losses when a loan is given? For example, if Entity A lends Rs. 1,000 to Customer B, can it recognise an immediate impairment loss of Rs. 10 if Entity A, based on historical experience, expects that 1 per cent of the principal amount of loans given will not be collected?

No. Paragraph 47 of AS 30 requires a financial asset to be initially measured at fair value. For a loan asset, the fair value is the amount of cash lent adjusted for any fees and costs (unless a portion of the amount lent is compensation for other stated or implied rights or privileges). In addition, paragraph 64 of AS 30 requires that an impairment loss is recognised only if there is objective evidence of impairment as a result of a past event that occurred after initial recognition. Accordingly, it is inconsistent with paragraphs 47 and 64 of AS 30 to reduce the carrying amount of a loan asset on initial recognition through the recognition of an immediate impairment loss.

E.4.3 Assessment of impairment: principal and interest

Because of Customer B's financial difficulties, Entity A is concerned that Customer B will not be able to make all principal and interest payments due on a loan in a timely manner. It negotiates a restructuring of the loan. Entity A expects that Customer B will be able to meet its obligations under the restructured terms. Would Entity A recognise an impairment loss if the restructured terms are as reflected in any of the following cases?

(a) Customer B will pay the full principal amount of the original loan five years after the original due date, but none of the interest due under the original terms.

(b) Customer B will pay the full principal amount of the original loan on the original due date, but none of the interest due under the original terms.

(c) Customer B will pay the full principal amount of the original loan on the original due date with interest only at a lower interest rate than the interest rate inherent in the original loan.

(d) Customer B will pay the full principal amount of the original loan five years after the original due date and all interest accrued during the original loan term, but no interest for the extended term.

(e) Customer B will pay the full principal amount of the original loan five years after the original due date and all interest, including interest for both the original term of the loan and the extended term.

Paragraph 64 of AS 30 indicates that an impairment loss has been incurred if there is objective evidence of impairment. The amount of the impairment loss for a loan measured at amortised cost is the difference between the carrying amount of the loan and the present value of future principal and interest payments discounted at the loan's original effective interest rate. In cases (a)-(d) above, the present value of the future principal and interest payments discounted at the loan's original effective interest rate will be lower than the carrying amount of the loan. Therefore, an impairment loss is recognised in those cases.

In case (e), even though the timing of payments has changed, the lender will receive interest on interest, and the present value of the future principal and interest payments discounted at the loan's original effective interest rate will equal the carrying amount of the loan. Therefore, there is no impairment loss. However, this fact pattern is unlikely given Customer B's financial difficulties.

E.4.4 Assessment of impairment: fair value hedge

A loan with fixed interest rate payments is hedged against the exposure to interest rate risk by a receive-variable, pay-fixed interest rate swap. The hedge relationship qualifies for fair value hedge accounting and is reported as a fair value hedge. Thus, the carrying amount of the loan includes an adjustment for fair value changes attributable to movements in interest rates. Should an assessment of impairment in the loan take into account the fair value adjustment for interest rate risk?

Yes. The loan's original effective interest rate before the hedge becomes irrelevant once the carrying amount of the loan is adjusted for any changes in its fair value attributable to interest rate movements. Therefore, the original effective interest rate and amortised cost of the loan are adjusted to take into account recognised fair value changes. The adjusted effective interest rate is calculated using the adjusted carrying amount of the loan.

An impairment loss on the hedged loan is calculated as the difference between its carrying amount after adjustment for fair value changes attributable to the risk being hedged and the estimated future cash flows of the loan discounted at the adjusted effective interest rate. When a loan is included in a portfolio hedge of interest rate risk, the entity should allocate the change in the fair value of the hedged portfolio to the loans (or groups of similar loans) being assessed for impairment on a systematic and rational basis.

E.4.5 Impairment: provision matrix

A financial institution calculates impairment in the unsecured portion of loans and receivables on the basis of a provision matrix that specifies fixed provision rates for the number of days a loan has been classified as non-performing (zero per cent if less than 90 days, 20 per cent if 90-180 days, 50 per cent if 181-365 days and 100 per cent if more than

365 days). Can the results be considered to be appropriate for the purpose of calculating the impairment loss on loans and receivables under paragraph 69 of AS 30?

Not necessarily. Paragraph 69 of AS 30 requires impairment or bad debt losses to be calculated as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial instrument's original effective interest rate.

E.4.6 Impairment: excess losses

Does AS 30 permit an entity to recognise impairment or bad debt losses in excess of impairment losses that are determined on the basis of objective evidence about impairment in identified individual financial assets or identified groups of similar financial assets?

No. AS 30 does not permit an entity to recognise impairment or bad debt losses in addition to those that can be attributed to individually identified financial assets or identified groups of financial assets with similar credit risk characteristics (paragraph 70 of AS 30) on the basis of objective evidence about the existence of impairment in those assets (paragraph 64 of AS 30). Amounts that an entity might want to set aside for additional possible impairment in financial assets, such as reserves that cannot be supported by objective evidence about impairment, are not recognised as impairment or bad debt losses under AS 30. If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics (paragraph 70 of AS 30).

E.4.7 Recognition of impairment on a portfolio basis

Paragraph 69 of AS 30 requires that impairment be recognised for financial assets carried at amortised cost. Paragraph 70 of AS 30 states that impairment may be measured and recognised individually or on a portfolio basis for a group of similar financial assets. If one asset in the group is impaired but the fair value of another asset in the group is above its amortised cost, does AS 30 allow non-recognition of the impairment of the first asset?

No. If an entity knows that an individual financial asset carried at amortised cost is impaired, Paragraph 69 of AS 30 requires that the impairment of that asset should be recognised. It states: "the amount of the loss is measured as the difference between *the asset's* carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate" (*emphasis added*). Measurement of impairment on a portfolio basis under paragraph 70 AS 30 may be applied to groups of small balance items and to financial assets that are individually assessed and found not to be impaired when there is indication of impairment in a group of similar assets and impairment cannot be identified with an individual asset in that group.

E.4.8 Impairment: recognition of collateral

If an impaired financial asset is secured by collateral and foreclosure is probable, is the collateral recognised as an asset separate from the impaired financial asset?

No. The measurement of the impaired financial asset reflects the fair value of the collateral. The collateral would generally not meet the recognition criteria until it is transferred to the lender. Accordingly, the collateral is not recognised as an asset separate from the impaired financial asset before foreclosure.

E.4.9 Impairment of non-monetary available-for-sale financial asset

If a non-monetary financial asset, such as an equity instrument, measured at fair value with gains and losses recognised in the appropriate equity account becomes impaired, should the cumulative net loss recognised in the equity account, including any portion attributable to foreign currency changes, be recognised in the statement of profit and loss?

Yes. Paragraph 76 of AS 30 states that when a decline in the fair value of an available-for-sale financial asset has been recognised directly in the equity account and there is objective evidence that the asset is impaired, the cumulative net loss that had been recognised directly in the equity account should be removed from the equity account and recognised in the statement of profit and loss even though the asset has not been derecognised. Any portion of the cumulative net loss that is attributable to foreign currency changes on that asset that had been recognised in the equity account is also recognised in the statement of profit and loss. Any subsequent losses, including any portion attributable to foreign currency changes, are also recognised in the statement of profit and loss until the asset is derecognised.

E.4.10 Impairment: whether the appropriate equity account created to recognise gains or losses on the available-for-sale financial assets can be negative

Paragraph 76 of AS 30 requires that gains and losses arising from changes in fair value on available-for-sale financial assets are recognised directly in the appropriate equity account. If the aggregate fair value of such assets is less than their carrying amount, should the aggregate net loss that has been recognised directly in the equity account be removed from the equity account and recognised in the statement of profit and loss?

Not necessarily. The relevant criterion is not whether the aggregate fair value is less than the carrying amount, but whether there is objective evidence that a financial asset or group of assets is impaired. An entity assesses at each balance sheet date whether there is any objective evidence that a financial asset or group of assets may be impaired, in accordance with paragraphs 65-67 of AS 30.. Paragraph 66 of AS 30 states that a downgrade of an entity's credit rating is not, by itself, evidence of impairment, although it may be evidence of impairment when considered with other available information. Additionally, a decline in the fair value of a financial asset below its cost or amortised cost is not necessarily evidence of impairment (for example, a decline in the fair value of an investment in a debt instrument that results from an increase in the basic, risk-free interest rate).

Section F Hedging

F.1 Hedging Instruments

F.1.1 Hedging the fair value exposure of a bond denominated in a foreign currency

Entity J, whose functional currency is the Indian Rupees, has issued 5 million five-year US dollar fixed rate debt. Also, it owns a 5 million five-year fixed rate US dollar bond which it has classified as available for sale. Can Entity J designate its US dollar liability as a hedging instrument in a fair value hedge of the entire fair value exposure of its US dollar bond?

No. Paragraph 81 of AS 30 permits a non-derivative to be used as a hedging instrument only for a hedge of a foreign currency risk. Entity J's bond has a fair value exposure to foreign currency and interest rate changes and credit risk.

Alternatively, can the US dollar liability be designated as a fair value hedge or cash flow hedge of the foreign currency component of the bond?

Yes. However, hedge accounting is unnecessary because the amortised cost of the hedging instrument and the hedged item are both remeasured using closing rates. Regardless of whether Entity J designates the relationship as a cash flow hedge or a fair value hedge, the effect on profit or loss is the same. Any gain or loss on the non-derivative hedging instrument designated as a cash flow hedge is immediately recognised in the statement of profit and loss to correspond with the recognition of the change in spot rate on the hedged item in the statement of profit and loss as required by AS 11.

F.1.2 Hedging with a non-derivative financial asset or liability

Entity J's functional currency is the Indian Rupees. It has issued a fixed rate debt instrument with semi-annual interest payments that matures in two years with principal due at maturity of 5 million US dollars. It has also entered into a fixed price sales commitment for 5 million US dollars that matures in two years and is not accounted for as a derivative because it meets the exemption for normal sales in paragraph 4. Can Entity J

designate its US dollar liability as a fair value hedge of the entire fair value exposure of its fixed price sales commitment and qualify for hedge accounting?

No. Paragraph 81 of AS 30 permits a non-derivative asset or liability to be used as a hedging instrument only for a hedge of a foreign currency risk.

Alternatively, can Entity J designate its US dollar liability as a cash flow hedge of the foreign currency exposure associated with the future receipt of US dollars on the fixed price sales commitment?

Yes. AS 30 permits the designation of a non-derivative asset or liability as a hedging instrument in either a cash flow hedge or a fair value hedge of the exposure to changes in foreign exchange rates of a firm commitment (paragraph 97 of AS 30). Any gain or loss on the non-derivative hedging instrument that is recognised in the appropriate equity account during the period preceding the future sale is recognised in the statement of profit and loss when the sale takes place (paragraph 106 of AS 30).

Alternatively, can Entity J designate the sales commitment as the hedging instrument instead of the hedged item?

No. Only a derivative instrument or a non-derivative financial asset or liability can be designated as a hedging instrument in a hedge of a foreign currency risk. A firm commitment cannot be designated as a hedging instrument. However, if the foreign currency component of the sales commitment is required to be separated as an embedded derivative under paragraph 10 and Appendix A paragraph A53(d) of AS 30, it could be designated as a hedging instrument in a hedge of the exposure to changes in the fair value of the maturity amount of the debt attributable to foreign currency risk.

F.1.3 Hedge accounting: use of written options in combined hedging instruments

Issue (a) - Does Appendix A paragraph A114 of AS 30 preclude the use of an interest rate collar or other derivative instrument that combines a written option component and a purchased option component as a hedging instrument?

It depends. An interest rate collar or other derivative instrument that includes a written option cannot be designated as a hedging instrument if it is a net written option, because Appendix A paragraph A114 of AS 30 precludes the use of a written option as a hedging instrument unless it is designated as an offset to a purchased option. An interest rate collar or other derivative instrument that includes a written option may be designated as a hedging instrument, however, if the combination is a net purchased option or zero cost collar.

Issue (b) - What factors indicate that an interest rate collar or other derivative instrument that combines a written option component and a purchased option component is not a net written option?

The following factors taken together suggest that an interest rate collar or other derivative instrument that includes a written option is not a net written option.

(a) No net premium is received either at inception or over the life of the combination of options. The distinguishing feature of a written option is the receipt of a premium to compensate the writer for the risk incurred.

(b) Except for the strike prices, the critical terms and conditions of the written option component and the purchased option component are the same (including underlying variable or variables, currency denomination and maturity date). Also, the notional amount of the written option component is not greater than the notional amount of the purchased option component.

F.1.4 Internal hedges

Some entities use internal derivative contracts (internal hedges) to transfer risk exposures between different companies within a group or divisions within a single legal entity. Does paragraph 82 of AS 30 prohibit hedge accounting in such cases?

Yes, if the derivative contracts are internal to the entity being reported on. AS 30 does not specify how an entity should manage its risk. However, it states that internal hedging transactions do not qualify for hedge accounting. This applies both (a) in consolidated financial statements for intragroup hedging transactions, and (b) in the individual or separate financial statements of a legal entity for hedging transactions between divisions in the entity. The principles of preparing consolidated financial statements in AS 21 require that “intragroup balances, transactions, income and expenses should be eliminated in full”.

On the other hand, an intragroup hedging transaction may be designated as a hedge in the individual or separate financial statements of a group entity, if the intragroup transaction is an external transaction from the perspective of the group entity. In addition, if the internal contract is offset with an external party the external contract may be regarded as the hedging instrument and the hedging relationship may qualify for hedge accounting.

The following summarises the application of AS 30 to internal hedging transactions.

- AS 30 does not preclude an entity from using internal derivative contracts for risk management purposes and it does not preclude internal derivatives from being accumulated at the treasury level or some other central location so that risk can be managed on an entity-wide basis or at some higher level than the separate legal entity or division.

- Internal derivative contracts between two separate entities within a consolidated group can qualify for hedge accounting by those entities in their individual or separate financial statements, even though the internal contracts are not offset by derivative contracts with a party external to the consolidated group.

- Internal derivative contracts between two separate divisions within the same legal entity can qualify for hedge accounting in the individual or separate financial statements of that legal entity only if those contracts are offset by derivative contracts with a party external to the legal entity.

- Internal derivative contracts between separate divisions within the same legal entity and between separate entities within the consolidated group can qualify for hedge accounting in the consolidated financial statements only if the internal contracts are offset by derivative contracts with a party external to the consolidated group.

- If the internal derivative contracts are not offset by derivative contracts with external parties, the use of hedge accounting by group entities and divisions using internal contracts must be reversed on consolidation.

To illustrate: the banking division of Entity A enters into an internal interest rate swap with the trading division of the same entity. The purpose is to hedge the interest rate risk exposure of a loan (or group of similar loans) in the loan portfolio. Under the swap, the banking division pays fixed interest payments to the trading division and receives variable interest rate payments in return.

If a hedging instrument is not acquired from an external party, AS 30 does not allow hedge accounting treatment for the hedging transaction undertaken by the banking and trading divisions. Paragraph 82 of AS 30 indicates that only derivatives that involve a party external to the entity can be designated as hedging instruments and, further, that any gains or losses on intragroup or intra-entity transactions should be eliminated on consolidation. Therefore, transactions between different divisions within Entity A do not qualify for hedge accounting treatment in the financial statements of Entity A. Similarly, transactions between different entities within a group do not qualify for hedge accounting treatment in consolidated financial statements.

However, if in addition to the internal swap in the above example the trading division enters into an interest rate swap or other contract with an external party that offsets the exposure hedged in the internal swap, hedge accounting is permitted under AS 30. For the purposes of AS 30, the hedged item is the loan (or group of similar loans) in the banking division and the hedging instrument is the external interest rate swap or other contract.

The trading division may aggregate several internal swaps or portions of them that are not offsetting each other and enter into a single third party derivative contract that offsets the aggregate exposure. Under AS 30, such external hedging transactions may qualify for hedge accounting treatment provided that the hedged items in the banking division are identified and the other conditions for hedge accounting are met. It should, however, be noted that paragraph 88 of AS 30 does not permit hedge accounting treatment for held-to-maturity investments if the hedged risk is the exposure to interest rate changes.

F.1.5 Offsetting internal derivative contracts used to manage interest rate risk

If a central treasury function enters into internal derivative contracts with subsidiaries and various divisions within the consolidated group to manage interest rate risk on a centralised basis, can those contracts qualify for hedge accounting in the consolidated financial statements if, before laying off the risk, the internal contracts are first netted against each other and only the net exposure is offset in the marketplace with external derivative contracts?

No. An internal contract designated at the subsidiary level or by a division as a hedge results in the recognition of changes in the fair value of the item being hedged in the statement of profit and loss (a fair value hedge) or in the recognition of the changes in the fair value of the internal derivative in the appropriate equity account (a cash flow hedge). There is no basis for changing the measurement attribute of the item being hedged in a fair value hedge unless the exposure is offset with an external derivative. There is also no basis for including the gain or loss on the internal derivative in the equity account for one entity and recognising it in the statement of profit and loss by the other entity unless it is offset with an external derivative. In cases where two or more internal derivatives are used to manage interest rate risk on assets or liabilities at the subsidiary or division level and those internal derivatives are offset at the treasury level, the effect of designating the internal derivatives as hedging instruments is that the hedged non-derivative exposures at the subsidiary or division levels would be used to offset each other on consolidation. Accordingly, since paragraph 81 of AS 30 does not permit designating non-derivatives as hedging instruments, except for foreign currency exposures, the results of hedge accounting from the use of internal derivatives at the subsidiary or division level that are not laid off with external parties must be reversed on consolidation.

It should be noted, however, that there will be no effect on profit or loss and equity of reversing the effect of hedge accounting in consolidation for internal derivatives that offset each other at the consolidation level if they are used in the same type of hedging relationship at the subsidiary or division level and, in the case of cash flow hedges, where the hedged items affect profit or loss in the same period. Just as the internal derivatives offset at the treasury level, their use as fair value hedges by two separate entities or divisions within the consolidated group will also result in the offset of the fair value amounts recognised in the statement of profit and loss, and their use as cash flow hedges by two separate entities or divisions within the consolidated group will also result in the fair value amounts being offset against each other in the appropriate equity account. However, there may be an effect on individual line items in both the consolidated statement of profit and loss and the consolidated balance sheet, for example when internal derivatives that hedge assets (or liabilities) in a fair value hedge are offset by internal derivatives that are used as a fair value hedge of other assets (or liabilities) that are recognised in a different balance sheet or statement of profit and loss line item. In addition, to the extent that one of the internal contracts is used as a cash flow hedge and the other is used in a fair value hedge, the effect on profit or loss and equity would not offset since the gain (or loss) on the internal derivative used as a fair value hedge would be recognised in the statement of profit and loss and the corresponding loss (or gain) on the internal derivative used as a cash flow hedge would be recognised in the appropriate equity account. Question F.1.4 describes the application of AS 30 to internal hedging transactions.

F.1.6 Offsetting internal derivative contracts used to manage foreign currency risk

If a central treasury function enters into internal derivative contracts with subsidiaries and various divisions within the consolidated group to manage foreign currency risk on a centralised basis, can those contracts be used as a basis for identifying external transactions that qualify for hedge accounting in the consolidated financial statements if, before laying off the risk, the internal contracts are first netted against each other and only the net exposure is offset by entering into a derivative contract with an external party?

It depends. AS 21, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements,* requires all internal transactions to be eliminated in consolidated financial statements. As stated in paragraph 82 of AS 30, internal hedging transactions do not qualify for hedge accounting in the consolidated financial statements of the group. Therefore, if an entity wishes to achieve hedge accounting in the consolidated financial statements, it must designate a hedging relationship between a qualifying external hedging instrument and a qualifying hedged item.

As discussed in Question F.1.5, the accounting effect of two or more internal derivatives that are used to manage interest rate risk at the subsidiary or division level and are offset at the treasury level is that the hedged non-derivative exposures at those levels would be used to offset each other on consolidation. There is no effect on profit or loss or equity if (a) the internal derivatives are used in the same type of hedge relationship (i.e. fair value or cash flow hedges) and (b), in the case of cash flow hedges, any derivative gains and losses that are initially recognised in the equity account are recognised in the statement of profit and loss in the same period(s). When these two conditions are met, the gains and losses on the internal derivatives that are recognised in the statement of profit and loss or in the equity account will offset on consolidation resulting in the same profit or loss and equity as if the derivatives had been eliminated. However, there may be an effect on individual line items, in both the consolidated statement of profit and loss and the consolidated balance sheet, that would need to be eliminated. In addition, there is an effect on profit or loss and equity if some of the offsetting internal derivatives are used in cash flow hedges, while others are used in fair value hedges. There is also an effect on profit or loss and equity for offsetting internal derivatives that are used in cash flow hedges if the derivative gains and losses that are initially recognised in the equity account are recognised in the statement of profit and loss in different periods (because the hedged items affect profit or loss in different periods).

As regards foreign currency risk, provided that the internal derivatives represent the transfer of foreign currency risk on underlying non-derivative financial assets or liabilities, hedge accounting can be applied because paragraph 81 of AS 30 permits a non-derivative financial asset or liability to be designated as a hedging instrument for hedge accounting purposes for a hedge of a foreign currency risk. Accordingly, in this case the internal derivative contracts can be used as a basis for identifying external transactions that qualify for hedge accounting in the consolidated financial statements even if they are offset against each other. However, for consolidated financial statements, it is necessary to designate the hedging relationship so that it involves only external transactions.

Furthermore, the entity cannot apply hedge accounting to the extent that two or more offsetting internal derivatives represent the transfer of foreign currency risk on underlying forecast transactions or unrecognised firm commitments. This is because an unrecognised firm commitment or forecast transaction does not qualify as a hedging instrument under AS 30. Accordingly, in this case the internal derivatives cannot be used as a basis for identifying external transactions that qualify for hedge accounting in the consolidated financial statements. As a result, any cumulative net gain or loss on an internal derivative that has been included in the initial carrying amount of an asset or liability (basis adjustment) or deferred in the equity account would have to be reversed on consolidation if it cannot be demonstrated that the offsetting internal derivative represented the transfer of a foreign currency risk on a financial asset or liability to an external hedging instrument.

F.1.7 Internal derivatives: examples of applying Question F.1.6

In each case, FC = foreign currency, Indian Rupees (Rs.) = local currency (which is the entity's functional currency), and TC = treasury centre.

Case 1: Offset of fair value hedges

Subsidiary A has trade receivables of FC100, due in 60 days, which it hedges using a forward contract with TC. Subsidiary B has payables of FC50, also due in 60 days, which it hedges using a forward contact with TC.

TC nets the two internal derivatives and enters into a net external forward contract to pay FC50 and receive Indian Rupees in 60 days.

At the end of month 1, FC weakens against Rupees. A incurs a foreign exchange loss of Rs. 10 on its receivables, offset by a gain of Rs. 10 on its forward contract with TC. B makes a foreign exchange gain of Rs. 5 on its payables offset by a loss of Rs. 5 on its forward contract with TC. TC makes a loss of Rs. 10 on its internal forward contract with A, a gain of Rs. 5 on its internal forward contract with B, and a gain of Rs. 5 on its external forward contract.

At the end of month 1, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting intragroup transactions or events are shown in italics.

A's entries

Dr	Foreign exchange loss	Rs. 10	
	Cr Receivables		Rs. 10
Dr	*Internal contract TC*	*Rs. 10*	
	Cr *Internal gain TC*		*Rs. 10*

B's entries

Dr	Payables	Rs. 5	
	Cr Foreign exchange gain		Rs. 5
Dr	*Internal loss TC*	*Rs. 5*	
	Cr *Internal contract TC*		*Rs. 5*

TC's entries

Dr	*Internal loss A*	*Rs. 10*	
	Cr *Internal contract A*		*Rs. 10*
Dr	*Internal contract B*	*Rs. 5*	
	Cr *Internal gain B*		*Rs. 5*
Dr	External forward contract	Rs. 5	
	Cr Foreign exchange gain		Rs. 5

Both A and B could apply hedge accounting in their individual financial statements provided all conditions in AS 30 are met. However, in this case, no hedge accounting is required because gains and losses on the internal derivatives and the offsetting losses and gains on the hedged receivables and payables are recognised immediately in the statements of profit and loss of A and B without hedge accounting.

In the consolidated financial statements, the internal derivative transactions are eliminated. In economic terms, the payable in B hedges FC50 of the receivables in A. The external forward contract in TC hedges the remaining FC50 of the receivable in A. Hedge accounting is not necessary in the consolidated financial statements because monetary items are measured at spot foreign exchange rates under AS 11 irrespective of whether hedge accounting is applied.

The net balances before and after elimination of the accounting entries relating to the internal derivatives are the same, as set out below. Accordingly, there is no need to make any further accounting entries to meet the requirements of AS 30.

	Debit	Credit
Receivables	-	Rs. 10
Payables	Rs. 5	-
External forward contract	Rs. 5	-
Gains and losses	-	-
Internal contracts	-	-

Case 2: Offset of cash flow hedges

To extend the example, A also has highly probable future revenues of FC200 on which it expects to receive cash in 90 days. B has highly probable future expenses of FC500 (advertising cost), also to be paid for in 90 days. A and B enter into separate forward contracts with TC to hedge these exposures and TC enters into an external forward contract to receive FC300 in 90 days.

As before, FC weakens at the end of month 1. A incurs a 'loss' of Rs. 20 on its anticipated revenues because the Rupees value of these revenues decreases. This is offset by a 'gain' of Rs. 20 on its forward contract with TC.

B incurs a 'gain' of Rs. 50 on its anticipated advertising cost because the Rupees value of the expense decreases. This is offset by a 'loss' of Rs. 50 on its transaction with TC.

TC incurs a 'gain' of Rs. 50 on its internal transaction with B, a 'loss' of Rs. 20 on its internal transaction with A and a loss of Rs. 30 on its external forward contract.

A and B complete the necessary documentation, the hedges are effective, and both A and B qualify for hedge accounting in their individual financial statements. A defers the gain of Rs. 20 on its internal derivative transaction in the 'Hedging Reserve' Account and B defers the loss of Rs. 50 in its 'Hedging Reserve' Account. TC does not claim hedge accounting, but measures both its internal and external derivative positions at fair value, which net to zero.

At the end of month 1, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting intragroup transactions or events are shown in italics.

A's entries

Dr	*Internal contract TC*	*Rs. 20*	
	Cr Hedging Reserve Account		*Rs. 20*

B's entries

Dr	*Hedging Reserve Account*	*Rs. 50*	
	Cr Internal contract TC		*Rs. 50*

TC's entries

Dr	*Internal loss A*	*Rs. 20*	
	Cr Internal contract A		*Rs. 20*
Dr	*Internal contract B*	*Rs. 50*	
	Cr Internal gain B		*Rs. 50*
Dr	Foreign exchange loss	Rs. 30	
	Cr External forward contract		Rs. 30

For the consolidated financial statements, TC's external forward contract on FC300 is designated, at the beginning of month 1, as a hedging instrument of the first FC300 of B's highly probable future expenses. AS 30 requires that in the consolidated financial statements at the end of month 1, the accounting effects of the internal derivative transactions must be eliminated.

However, the net balances before and after elimination of the accounting entries relating to the internal derivatives are the same, as set out below. Accordingly, there is no need to make any further accounting entries in order for the requirements of AS 30 to be met.

	Debit	**Credit**
External forward contract	-	Rs. 30
Hedging Reserve Account	Rs. 30	-
Gains and losses	-	-
Internal contracts	-	-

Case 3: Offset of fair value and cash flow hedges

Assume that the exposures and the internal derivative transactions are the same as in cases 1 and 2. However, instead of entering into two external derivatives to hedge separately the fair value and cash flow exposures, TC enters into a single net external derivative to receive FC250 in exchange for Rupees in 90 days.

TC has four internal derivatives, two maturing in 60 days and two maturing in 90 days. These are offset by a net external derivative maturing in 90 days. The interest rate differential between FC and Rupees is minimal, and therefore the ineffectiveness resulting from the mismatch in maturities is expected to have a minimal effect on profit or loss in TC.

As in cases 1 and 2, A and B apply hedge accounting for their cash flow hedges and TC measures its derivatives at fair value. A defers a gain of Rs. 20 on its internal derivative transaction in Hedging Reserve Account and B defers a loss of Rs. 50 on its internal derivative transaction in its Hedging Reserve Account.

At the end of month 1, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting intragroup transactions or events are shown in italics.

A's entries

Dr	Foreign exchange loss	Rs. 10	
	Cr Receivables		Rs. 10
Dr	*Internal contract TC*	*Rs. 10*	
	Cr Internal gain TC		*Rs. 10*
Dr	*Internal contract TC*	*Rs. 20*	
	Cr Hedging Reserve Account		*Rs. 20*

B's entries

Dr	Payables	Rs. 5	
	Cr Foreign exchange gain		Rs. 5
Dr	*Internal loss TC*	*Rs. 5*	
	Cr Internal contract TC		*Rs. 5*
Dr	*Hedging Reserve Account*	*Rs. 50*	
	Cr Internal contract TC		*Rs. 50*

TC's entries

Dr	*Internal loss A*	*Rs. 10*	
	Cr Internal contract A		*Rs. 10*
Dr	*Internal loss A*	*Rs. 20*	
	Cr Internal contract A		*Rs. 20*
Dr	*Internal contract B*	*Rs. 5*	
	Cr Internal gain B		*Rs. 5*
Dr	*Internal contract B*	*Rs. 50*	
	Cr Internal gain B		*Rs. 50*
Dr	Foreign exchange loss	Rs. 25	
	Cr External forward contract		Rs. 25

TOTAL (for the internal derivatives)	**A** **Rs.**	**B** **Rs.**	**Total** **TC**
Income (fair value hedges)	10	(5)	5
Hedging Reserve Account (cash flow hedges)	20	(50)	(30)
Total	30	(55)	(25)

Combining these amounts with the external transactions (i.e., those not marked in italics above) produces the total net balances before elimination of the internal derivatives as follows:

	Debit	**Credit**
Receivables	-	Rs. 10
Payables	Rs. 5	-
Forward contract	-	Rs. 25
Hedging Reserve Account	Rs. 30	-
Gains and losses	-	-
Internal contracts	-	-

For the consolidated financial statements, the following designations are made at the beginning of month 1:

- the payable of FC50 in B is designated as a hedge of the first FC50 of the highly probable future revenues in A. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Payable Rs. 5; Cr Hedging Reserve Account Rs. 5;

- the receivable of FC100 in A is designated as a hedge of the first FC100 of the highly probable future expenses in B. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Hedging Reserve Account Rs. 10, Cr Receivable Rs. 10; and

- the external forward contract on FC250 in TC is designated as a hedge of the next FC250 of highly probable future expenses in B. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Hedging Reserve Account Rs. 25; Cr External forward contract Rs. 25.

In the consolidated financial statements at the end of month 1, AS 30 requires the accounting effects of the internal derivative transactions to be eliminated.

However, the total net balances before and after elimination of the accounting entries relating to the internal derivatives are the same, as set out below. Accordingly, there is no need to make any further accounting entries to meet the requirements of AS 30.

	Debit	Credit
Receivables	-	Rs. 10
Payables	Rs. 5	-
Forward contract	-	Rs. 25
Hedging Reserve Account	Rs. 30	-
Gains and losses	-	-
Internal contracts	-	-

Case 4: Offset of fair value and cash flow hedges with adjustment to carrying amount of inventory

Assume similar transactions as in case 3, except that the anticipated cash outflow of FC500 in B relates to the purchase of inventory that is delivered after 60 days. Assume also that the entity has a policy of basis-adjusting hedged forecast non-financial items. At the end of month 2, there are no further changes in exchange rates or fair values. At that date, the inventory is delivered and the loss of Rs. 50 on B's internal derivative, deferred in Hedging Reserve Account in month 1, is adjusted against the carrying amount of inventory in B. The gain of Rs. 20 on A's internal derivative is deferred in Hedging Reserve Account as before.

In the consolidated financial statements, there is now a mismatch compared with the result that would have been achieved by unwinding and redesignating the hedges. The external derivative (FC250) and a proportion of the receivable (FC50) offset FC300 of the anticipated inventory purchase. There is a natural hedge between the remaining FC200 of anticipated cash outflow in B and the anticipated cash inflow of FC200 in A. This relationship does not qualify for hedge accounting under AS 30 and this time there is only a partial offset between gains and losses on the internal derivatives that hedge these amounts.

At the end of months 1 and 2, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting intragroup transactions or events are shown in italics.

A's entries (all at the end of month 1)

Dr	Foreign exchange loss	Rs. 10	
	Cr Receivables		Rs. 10
Dr	*Internal contract TC*	*Rs. 10*	
	Cr Internal gain TC		*Rs. 10*
Dr	*Internal contract TC*	*Rs. 20*	
	Cr Hedging Reserve Account		*Rs. 20*

B's entries

At the end of month 1:

Dr	Payables	Rs. 5	
	Cr Foreign exchange gain		Rs. 5
Dr	*Internal loss TC*	*Rs. 5*	
	Cr Internal contract TC		*Rs. 5*
Dr	*Hedging Reserve Account*	*Rs. 50*	
	Cr Internal contract TC		*Rs. 50*

At the end of month 2:

Dr	Inventory	Rs. 50	
	Cr Hedging Reserve Account		Rs. 50

TC's entries (all at the end of month 1)

Dr	*Internal loss A*	*Rs. 10*	
	Cr Internal contract A		*Rs. 10*
Dr	*Internal loss A*	*Rs. 20*	
	Cr Internal contract A		*Rs. 20*
Dr	*Internal contract B*	*Rs. 5*	
	Cr Internal gain B		*Rs. 5*
Dr	*Internal contract B*	*Rs. 50*	
	Cr Internal gain B		*Rs. 50*
Dr	Foreign exchange loss	Rs. 25	
	Cr Forward contract		Rs. 25

TOTAL (for the internal derivatives)	**A Rs.**	**B Rs.**	**Total Rs.**
Income (fair value hedges)	10	(5)	5
Hedging Reserve Account (cash flow hedges)	20	-	20
Basis adjustment (inventory)	-	(50)	(50)
Total	30	(55)	(25)

Combining these amounts with the external transactions (*i.e.*, those not marked in italics above) produces the total net balances before elimination of the internal derivatives as follows:

PREVIOUS HOME NEXT

	Debit	Credit
Receivables	-	Rs. 10
Payables	Rs. 5	-
Forward contract	-	Rs. 25
Hedging Reserve Account	-	Rs. 20
Basis adjustment (inventory)	Rs. 50	-
Gains and losses	-	-
Internal contracts	-	-

For the consolidated financial statements, the following designations are made at the beginning of month 1:

- the payable of FC50 in B is designated as a hedge of the first FC50 of the highly probable future revenues in A. Therefore, at the end of month 1, the following entry is made in the consolidated financial statements: Dr Payables Rs. 5; Cr Hedging Reserve Account Rs. 5.

- the receivable of FC100 in A is designated as a hedge of the first FC100 of the highly probable future expenses in B. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Hedging Reserve Account Rs. 10; Cr Receivables Rs. 10; and at the end of month 2, Dr Inventory Rs. 10; Cr Hedging Reserve Account Rs. 10.

- the external forward contract on FC250 in TC is designated as a hedge of the next FC250 of highly probable future expenses in B. Therefore, at the end of month 1, the following entry is made in the consolidated financial statements: Dr Hedging Reserve Account Rs. 25; Cr External forward contract Rs. 25; and at the end of month 2, Dr Inventory Rs. 25; Cr Hedging Reserve Account Rs. 25.

The total net balances after elimination of the accounting entries relating to the internal derivatives are as follows:

	Debit	Credit
Receivables	-	Rs. 10
Payables	Rs. 5	-
Forward contract	-	Rs. 25
Hedging Reserve Account	-	Rs. 5
Basis adjustment (inventory)	Rs. 35	-
Gains and losses	-	-
Internal contracts	-	-

These total net balances are different from those that would be recognised if the internal derivatives were not eliminated, and it is these net balances that AS 30 requires to be included in the consolidated financial statements. The accounting entries required to adjust the total net balances before elimination of the internal derivatives are as follows:

(a) to reclassify Rs. 15 of the loss on B's internal derivative that is included in inventory to reflect that FC150 of the forecast purchase of inventory is not hedged by an external instrument (neither the external forward contract of FC250 in TC nor the external payable of FC100 in A); and

(b) to reclassify the gain of Rs. 15 on A's internal derivative to reflect that the forecast revenues of FC150 to which it relates is not hedged by an external instrument.

The net effect of these two adjustments is as follows:

Dr	Hedging Reserve Account	Rs. 15	
	Cr Inventory		Rs. 15

F.1.8 Combination of written and purchased options

In most cases, Appendix A paragraph A114 of AS 30 prohibits the use of written options as hedging instruments. If a combination of a written option and purchased option (such as an interest rate collar) is transacted as a single instrument with one counterparty, can an entity split the derivative instrument into its written option component and purchased option component and designate the purchased option component as a hedging instrument?

No. Paragraph 83 of AS 30 specifies that a hedging relationship is designated by an entity for a hedging instrument in its entirety. The only exceptions permitted are splitting the time value and intrinsic value of an option and splitting the interest element and spot price on a forward. Question F.1.3 addresses the issue of whether and when a combination of options is considered as a written option.

F.1.9 Delta-neutral hedging strategy

Does AS 30 permit an entity to apply hedge accounting for a 'delta-neutral' hedging strategy and other dynamic hedging strategies under which the quantity of the hedging instrument is constantly adjusted in order to maintain a desired hedge ratio, for example, to achieve a delta-neutral position insensitive to changes in the fair value of the hedged item?

Yes. Paragraph 83 of AS 30 states that "a dynamic hedging strategy that assesses both the intrinsic value and time value of an option contract can qualify for hedge accounting". For example, a portfolio insurance strategy that seeks to ensure that the fair value of the hedged item does not drop below a certain level, while allowing the fair value to increase, may qualify for hedge accounting.

To qualify for hedge accounting, the entity must document how it will monitor and update the hedge and measure hedge effectiveness, be able to track properly all terminations and redesignations of the hedging instrument, and demonstrate that all other criteria for hedge accounting in paragraph 98 of AS 30 are met. Also, it must be able to demonstrate an expectation that the hedge will be highly effective for a specified short period of time during which the hedge is not expected to be adjusted.

F.1.10 Hedging instrument: out of the money put option

Entity A has an investment in one share of Entity B, which it has classified as available for sale. To give itself partial protection against decreases in the share price of Entity B, Entity A acquires a put option on one share of Entity B and designates the change in the intrinsic value of the put as a hedging instrument in a fair value hedge of changes in the fair value of its share in Entity B. The put gives Entity A the right to sell one share of Entity B at a strike price of Rs. 90. At the inception of the hedging relationship, the share has a quoted price of Rs. 100. Since the put option gives Entity A the right to dispose of the share at a price of Rs. 90, the put should normally be fully effective in offsetting price declines below Rs. 90 on an intrinsic value basis. Price changes above Rs. 90 are not hedged. In this case, are changes in the fair value of the share of Entity B for prices above Rs. 90 regarded as hedge ineffectiveness under paragraph 98 of AS 30 and recognised in the statement of profit and loss under paragraph 99 of AS 30?

No. Paragraph 83 of AS 30 permits Entity A to designate changes in the intrinsic value of the option as the hedging instrument. The changes in the intrinsic value of the option provide protection against the risk of variability in the fair value of one share of Entity B below or equal to the strike price of the put of Rs. 90. For prices above Rs. 90, the option is out of the money and has no intrinsic value. Accordingly, gains and losses on one share of Entity B for prices above Rs. 90 are not attributable to the hedged risk for the purposes of assessing hedge effectiveness and recognising gains and losses on the hedged item.

Therefore, Entity A reports changes in the fair value of the share in the Investment Revaluation Reserve Account if it is associated with variation in its price above Rs. 90 (paragraphs 61 and 101 of AS 30). Changes in the fair value of the share associated with price declines below Rs. 90 form part of the designated fair value hedge and are recognised in the statement of profit and loss under paragraph 99(b) of AS 30. Assuming the hedge is effective, those changes are offset by changes in the intrinsic value of the put, which are also recognised in the statement of profit and loss (paragraph 99(a) of AS 30). Changes in the time value of the put are excluded from the designated hedging relationship and recognised in the statement of profit and loss under paragraph 61(a) of AS 30.

F.1.11 Hedging instrument: proportion of the cash flows of a cash instrument

In the case of foreign exchange risk, a non-derivative financial asset or non-derivative financial liability can potentially qualify as a hedging instrument. Can an entity treat the cash flows for specified periods during which a financial asset or financial liability that is designated as a hedging instrument remains outstanding as a proportion of the hedging instrument under paragraph 84 of AS 30, and exclude the other cash flows from the designated hedging relationship?

No. Paragraph 84 of AS 30 indicates that a hedging relationship may not be designated for only a portion of the time period in which the hedging instrument is outstanding. For example, the cash flows during the first three years of a ten-year borrowing denominated in a foreign currency cannot qualify as a hedging instrument in a cash flow hedge of the first three years of revenue in the same foreign currency. On the other hand, a non-derivative financial asset or financial liability denominated in a foreign currency may potentially qualify as a hedging instrument in a hedge of the foreign currency risk associated with a hedged item that has a remaining time period until maturity that is equal to or longer than the remaining maturity of the hedging instrument (see Question F.2.17).

F.1.12 Hedges of more than one type of risk

Issue (a) - Normally a hedging relationship is designated between an entire hedging instrument and a hedged item so that there is a single measure of fair value for the hedging instrument. Does this preclude designating a single financial instrument simultaneously as a hedging instrument in both a cash flow hedge and a fair value hedge?

No. For example, entities commonly use a combined interest rate and currency swap to convert a variable rate position in a foreign currency to a fixed rate position in the functional currency. Paragraph 85 of AS 30 allows the swap to be designated separately as a fair value hedge of the currency risk and a cash flow hedge of the interest rate risk provided the conditions in paragraph 85 of AS 30 are met.

Issue (b) - If a single financial instrument is a hedging instrument in two different hedges, is special disclosure required?

AS 32 on '*Financial Instruments: Disclosures*'[53] requires disclosures separately for designated fair value hedges, cash flow hedges and hedges of a net investment in a non-integral foreign operation. The instrument in question would be reported in the AS 32 disclosures separately for each type of hedge.

[53] AS 32 *Financial Instruments: Disclosures* has been formulated and published elsewhere in this Compendium.

F.1.13 Hedging instrument: dual foreign currency forward exchange contract

Entity A's functional currency is the Indian rupees. Entity A has a five-year floating rate US dollar liability and a ten-year fixed rate pound sterling-denominated note receivable. The principal amounts of the asset and liability when converted into the Indian rupees are the same. Entity A enters into a single foreign currency forward contract to hedge its foreign currency exposure on both instruments under which it receives US dollars and pays pounds sterling at the end of five years. If Entity A designates the forward exchange contract as a hedging instrument in a cash flow hedge against the foreign currency exposure on the principal repayments of both instruments, can it qualify for hedge accounting?

Yes. Paragraph 85 of AS 30 permits designating a single hedging instrument as a hedge of multiple types of risk if three conditions are met. In this example, the derivative hedging instrument satisfies all of these conditions, as follows:

(a) The risks hedged can be identified clearly. The risks are the exposures to changes in the exchange rates between US dollars and Indian Rupees, and Indian Rupees and pounds, respectively.

(b) The effectiveness of the hedge can be demonstrated. For the pound sterling loan, the effectiveness is measured as the degree of offset between the fair value of the principal repayment in pounds sterling and the fair value of the pound sterling payment on the forward exchange contract. For the US dollar liability, the effectiveness is measured as the degree of offset between the fair value of the principal repayment in US dollars and the US dollar receipt on the forward exchange contract. Even though the receivable has a ten-year life and the forward protects it for only the first five years, hedge accounting is permitted for only a portion of the exposure as described in Question F.2.17.

(c) It is possible to ensure that there is specific designation of the hedging instrument and different risk positions. The hedged exposures are identified as the principal amounts of the liability and the note receivable in their respective currency of denomination.

F.1.14 Concurrent offsetting swaps and use of one as a hedging instrument

Entity A enters into an interest rate swap and designates it as a hedge of the fair value exposure associated with fixed rate debt. The fair value hedge meets the hedge accounting criteria of AS 30. Entity A simultaneously enters into a second interest rate swap with the same swap counterparty that has terms that fully offset the first interest rate swap. Is Entity A required to view the two swaps as one unit and therefore precluded from applying fair value hedge accounting to the first swap?

It depends. AS 30 is transaction-based. If the second swap was not entered into in contemplation of the first swap or there is a substantive business purpose for structuring the transactions separately, then the swaps are not viewed as one unit.

For example, some entities have a policy that requires a centralised dealer or treasury subsidiary to enter into third-party derivative contracts on behalf of other subsidiaries within the organisation to hedge the subsidiaries' interest rate risk exposures. The dealer or treasury subsidiary also enters into internal derivative transactions with those subsidiaries in order to track those hedges operationally within the organisation. Because the dealer or treasury subsidiary also enters into derivative contracts as part of its trading operations, or because it may wish to rebalance the risk of its overall portfolio, it may enter into a derivative contract with the same third party during the same business day that has substantially the same terms as a contract entered into as a hedging instrument on behalf of another subsidiary. In this case, there is a valid business purpose for entering into each contract.

Judgement is applied to determine whether there is a substantive business purpose for structuring the transactions separately. For example, if the sole purpose is to obtain fair value accounting treatment for the debt, there is no substantive business purpose.

F.2 Hedged Items

F.2.1 Whether a derivative can be designated as a hedged item

Does AS 30 permit designating a derivative instrument (whether a stand-alone or separately recognised embedded derivative) as a hedged item either individually or as part of a hedged group in a fair value or cash flow hedge, for example, by designating a pay-variable, receive-fixed Forward Rate Agreement (FRA) as a cash flow hedge of a pay-fixed, receive-variable FRA?

No. Derivative instruments are always deemed held for trading and measured at fair value with gains and losses recognised in the statement of profit and loss unless they are designated and effective hedging instruments (paragraph 8.17 of AS 30). As an exception, Appendix A paragraph A114 of AS 30 permits the designation of a purchased option as the hedged item in a fair value hedge.

F.2.2 Cash flow hedge: anticipated issue of fixed rate debt

Is hedge accounting allowed for a hedge of an anticipated issue of fixed rate debt?

Yes. This would be a cash flow hedge of a highly probable forecast transaction that will affect profit or loss (paragraph 96 of AS 30) provided that the conditions in paragraph 98 of AS 30 are met.

To illustrate: Entity R periodically issues new bonds to refinance maturing bonds, provide working capital and for various other purposes. When Entity R decides it will be issuing bonds, it may hedge the risk of changes in the long-term interest rate from the date it decides to issue the bonds to the date the bonds are issued. If long-term interest rates go up, the bond will be issued either at a higher rate or with a higher discount or smaller premium than was originally expected. The higher rate being paid or decrease in proceeds is normally offset by the gain on the hedge. If long-term interest rates go down, the bond will be issued either at a lower rate or with a higher premium or a smaller discount than was originally expected. The lower rate being paid or increase in proceeds is normally offset by the loss on the hedge.

For example, in August 20x6 Entity R decided it would issue Rs. 200 million seven-year bonds in January 20x7. Entity R performed historical correlation studies and determined that a seven-year treasury bond adequately correlates to the bonds Entity R expected to issue, assuming a hedge ratio of 0.93 futures contracts to one debt unit. Therefore, Entity R hedged the anticipated issue of the bonds by selling (shorting) Rs. 186 million worth of futures on seven-year treasury bonds. From August 20x6 to January 20x7 interest rates increased. The short futures positions were closed in January 20x7, the date the bonds were issued, and resulted in a Rs. 1.2 million gain that will offset the increased interest payments on the bonds and, therefore, will affect profit or loss over the life of the bonds. The hedge qualifies as a cash flow hedge of the interest rate risk on the forecast issue of debt.

F.2.3 Hedge accounting: core deposit intangibles

Is hedge accounting treatment permitted for a hedge of the fair value exposure of core deposit intangibles (i.e., value of long-term relationships with depositors)?

It depends on whether the core deposit intangible is generated internally or acquired (*e.g.*, as part of a business combination).

Internally generated core deposit intangibles are not recognised as intangible assets under AS 26. Because they are not recognised, they cannot be designated as a hedged item.

If a core deposit intangible is acquired together with a related portfolio of deposits, the core deposit intangible is required to be recognised separately as an intangible asset (or as part of the related acquired portfolio of deposits) if it meets the recognition criteria in paragraph 20 of AS 26, *Intangible Assets*. A recognised core deposit intangible asset could be designated as a hedged item, but only if it meets the conditions in paragraph 98 of AS 30, including the requirement in paragraph 98(d) of AS 30 that the effectiveness of the hedge can be measured reliably. Because it is often difficult to measure reliably the fair value of a core deposit intangible asset on initial recognition, it is unlikely that the requirement in paragraph 98(d) of AS 30 will be met.

F.2.4 Hedge accounting: hedging of future foreign currency revenue streams

Is hedge accounting permitted for a currency borrowing that hedges an expected but not contractual revenue stream in foreign currency?

Yes, if the revenues are highly probable. Under paragraph 96(b) of AS 30 a hedge of an anticipated sale may qualify as a cash flow hedge. For example, an airline entity may use sophisticated models based on experience and economic data to project its revenues in various currencies. If it can demonstrate that forecast revenues for a period of time into the future in a particular currency are "highly probable", as required by paragraph 98 of AS 30, it may designate a currency borrowing as a cash flow hedge of the future revenue stream. The portion of the gain or loss on the borrowing that is determined to be an effective hedge is recognised directly in the appropriate equity account until the revenues occur.

It is unlikely that an entity can reliably predict 100 per cent of revenues for a future year. On the other hand, it is possible that a portion of predicted revenues, normally those expected in the short term, will meet the "highly probable" criterion.

F.2.5 Cash flow hedges: 'all in one' hedge

If a derivative instrument is expected to be settled gross by delivery of the underlying asset in exchange for the payment of a fixed price, can the derivative instrument be designated as the hedging instrument in a cash flow hedge of that gross settlement assuming the other cash flow hedge accounting criteria are met?

Yes. A derivative instrument that will be settled gross can be designated as the hedging instrument in a cash flow hedge of the variability of the consideration to be paid or received in the future transaction that will occur on gross settlement of the derivative contract itself because there would be an exposure to variability in the purchase or sale price without the derivative. This applies to all fixed price contracts that are accounted for as derivatives under AS 30.

For example, if an entity enters into a fixed price contract to sell a commodity and that contract is accounted for as a derivative under AS 30 (for example, because the entity has a practice of settling such contracts net in cash or of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin), the entity may designate the fixed price contract as a cash flow hedge of the variability of the consideration to be received on the sale of the asset (a future transaction) even though the fixed price contract is the contract under which the asset will be sold. Also, if an entity enters into a forward contract to purchase a debt instrument that will be settled by delivery, but the forward contract is a derivative because its term exceeds the regular way delivery period in the marketplace, the entity may designate the forward as a cash flow hedge of the variability of the consideration to be paid to acquire the debt instrument (a future transaction), even though the derivative is the contract under which the debt instrument will be acquired.

F.2.6 Hedge relationships: entity-wide risk

An entity has a fixed rate asset and a fixed rate liability, each having the same principal amount. Under the terms of the instruments, interest payments on the asset and liability occur in the same period and the net cash flow is always positive because the interest rate on the asset exceeds the interest rate on the liability. The entity enters into an interest rate swap to receive a floating interest rate and pay a fixed interest rate on a notional amount equal to the principal of the asset and designates the interest rate swap as a fair value hedge of the fixed rate asset. Does the hedging relationship qualify for hedge accounting even though the effect of the interest rate swap on an entity-wide basis is to create an exposure to interest rate changes that did not previously exist?

Yes. AS 30 does not require risk reduction on an entity-wide basis as a condition for hedge accounting. Exposure is assessed on a transaction basis and, in this instance, the asset being hedged has a fair value exposure to interest rate increases that is offset by the interest rate swap.

F.2.7 Cash flow hedge: forecast transaction related to an entity's equity

Can a forecast dividend payments to shareholders be designated as a hedged item in a cash flow hedge?

No. To qualify as a hedged item, the forecast transaction must expose the entity to a particular risk that can affect profit or loss (paragraph 96 of AS 30). The classification of financial instruments as liabilities or equity generally provides the basis for determining whether transactions or other payments relating to such instruments are recognised as expense or income in the statement of profit and loss or are recognised directly in the revenue reserves and surplus (AS 31). For example, distributions to holders of an equity instrument are recognised by the issuer directly in the revenue reserves and surplus (paragraph 64 of AS 31). Therefore, such distributions cannot be designated as a hedged item. However, a declared dividend that has not yet been paid and is recognised as a financial liability may qualify as a hedged item, for example, for foreign currency risk if it is denominated in a foreign currency.

F.2.8 Hedge accounting: risk of a transaction not occurring

Does AS 30 permit an entity to apply hedge accounting to a hedge of the risk that a transaction will not occur, for example, if that would result in less revenue to the entity than expected?

No. The risk that a transaction will not occur is an overall business risk that is not eligible as a hedged item. Hedge accounting is permitted only for risks associated with recognised assets and liabilities, firm commitments, highly probable forecast transactions and net investments in foreign operations (paragraph 96 of AS 30).

F.2.9 Held-to-maturity investments: hedging variable interest rate payments

Can an entity designate a pay-variable, receive-fixed interest rate swap as a cash flow hedge of a variable rate, held-to-maturity investment?

No. It is inconsistent with the designation of a debt investment as being held-to-maturity to designate a swap as a cash flow hedge of the debt investment's variable interest rate payments. Paragraph 88 of AS 30 states that a held-to-maturity investment cannot be a hedged item with respect to interest rate risk or prepayment risk "because designation of an investment as held-to-maturity requires an intention to hold the investment until maturity without regard to changes in the fair value or cash flows of such an investment attributable to changes in interest rates".

F.2.10 Hedged items: purchase of held-to-maturity investment

An entity forecasts the purchase of a financial asset that it intends to classify as held-to-maturity when the forecast transaction occurs. It enters into a derivative contract with the intent to lock in the current interest rate and designates the derivative as a hedge of the forecast purchase of the financial asset. Can the hedging relationship qualify for cash flow hedge accounting even though the asset will be classified as a held-to-maturity investment?

Yes. With respect to interest rate risk, AS 30 prohibits hedge accounting for financial assets that are classified as held-to-maturity (paragraph 88 of AS 30). However, even though the entity intends to classify the asset as held-to-maturity, the instrument is not classified as such until the transaction occurs.

F.2.11 Cash flow hedges: reinvestment of funds obtained from held-to-maturity investments

An entity owns a variable rate asset that it has classified as held-to-maturity. It enters into a derivative contract with the intention to lock in the current interest rate on the reinvestment of variable rate cash flows, and designates the derivative as a cash flow hedge of the forecast future interest receipts on debt instruments resulting from the reinvestment of interest receipts on the held-to-maturity asset. Assuming that the other hedge accounting criteria are met, can the hedging relationship qualify for cash flow hedge accounting even though the interest payments that are being reinvested come from an asset that is classified as held-to-maturity?

Yes. Paragraph 88 of AS 30 states that a held-to-maturity investment cannot be a hedged item with respect to interest rate risk. Question F.2.9 specifies that this applies not only to fair value hedges (*i.e.*, hedges of the exposure to fair value interest rate risk associated with held-to-maturity investments that pay fixed interest), but also to cash flow hedges (*i.e.*, hedges of the exposure to cash flow interest rate risk associated with held-to-maturity investments that pay variable interest at current market rates). However, in this instance, the derivative is designated as an offset of the exposure to cash flow risk associated with forecast future interest receipts on debt instruments resulting from the forecast reinvestment of variable rate cash flows on the held-to-maturity investment. The source of the funds forecast to be reinvested is not relevant in determining whether the reinvestment risk can be hedged. Accordingly, designation of the derivative as a cash flow hedge is permitted. This answer applies also to a hedge of the exposure to cash flow risk associated with the forecast future interest receipts on debt instruments resulting from the reinvestment of interest receipts on a fixed rate asset classified as held to maturity.

F.2.12 Hedge accounting: prepayable financial asset

If the issuer has the right to prepay a financial asset, can the investor designate the cash flows after the prepayment date as part of the hedged item?

Cash flows after the prepayment date may be designated as the hedged item to the extent it can be demonstrated that they are "highly probable" (paragraph 98 of AS 30). For example, cash flows after the prepayment date may qualify as highly probable if they result from a group or pool of similar assets (for example, mortgage loans) for which prepayments can be estimated with a high degree of accuracy or if the prepayment option is significantly out of the money. In addition, the cash flows after the prepayment date may be designated as the hedged item if a comparable option exists in the hedging instrument.

F.2.13 Fair value hedge: risk that could affect profit or loss

Is fair value hedge accounting permitted for exposure to interest rate risk in fixed rate loans that are classified as loans and receivables?

Yes. Under AS 30, loans and receivables are carried at amortised cost. Banking institutions generally hold the bulk of their loans and receivables until maturity. Thus, changes in the fair value of such loans and receivables that are due to changes in market interest rates will not affect profit or loss. Paragraph 96 of AS 30 specifies that a fair value hedge is a hedge of the exposure to changes in fair value that is attributable to a particular risk and that can affect profit or loss. Therefore, paragraph 96 of AS 30 may appear to preclude fair value hedge accounting for loans and receivables. However, it follows from paragraph 88 of AS 30 that loans and receivables can be hedged items with respect to interest rate risk since they are not designated as held-to-maturity investments. The entity could sell them and the change in fair values would affect profit or loss. Thus, fair value hedge accounting is permitted for loans and receivables.

F.2.14 Intragroup and intra-entity hedging transactions

An Australian entity, whose functional currency is the Australian dollar, has forecast purchases in Japanese yen that are highly probable. The Australian entity is wholly owned by an Indian entity, which prepares consolidated financial statements (which include the Australian subsidiary) in Indian Rupees. The Indian parent entity enters into a forward contract to hedge the change in yen relative to the Australian dollar. Can that hedge qualify for hedge accounting in the consolidated financial statements, or must the Australian subsidiary that has the foreign currency exposure be a party to the hedging transaction?

Yes. The hedge can qualify for hedge accounting provided the other hedge accounting criteria in AS 30 are met. Since the Australian entity did not hedge the foreign currency exchange risk associated with the forecast purchases in yen, the effects of exchange rate changes between the Australian dollar and the yen will affect the Australian entity's statement of profit and loss and, therefore, would also affect consolidated statement of profit and loss. AS 30 does not require that the operating unit that is exposed to the risk being hedged be a party to the hedging instrument.

F.2.15 Internal contracts: single offsetting external derivative

An entity uses what it describes as internal derivative contracts to document the transfer of responsibility for interest rate risk exposures from individual divisions to a central treasury function. The central treasury function aggregates the internal derivative contracts and enters into a single external derivative contract that offsets the internal derivative contracts on a net basis. For example, if the central treasury function has entered into three internal receive-fixed, pay-variable interest rate swaps that lay off the exposure to variable interest cash flows on variable rate liabilities in other divisions and one internal receive-variable, pay-fixed interest rate swap that lays off the exposure to variable interest cash flows on variable rate assets in another division, it would enter into an interest rate swap with an external counterparty that exactly offsets the four internal swaps. Assuming that the hedge accounting criteria are met, in the entity's financial statements would the single offsetting external derivative qualify as a hedging instrument in a hedge of a part of the underlying items on a gross basis?

Yes, but only to the extent the external derivative is designated as an offset of cash inflows or cash outflows on a gross basis. Paragraph 94 of AS 30 indicates that a hedge of an overall net position does not qualify for hedge accounting. However, it does permit designating a part of the underlying items as the hedged position on a gross basis. Therefore, even though the purpose of entering into the external derivative was to offset internal derivative contracts on a net basis, hedge accounting is permitted if the hedging relationship is defined and documented as a hedge of a part of the underlying cash inflows or cash outflows on a gross basis. An entity follows the approach outlined in paragraph 94 and Appendix A paragraph A125 of AS 30 to designate part of the underlying cash flows as the hedged position.

F.2.16 Internal contracts: external derivative contracts that are settled net

Issue (a) - An entity uses internal derivative contracts to transfer interest rate risk exposures from individual divisions to a central treasury function. For each internal derivative contract, the central treasury function enters into a derivative contract with a single external counterparty that offsets the internal derivative contract. For example, if the central treasury function has entered into a receive-5 per cent-fixed, pay-LIBOR interest rate swap with another division that has entered into the internal contract with central treasury to hedge the exposure to variability in interest cash flows on a pay-LIBOR borrowing, central treasury would enter into a pay-5 per cent-fixed, receive-LIBOR interest rate swap on the same principal terms with the external counterparty. Although each of the external derivative contracts is formally documented as a separate contract, only the net of the payments on all of the external derivative contracts is settled since there is a netting agreement with the external counterparty. Assuming that the other hedge accounting criteria are met, can the individual external derivative contracts, such as the pay-5 per cent-fixed, receive- LIBOR interest rate swap above, be designated as hedging instruments of underlying gross exposures, such as the exposure to changes in variable interest payments on the pay-LIBOR borrowing above, even though the external derivatives are settled on a net basis?

Generally, yes. External derivative contracts that are legally separate contracts and serve a valid business purpose, such as laying off risk exposures on a gross basis, qualify as hedging instruments even if those external contracts are settled on a net basis with the same external counterparty, provided the hedge accounting criteria in AS 30 are met. See also Question F.1.14.

Issue (b) - Treasury observes that by entering into the external offsetting contracts and including them in the centralised portfolio, it is no longer able to evaluate the exposures on a net basis. Treasury wishes to manage the portfolio of offsetting external derivatives separately from other exposures of the entity. Therefore, it enters into an additional, single derivative to offset the risk of the portfolio. Can the individual external derivative contracts in the portfolio still be designated as hedging instruments of underlying gross exposures even though a single external derivative is used to offset fully the market exposure created by entering into the external contracts?

Generally, yes. The purpose of structuring the external derivative contracts in this manner is consistent with the entity's risk management objectives and strategies. As indicated above, external derivative contracts that are legally separate contracts and serve a valid business purpose qualify as hedging instruments. Moreover, the answer to Question F.1.14 specifies that hedge accounting is not precluded simply because the entity has entered into a swap that mirrors exactly the terms of another swap with the same counterparty if there is a substantive business purpose for structuring the transactions separately.

F.2.17 Partial term hedging

Paragraph 84 of AS 30 indicates that a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding. Is it permitted to designate a derivative as hedging only a portion of the time period to maturity of a hedged item?

Yes. A financial instrument may be a hedged item for only a portion of its cash flows or fair value, if effectiveness can be measured and the other hedge accounting criteria are met.

To illustrate: Entity A acquires a 10 per cent fixed rate government bond with a remaining term to maturity of ten years. Entity A classifies the bond as available for sale. To hedge itself against fair value exposure on the bond associated with the present value of the interest rate payments until year 5, Entity A acquires a five-year pay-fixed, receive-floating swap. The swap may be designated as hedging the fair value exposure of the interest rate payments on the government bond until year 5 and the change in value of the principal payment due at maturity to the extent affected by changes in the yield curve relating to the five years of the swap.

F.2.18 Hedging instrument: cross-currency interest rate swap

Entity A's functional currency is the Indian Rupee. Entity A has a five-year floating rate US dollar liability and a 10-year fixed rate pound sterling-denominated note receivable. Entity A wishes to hedge the foreign currency exposure on its asset and liability and the fair value interest rate exposure on the receivable and enters into a matching cross-currency interest rate swap to receive floating rate US dollars and pay fixed rate pounds sterling and to exchange the dollars for the pounds at the end of five years. Can Entity A designate the swap as a hedging instrument in a fair value hedge against both foreign currency risk and interest rate risk, although both the pound sterling and US dollar are foreign currencies to Entity A?

Yes. Paragraph 90 of AS 30 permits hedge accounting for components of risk, if effectiveness can be measured. Also, paragraph 85 of AS 30 permits designating a single hedging instrument as a hedge of more than one type of risk if the risks can be identified clearly, effectiveness can be demonstrated, and specific designation of the hedging instrument and different risk positions can be ensured. Therefore, the swap may be designated as a hedging instrument in a fair value hedge of the pound sterling receivable against exposure to changes in its fair value associated with changes in UK interest rates for the initial partial term of five years and the exchange rate between pounds and US dollars. The swap is measured at fair value with changes in fair value recognised in the statement of profit and loss. The carrying amount of the receivable is adjusted for changes in its fair value caused by changes in UK interest rates for the first five-year portion of the yield curve. The receivable and payable are remeasured using spot exchange rates under AS 11 and the changes to their carrying amounts recognised in the statement of profit and loss.

F.2.19 Hedged items: hedge of foreign currency risk of publicly traded shares

Entity A acquires shares in Entity B on a US stock exchange for their fair value of US Dollar (USD) 1,000. It classifies the shares as available for sale. To protect itself from the exposure to changes in the foreign exchange rate associated with the shares, it enters into a forward contract to sell USD 750. Entity A intends to roll over the forward exchange contract for as long as it retains the shares. Assuming that the other hedge accounting criteria are met, could the forward exchange contract qualify as a hedge of the foreign exchange risk associated with the shares?

Yes, but only if there is a clear and identifiable exposure to changes in foreign exchange rates. Therefore, hedge accounting is permitted if (a) the equity instrument is not traded on an exchange (or in another established marketplace) where trades are denominated in the same currency as the functional currency of Entity A and (b) dividends to Entity A are not denominated in that currency. Thus, if a share is traded in multiple currencies and one of those currencies is the functional currency of the reporting entity, hedge accounting for the foreign currency component of the share price is not permitted.

If so, could the forward exchange contract be designated as a hedging instrument in a hedge of the foreign exchange risk associated with the portion of the fair value of the shares up to USD 750 in foreign currency?

Yes. AS 30 permits designating a portion of the cash flow or fair value of a financial asset as the hedged item if effectiveness can be measured (paragraph 90 of AS 30). Therefore, Entity A may designate the forward exchange contract as a hedge of the foreign exchange risk associated with only a portion of the fair value of the shares in foreign currency. It could either be designated as a fair value hedge of the foreign exchange exposure of USD 750 associated with the shares or as a cash flow hedge of a forecast sale of the shares, provided the timing of the sale is identified. Any variability in the fair value of the shares in foreign currency would not affect the assessment of hedge effectiveness unless the fair value of the shares in foreign currency was to fall below USD 750.

F.2.20 Hedge accounting: stock index

An entity may acquire a portfolio of shares to replicate a stock index and a put option on the index to protect itself from fair value losses. Does AS 30 permit designating the put on the stock index as a hedging instrument in a hedge of the portfolio of shares?

No. If similar financial instruments are aggregated and hedged as a group, paragraph 93 of AS 30 states that the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group. In the scenario above, the change in the fair value attributable to the hedged risk for each individual item in the group (individual share prices) is not expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group.

F.2.21 Hedge accounting: netting of assets and liabilities

Can an entity group financial assets together with financial liabilities for the purpose of determining the net cash flow exposure to be hedged for hedge accounting purposes?

An entity's hedging strategy and risk management practices may assess cash flow risk on a net basis but paragraph 94 of AS 30 does not permit designating a net cash flow exposure as a hedged item for hedge accounting purposes. Appendix A paragraph A125 of AS 30 provides an example of how a bank might assess its risk on a net basis (with similar assets and liabilities grouped together) and then qualify for hedge accounting by hedging on a gross basis.

F.3 Hedge Accounting

F.3.1 Cash flow hedge: fixed interest rate cash flows

An entity issues a fixed rate debt instrument and enters into a receive-fixed, pay-variable interest rate swap to offset the exposure to interest rate risk associated with the debt instrument. Can the entity designate the swap as a cash flow hedge of the future interest cash outflows associated with the debt instrument?

No. Paragraph 96(b) of AS 30 states that a cash flow hedge is "a hedge of the exposure to variability in cash flows". In this case, the issued debt instrument does not give rise to any exposure to variability in cash flows since the interest payments are fixed. The entity may designate the swap as a fair value hedge of the debt instrument, but it cannot designate the swap as a cash flow hedge of the future cash outflows of the debt instrument.

F.3.2 Cash flow hedge: reinvestment of fixed interest rate cash flows

An entity manages interest rate risk on a net basis. On 1 January 20x7, it forecasts aggregate cash inflows of Rs. 100 on fixed rate assets and aggregate cash outflows of Rs. 90 on fixed rate liabilities in the first quarter of 20x8. For risk management purposes it uses a receive-variable, pay-fixed Forward Rate Agreement (FRA) to hedge the forecast net cash inflow of Rs. 10. The entity designates as the hedged item the first Rs. 10 of cash inflows on fixed rate assets in the first quarter of 20x8. Can it designate the receive-variable, pay-fixed FRA as a cash flow hedge of the exposure to variability to cash flows in the first quarter of 20x8 associated with the fixed rate assets?

No. The FRA does not qualify as a cash flow hedge of the cash flow relating to the fixed rate assets because they do not have a cash flow exposure. The entity could, however, designate the FRA as a hedge of the fair value exposure that exists before the cash flows are remitted.

In some cases, the entity could also hedge the interest rate exposure associated with the forecast reinvestment of the interest and principal it receives on fixed rate assets (see Question F.6.2). However, in this example, the FRA does not qualify for cash flow hedge accounting because it increases rather than reduces the variability of interest cash flows resulting from the reinvestment of interest cash flows (for example, if market rates increase, there will be a cash inflow on the FRA and an increase in the expected interest cash inflows resulting from the reinvestment of interest cash inflows on fixed rate assets). However, potentially it could qualify as a cash flow hedge of a portion of the refinancing of cash outflows on a gross basis.

F.3.3 Foreign currency hedge

Entity A has a foreign currency liability payable in six months' time and it wishes to hedge the amount payable on settlement against foreign currency fluctuations. To that end, it takes out a forward contract to buy the foreign currency in six months' time. Should the hedge be treated as:

(a) a fair value hedge of the foreign currency liability with gains and losses on revaluing the liability and the forward contract at the year-end both recognized in the statement of profit and loss; or

(b) a cash flow hedge of the amount to be settled in the future with gains and losses on revaluing the forward contract recognised in the Hedging Reserve Account?

AS 30 does not preclude either of these two methods. If the hedge is treated as a fair value hedge, the gain or loss on the fair value remeasurement of the hedging instrument and the gain or loss on the fair value remeasurement of the hedged item for the hedged risk are recognised immediately in the statement of profit and loss. If the hedge is treated as a cash flow hedge with the gain or loss on remeasuring the forward contract recognised in the Hedging Reserve Account, that amount is recognised in the statement of profit and loss in the same period or periods during which the hedged item (the liability) affects profit or loss, *i.e.*, when the liability is remeasured for changes in foreign exchange rates. Therefore, if the hedge is effective, the gain or loss on the derivative is released to the statement of profit and loss in the same periods during which the liability is remeasured, not when the payment occurs. See Question F.3.4.

F.3.4 Foreign currency cash flow hedge

An entity exports a product at a price denominated in a foreign currency. At the date of the sale, the entity obtains a receivable for the sale price payable in 90 days and takes out a 90-day forward exchange contract in the same currency as the receivable to hedge its foreign currency exposure.

Under AS 11, the sale is recorded at the spot rate at the date of sale, and the receivable is restated during the 90-day period for changes in exchange rates with the difference being taken to the statement of profit and loss.

If the foreign exchange contract is designated as a hedging instrument, does the entity have a choice whether to designate the foreign exchange contract as a fair value hedge of the foreign currency exposure of the receivable or as a cash flow hedge of the collection of the receivable?

Yes. If the entity designates the foreign exchange contract as a fair value hedge, the gain or loss from remeasuring the forward exchange contract at fair value is recognised immediately in the statement of profit and loss and the gain or loss on remeasuring the receivable is also recognised in the statement of profit and loss.

If the entity designates the foreign exchange contract as a cash flow hedge of the foreign currency risk associated with the collection of the receivable, the portion of the gain or loss that is determined to be an effective hedge is recognised directly in the Hedging Reserve Account, and the ineffective portion in the statement of profit and loss (paragraph 106 of AS 30). The amount recognised directly in the Hedging Reserve Account is transferred to the statement of profit and loss in the same period or periods during which changes in the measurement of the receivable affect profit or loss (paragraph 111 of AS 30).

F.3.5 Fair value hedge: variable rate debt instrument

Does AS 30 permit an entity to designate a portion of the risk exposure of a variable rate debt instrument as a hedged item in a fair value hedge?

Yes. A variable rate debt instrument may have an exposure to changes in its fair value due to credit risk. It may also have an exposure to changes in its fair value relating to movements in the market interest rate in the periods between which the variable interest rate on the debt instrument is reset. For example, if the debt instrument provides for annual interest payments reset to the market rate each year, a portion of the debt instrument has an exposure to changes in fair value during the year.

F.3.6 Fair value hedge: inventory

Paragraph 96(a) of AS 30 states that a fair value hedge is "a hedge of the exposure to changes in fair value of a recognised asset or liability ... that is attributable to a particular risk and could affect profit or loss". Can an entity designate inventories, such as copper inventory, as the hedged item in a fair value hedge of the exposure to changes in the price of the inventories, such as the copper price, although inventories are measured at the lower of cost and net realisable value under AS 2, *Valuation of Inventories*?

Yes. The inventories may be hedged for changes in fair value due to changes in the copper price because the change in fair value of inventories will affect profit or loss when the inventories are sold or their carrying amount is written down. The adjusted carrying amount becomes the cost basis for the purpose of applying the lower of cost and net realisable value test under AS 2. The hedging instrument used in a fair value hedge of inventories may alternatively qualify as a cash flow hedge of the future sale of the inventory.

F.3.7 Hedge accounting: forecast transaction

For cash flow hedges, a forecast transaction that is subject to a hedge must be "highly probable". How should the term "highly probable" be interpreted?

The term "highly probable" indicates a much greater likelihood of happening than the term "more likely than not". An assessment of the likelihood that a forecast transaction will take place is not based solely on management's intentions because intentions are not verifiable. A transaction's probability should be supported by observable facts and the attendant circumstances.

In assessing the likelihood that a transaction will occur, an entity should consider the following circumstances:

(a) the frequency of similar past transactions;

(b) the financial and operational ability of the entity to carry out the transaction;

(c) substantial commitments of resources to a particular activity (for example, a manufacturing facility that can be used in the short run only to process a particular type of commodity);

(d) the extent of loss or disruption of operations that could result if the transaction does not occur;

(e) the likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose (for example, an entity that intends to raise cash may have several ways of doing so, ranging from a short-term bank loan to an offering of equity shares); and

(f) the entity's business plan.

The length of time until a forecast transaction is projected to occur is also a factor in determining probability. Other factors being equal, the more distant a forecast transaction is, the less likely it is that the transaction would be regarded as highly probable and the stronger the evidence that would be needed to support an assertion that it is highly probable.

For example, a transaction forecast to occur in five years may be less likely to occur than a transaction forecast to occur in one year. However, forecast interest payments for the next 20 years on variable rate debt would typically be highly probable if supported by an existing contractual obligation.

In addition, other factors being equal, the greater the physical quantity or future value of a forecast transaction in proportion to the entity's transactions of the same nature, the less likely it is that the transaction would be regarded as highly probable and the stronger the evidence that would be required to support an assertion that it is highly probable. For example, less evidence generally would be needed to support forecast sales of 100,000 units in the next month than 950,000 units in that month when recent sales have averaged 950,000 units per month for the past three months.

A history of having designated hedges of forecast transactions and then determining that the forecast transactions are no longer expected to occur would call into question both an entity's ability to predict forecast transactions accurately and the propriety of using hedge accounting in the future for similar forecast transactions.

F.3.8 Retrospective designation of hedges

Does AS 30 permit an entity to designate hedge relationships retrospectively?

No. Designation of hedge relationships takes effect prospectively from the date all hedge accounting criteria in paragraph 98 of AS 30 are met. In particular, hedge accounting can be applied only from the date the entity has completed the necessary documentation of the hedge relationship, including identification of the hedging instrument, the related hedged item or transaction, the nature of the risk being hedged, and how the entity will assess hedge effectiveness.

F.3.9 Hedge accounting: designation at the inception of the hedge

Does AS 30 permit an entity to designate and formally document a derivative contract as a hedging instrument after entering into the derivative contract?

Yes, prospectively. For hedge accounting purposes, AS 30 requires a hedging instrument to be designated and formally documented as such from the inception of the hedge relationship (paragraph 98 of AS 30); in other words, a hedge relationship cannot be designated retrospectively. Also, it precludes designating a hedging relationship for only a portion of the time period during which the hedging instrument remains outstanding (paragraph 84 of AS 30). However, it does not require the hedging instrument to be acquired at the inception of the hedge relationship.

F.3.10 Hedge accounting: identification of hedged forecast transaction

Can a forecast transaction be identified as the purchase or sale of the last 15,000 units of a product in a specified period or as a percentage of purchases or sales during a specified period?

No. The hedged forecast transaction must be identified and documented with sufficient specificity so that when the transaction occurs, it is clear whether the transaction is or is not the hedged transaction. Therefore, a forecast transaction may be identified as the sale of the first 15,000 units of a specific product during a specified three-month period, but it could not be identified as the last 15,000 units of that product sold during a three-month period because the last 15,000 units cannot be identified when they are sold. For the same reason, a forecast transaction cannot be specified solely as a percentage of sales or purchases during a period.

F.3.11 Cash flow hedge: documentation of timing of forecast transaction

For a hedge of a forecast transaction, should the documentation of the hedge relationship that is established at inception of the hedge identify the date on, or time period in which, the forecast transaction is expected to occur?

Yes. To qualify for hedge accounting, the hedge must relate to a specific identified and designated risk (Appendix A paragraph A135 of AS 30) and it must be possible to measure its effectiveness reliably (paragraph 98(d) of AS 30). Also, the hedged forecast transaction must be highly probable (paragraph 98(c) of AS 30). To meet these criteria, an entity is not required to predict and document the exact date a forecast transaction is expected to occur. However, it is required to identify and document the time period during which the forecast transaction is expected to occur within a reasonably specific and generally narrow range of time from a most probable date, as a basis for assessing hedge effectiveness. To determine that the hedge will be highly effective in accordance with paragraph 98(d) AS 30, it is necessary to ensure that changes in the fair value of the expected cash flows are offset by changes in the fair value of the hedging instrument and this test may be met only if the timing of the cash flows occur within close proximity to each other. If the forecast transaction is no longer expected to occur, hedge accounting is discontinued in accordance with paragraph 112(c) of AS 30.

F.4 Hedge Effectiveness

F.4.1 Hedging on an after-tax basis

Hedging is often done on an after-tax basis. Is hedge effectiveness assessed after taxes?

AS 30 permits, but does not require, assessment of hedge effectiveness on an after-tax basis. If the hedge is undertaken on an after-tax basis, it is so designated at inception as part of the formal documentation of the hedging relationship and strategy.

F.4.2 Hedge effectiveness: assessment on cumulative basis

Paragraph 98(b) of AS 30 requires that the hedge is expected to be highly effective. Should expected hedge effectiveness be assessed separately for each period or cumulatively over the life of the hedging relationship?

Expected hedge effectiveness may be assessed on a cumulative basis if the hedge is so designated, and that condition is incorporated into the appropriate hedging documentation. Therefore, even if a hedge is not expected to be highly effective in a particular period, hedge accounting is not precluded if effectiveness is expected to remain sufficiently high over the life of the hedging relationship. However, any ineffectiveness is required to be recognised in the statement of profit and loss as it occurs.

To illustrate: an entity designates a LIBOR-based interest rate swap as a hedge of a borrowing whose interest rate is a UK base rate plus a margin. The UK base rate changes, perhaps, once each quarter or less, in increments of 25-50 basis points, while LIBOR changes daily. Over a period of 1-2 years, the hedge is expected to be almost perfect. However, there will be quarters when the UK base rate does not change at all, while LIBOR has changed significantly. This would not necessarily preclude hedge accounting.

F.4.3 Hedge effectiveness: counterparty credit risk

Must an entity consider the likelihood of default by the counterparty to the hedging instrument in assessing hedge effectiveness?

Yes. An entity cannot ignore whether it will be able to collect all amounts due under the contractual provisions of the hedging instrument. When assessing hedge effectiveness, both at the inception of the hedge and on an ongoing basis, the entity considers the risk that the counterparty to the hedging instrument will default by failing to make any contractual payments to the entity. For a cash flow hedge, if it becomes probable that a counterparty will default, an entity would be unable to conclude that the hedging relationship is expected to be highly effective in achieving offsetting cash flows. As a result, hedge accounting would be discontinued. For a fair value hedge, if there is a change in the counterparty's creditworthiness, the fair value of the hedging instrument will change, which affects the assessment of whether the hedge relationship is effective and whether it qualifies for continued hedge accounting.

F.4.4 Hedge effectiveness: effectiveness tests

How should hedge effectiveness be measured for the purposes of initially qualifying for hedge accounting and for continued qualification?

AS 30 does not provide specific guidance about how effectiveness tests are performed. Appendix A paragraph A129 of AS 30 specifies that a hedge is normally regarded as highly effective only if (a) at inception and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated, and (b) the actual results are within a range of 80-125 per cent. Appendix A paragraph A129 of AS 30 also states that the expectation in (a) can be demonstrated in various ways.

The appropriateness of a given method of assessing hedge effectiveness will depend on the nature of the risk being hedged and the type of hedging instrument used. The method of assessing effectiveness must be reasonable and consistent with other similar hedges unless different methods are explicitly justified. An entity is required to document at the inception of the hedge how effectiveness will be assessed and then to apply that effectiveness test on a consistent basis for the duration of the hedge.

Several mathematical techniques can be used to measure hedge effectiveness, including ratio analysis, *i.e.*, a comparison of hedging gains and losses with the corresponding gains and losses on the hedged item at a point in time, and statistical measurement techniques such as regression analysis. If regression analysis is used, the entity's documented policies for assessing effectiveness must specify how the results of the regression will be assessed.

F.4.5 Hedge effectiveness: less than 100 per cent offset

If a cash flow hedge is regarded as highly effective because the actual risk offset is within the allowed 80-125 per cent range of deviation from full offset, is the gain or loss on the ineffective portion of the hedge recognised in the appropriate equity account?

No. Paragraph 106(a) of AS 30 indicates that only the effective portion is recognised directly in the equity account. Paragraph 106(b) of AS 30 requires the portion of the gain or loss on the hedging instrument that is determined to be an ineffective hedge to be recognised in the statement of profit and loss.

F.4.6 Assuming perfect hedge effectiveness

If the principal terms of the hedging instrument and of the entire hedged asset or liability or hedged forecast transaction are the same, can an entity assume perfect hedge effectiveness without further effectiveness testing?

No. Paragraph 98(e) of AS 30 requires an entity to assess hedges on an ongoing basis for hedge effectiveness. It cannot assume hedge effectiveness even if the principal terms of the hedging instrument and the hedged item are the same, since hedge ineffectiveness may arise because of other attributes such as the liquidity of the instruments or their credit risk (Appendix A paragraph A134 of AS 30). It may, however, designate only certain risks in an overall exposure as being hedged and thereby improve the effectiveness of the hedging relationship. For example, for a fair value hedge of a debt instrument, if the derivative hedging instrument has a credit risk that is equivalent to the AA-rate, it may designate only the risk related to AA-rated interest rate movements as being hedged, in which case changes in credit spreads generally will not affect the effectiveness of the hedge.

F.5 Cash Flow Hedges

F.5.1 Hedge accounting: non-derivative monetary asset or non-derivative monetary liability used as a hedging instrument

If an entity designates a non-derivative monetary asset as a foreign currency cash flow hedge of the repayment of the principal of a non-derivative monetary liability, would the exchange differences on the hedged item be recognised in the statement of profit and loss (AS 11) and the exchange differences on the hedging instrument be recognised in the appropriate equity account until the repayment of the liability (paragraph 106 of AS 30)?

No. Exchange differences on the monetary asset and the monetary liability are both recognised in the statement of profit and loss in the period in which they arise (AS 11). Appendix A paragraph A103 of AS 30 specifies that if there is a hedge relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in fair values of those financial instruments are recognised in the statement of profit and loss.

F.5.2 Cash flow hedges: performance of hedging instrument (1)

Entity A has a floating rate liability of Rs. 1,000 with five years remaining to maturity. It enters into a five-year pay-fixed, receive-floating interest rate swap in the same currency and with the same principal terms as the liability to hedge the exposure to variable cash flow payments on the floating rate liability attributable to interest rate risk. At inception, the fair value of the swap is zero. Subsequently, there is an increase of Rs. 49 in the fair value of the swap. This increase consists of a change of Rs. 50 resulting from an increase in

PREVIOUS HOME NEXT

market interest rates and a change of minus Rs. 1 resulting from an increase in the credit risk of the swap counterparty. There is no change in the fair value of the floating rate liability, but the fair value (present value) of the future cash flows needed to offset the exposure to variable interest cash flows on the liability increases by Rs. 50. Assuming that Entity A determines that the hedge is still highly effective, is there ineffectiveness that should be recognised in the statement of profit and loss?

No. A hedge of interest rate risk is not fully effective if part of the change in the fair value of the derivative is attributable to the counterparty's credit risk (Appendix A paragraph A134 of AS 30). However, because Entity A determines that the hedge relationship is still highly effective, it credits the effective portion of the change in fair value of the swap, *i.e.*, the net change in fair value of Rs. 49, to the appropriate equity account. There is no debit to the statement of profit and loss for the change in fair value of the swap attributable to the deterioration in the credit quality of the swap counterparty, because the cumulative change in the present value of the future cash flows needed to offset the exposure to variable interest cash flows on the hedged item, *i.e.*, Rs. 50, exceeds the cumulative change in value of the hedging instrument, i.e., Rs. 49.

Dr	Swap	Rs. 49	
	Cr Appropriate equity account		Rs. 49

If Entity A concludes that the hedge is no longer highly effective, it discontinues hedge accounting prospectively as from the date the hedge ceased to be highly effective in accordance with paragraph 112 of AS 30.

Would the answer change if the fair value of the swap instead increases to Rs. 51 of which Rs. 50 results from the increase in market interest rates and Rs. 1 from a decrease in the credit risk of the swap counterparty?

Yes. In this case, there is a credit to the statement of profit and loss of Rs. 1 for the change in fair value of the swap attributable to the improvement in the credit quality of the swap counterparty. This is because the cumulative change in the value of the hedging instrument, *i.e.*, Rs. 51, exceeds the cumulative change in the present value of the future cash flows needed to offset the exposure to variable interest cash flows on the hedged item, *i.e.*, Rs. 50. The difference of Rs. 1 represents the excess ineffectiveness attributable to the derivative hedging instrument, the swap, and is recognised in the statement of profit and loss.

Dr	Swap	Rs. 51	
	Cr Appropriate equity account		Rs. 50
	Cr Statement of profit and loss		Re. 1

F.5.3 Cash flow hedges: performance of hedging instrument (2)

On 30 September 20x7, Entity A hedges the anticipated sale of 24 tonnes of pulp on 1 March 20x8 by entering into a short forward contract on 24 tonnes of pulp. The contract requires net settlement in cash determined as the difference between the future spot price

of pulp on a specified commodity exchange and Rs. 1,000. Entity A expects to sell the pulp in a different, local market. Entity A determines that the forward contract is an effective hedge of the anticipated sale and that the other conditions for hedge accounting are met. It assesses hedge effectiveness by comparing the entire change in the fair value of the forward contract with the change in the fair value of the expected cash inflows. On 31 December, the spot price of pulp has increased both in the local market and on the exchange. The increase in the local market exceeds the increase on the exchange. As a result, the present value of the expected cash inflow from the sale on the local market is Rs. 1,100. The fair value of Entity A's forward contract is negative Rs. 80. Assuming that Entity A determines that the hedge is still highly effective, is there ineffectiveness that should be recognised in the statement of profit and loss?

No. In a cash flow hedge, ineffectiveness is not recognised in the financial statements when the cumulative change in the fair value of the hedged cash flows exceeds the cumulative change in the value of the hedging instrument. In this case, the cumulative change in the fair value of the forward contract is Rs. 80, while the fair value of the cumulative change in expected future cash flows on the hedged item is Rs. 100. Since the fair value of the cumulative change in expected future cash flows on the hedged item from the inception of the hedge exceeds the cumulative change in fair value of the hedging instrument (in absolute amounts), no portion of the gain or loss on the hedging instrument is recognised in the statement of profit and loss (paragraph 106(a) of AS 30). Because Entity A determines that the hedge relationship is still highly effective, it debits the entire change in fair value of the forward contract (Rs. 80) to the appropriate equity account.

Dr	Appropriate equity account	Rs. 80	
	Cr Forward		Rs. 80

If Entity A concludes that the hedge is no longer highly effective, it discontinues hedge accounting prospectively as from the date the hedge ceases to be highly effective in accordance with paragraph 112 of AS 30.

F.5.4 Cash flow hedges: forecast transaction occurs before the specified period

An entity designates a derivative as a hedging instrument in a cash flow hedge of a forecast transaction, such as a forecast sale of a commodity. The hedging relationship meets all the hedge accounting conditions, including the requirement to identify and document the period in which the transaction is expected to occur within a reasonably specific and narrow range of time (see Question F.2.17). If, in a subsequent period, the forecast transaction is expected to occur in an earlier period than originally anticipated, can the entity conclude that this transaction is the same as the one that was designated as being hedged?

Yes. The change in timing of the forecast transaction does not affect the validity of the designation. However, it may affect the assessment of the effectiveness of the hedging relationship. Also, the hedging instrument would need to be designated as a hedging instrument for the whole remaining period of its existence in order for it to continue to qualify as a hedging instrument (see paragraph 84 of AS 30 and Question F.2.17).

F.5.5 Cash flow hedges: measuring effectiveness for a hedge of a forecast transaction in a debt instrument

A forecast investment in an interest-earning asset or forecast issue of an interest-bearing liability creates a cash flow exposure to interest rate changes because the related interest payments will be based on the market rate that exists when the forecast transaction occurs. The objective of a cash flow hedge of the exposure to interest rate changes is to offset the effects of future changes in interest rates so as to obtain a single fixed rate, usually the rate that existed at the inception of the hedge that corresponds with the term and timing of the forecast transaction. During the period of the hedge, it is not possible to determine what the market interest rate for the forecast transaction will be at the time the hedge is terminated or when the forecast transaction occurs. In this case, how is the effectiveness of the hedge assessed and measured?

During this period, effectiveness can be measured on the basis of changes in interest rates between the designation date and the interim effectiveness measurement date. The interest rates used to make this measurement are the interest rates that correspond with the term and occurrence of the forecast transaction that existed at the inception of the hedge and that exist at the measurement date as evidenced by the term structure of interest rates.

Generally it will not be sufficient simply to compare cash flows of the hedged item with cash flows generated by the derivative hedging instrument as they are paid or received, since such an approach ignores the entity's expectations of whether the cash flows will offset in subsequent periods and whether there will be any resulting ineffectiveness.

The discussion that follows illustrates the mechanics of establishing a cash flow hedge and measuring its effectiveness. For the purpose of the illustrations, assume that an entity expects to issue a Rs. 100,000 one-year debt instrument in three months. The instrument will pay interest quarterly with principal due at maturity. The entity is exposed to interest rate increases and establishes a hedge of the interest cash flows of the debt by entering into a forward starting interest rate swap. The swap has a term of one year and will start in three months to correspond with the terms of the forecast debt issue. The entity will pay a fixed rate and receive a variable rate, and the entity designates the risk being hedged as the LIBOR-based interest component in the forecast issue of the debt.

Yield curve

The yield curve provides the foundation for computing future cash flows and the fair value of such cash flows both at the inception of, and during, the hedging relationship. It is based on current market yields on applicable reference bonds that are traded in the marketplace. Market yields are converted to spot interest rates ('spot rates' or 'zero coupon rates') by eliminating the effect of coupon payments on the market yield. Spot rates are used to discount future cash flows, such as principal and interest rate payments, to arrive at their fair value. Spot rates also are used to compute forward interest rates that are used to compute variable and estimated future cash flows. The relationship between spot rates and one-period forward rates is shown by the following formula:

Spot–forward relationship

$$F = \frac{(1 + SR_{t})^{t}}{(1 + SR_{t-1})^{t-1}} - 1$$

where F = forward rate (%)

SR = spot rate (%)

t = period in time (e.g., 1, 2, 3, 4, 5)

Also, for the purpose of this illustration, assume that the following quarterly-period term structure of interest rates using quarterly compounding exists at the inception of the hedge.

Yield curve at inception – (beginning of period 1)

Forward periods	**1**	**2**	**3**	**4**	**5**
Spot rates	3.75%	4.50%	5.50%	6.00%	6.25%
Forward rates (computed)	3.75%	5.25%	7.51%	7.50%	7.25%

The one-period forward rates are computed on the basis of spot rates for the applicable maturities. For example, the current forward rate for Period 2 calculated using the formula above is equal to $[1.0450^2 / 1.0375] – 1$ = 5.25 per cent. The current one-period forward rate for Period 2 is different from the current spot rate for Period 2, since the spot rate is an interest rate from the beginning of Period 1 (spot) to the end of Period 2, while the forward rate is an interest rate from the beginning of Period 2 to the end of Period 2.

Hedged item

In this example, the entity expects to issue a Rs. 100,000 one-year debt instrument in three months with quarterly interest payments. The entity is exposed to interest rate increases and would like to eliminate the effect on cash flows of interest rate changes that may happen before the forecast transaction takes place. If that risk is eliminated, the entity would obtain an interest rate on its debt issue that is equal to the one-year forward coupon rate currently available in the marketplace in three months. That forward coupon rate, which is different from the forward (spot) rate, is 6.86 per cent, computed from the term structure of interest rates shown above. It is the market rate of interest that exists at the inception of the hedge, given the terms of the forecast debt instrument. It results in the fair value of the debt being equal to par at its issue.

At the inception of the hedging relationship, the expected cash flows of the debt instrument can be calculated on the basis of the existing term structure of interest rates. For this purpose, it is assumed that interest rates do not change and that the debt would be issued at 6.86 per cent at the beginning of Period 2. In this case, the cash flows and fair value of the debt instrument would be as follows at the beginning of Period 2.

Issue of fixed rate debt

Beginning of period 2 - No rate changes (Spot based on forward rates)

	Total					
Original forward periods		**1**	**2**	**3**	**4**	**5**
Remaining periods			**1**	**2**	**3**	**4**
Spot rates (computed)			5.25%	6.38%	6.75%	6.88%
Forward rates			5.25%	7.51%	7.50%	7.25%
	Rs.		**Rs.**	**Rs.**	**Rs.**	**Rs.**
Cash flows:						
Fixed interest @ 6.86%			1,716	1,716	1,716	1,716
Principal						100,000
Fair value:						
Interest	6,592		1,694	1,663	1,632	1,603
Principal	93,408					93,408[54]
Total	100,000					

Since it is assumed that interest rates do not change, the fair value of the interest and principal amounts equals the par amount of the forecast transaction. The fair value amounts are computed on the basis of the spot rates that exist at the inception of the hedge for the applicable periods in which the cash flows would occur had the debt been issued at the date of the forecast transaction. They reflect the effect of discounting those cash flows on the basis of the periods that will remain after the debt instrument is issued. For example, the spot rate of 6.38 per cent is used to discount the interest cash flow that is expected to be paid in Period 3, but it is discounted for only two periods because it will occur two periods after the forecast transaction.

The forward interest rates are the same as shown previously, since it is assumed that interest rates do not change. The spot rates are different but they have not actually changed. They represent the spot rates one period forward and are based on the applicable forward rates.

Hedging instrument

The objective of the hedge is to obtain an overall interest rate on the forecast transaction and the hedging instrument that is equal to 6.86 per cent, which is the market rate at the inception of the hedge for the period from Period 2 to Period 5. This objective is accomplished by entering into a

[54] Rs. 100,000 / (1 + [0.0688 / 4])^4

forward starting interest rate swap that has a fixed rate of 6.86 per cent. Based on the term structure of interest rates that exist at the inception of the hedge, the interest rate swap will have such a rate. At the inception of the hedge, the fair value of the fixed rate payments on the interest rate swap will equal the fair value of the variable rate payments, resulting in the interest rate swap having a fair value of zero. The expected cash flows of the interest rate swap and the related fair value amounts are shown as follows.

Interest rate swap

	Total					
Original forward periods		*1*	*2*	*3*	*4*	*5*
Remaining periods			*1*	*2*	*3*	*4*
	Rs.		*Rs.*	*Rs.*	*Rs.*	*Rs.*
Cash flows:						
Fixed interest @ 6.86%			1,716	1,716	1,716	1,716
Forecast variable interest			1,313	1,877	1,876	1,813
Forecast based on forward rate			*5.25%*	*7.51%*	*7.50%*	*7.25%*
Net interest			(403)	161	160	97
Fair value:						
Discount rate (spot)			*5.25%*	*6.38%*	*6.75%*	*6.88%*
Fixed interest	6,592		1,694	1,663	1,632	1,603
Forecast variable interest	6,592		1,296	1,819	1,784	1,693
Fair value of interest rate swap	0		(398)	156	152	90

At the inception of the hedge, the fixed rate on the forward swap is equal to the fixed rate the entity would receive if it could issue the debt in three months under terms that exist today.

Measuring hedge effectiveness

If interest rates change during the period the hedge is outstanding, the effectiveness of the hedge can be measured in various ways.

Assume that interest rates change as follows immediately before the debt is issued at the beginning of Period 2.

Yield curve - Rates increase 200 basis points

Forward periods	*1*	*2*	*3*	*4*	*5*
Remaining periods		*1*	*2*	*3*	*4*
Spot rates		5.75%	6.50%	7.50%	8.00%
Forward rates		5.75%	7.25%	9.51%	9.50%

Under the new interest rate environment, the fair value of the pay-fixed at 6.86 per cent, receive-variable interest rate swap that was designated as the hedging instrument would be as follows.

Fair value of interest rate swap

	Total					
Original forward periods		*1*	*2*	*3*	*4*	*5*
Remaining periods			*1*	*2*	*3*	*4*
	Rs.	*Rs.*	*Rs.*	*Rs.*	*Rs.*	*Rs.*
Cash flows:						
Fixed interest @ 6.86%			1,716	1,716	1,716	1,716
Forecast variable interest			1,438	1,813	2,377	2,376
Forecast based on new forward rate			*5.75%*	*7.25%*	*9.51%*	*9.50%*
Net interest			(279)	97	661	660
Fair value:						
New discount rate (spot)			*5.75%*	*6.50%*	*7.50%*	*8.00%*
Fixed interest	6,562		1,692	1,662	1,623	1,585
Forecast variable interest	7,615		1,417	1,755	2,248	2,195
Fair value of net interest	1,053		(275)	93	625	610

In order to compute the effectiveness of the hedge, it is necessary to measure the change in the present value of the cash flows or the value of the hedged forecast transaction. There are at least two methods of accomplishing this measurement.

Method A – Compute change in fair value of debt

	Total					
Original forward periods		*1*	*2*	*3*	*4*	*5*
Remaining periods			*1*	*2*	*3*	*4*
	Rs.		*Rs.*	*Rs.*	*Rs.*	*Rs.*
Cash flows:						
Fixed interest @ 6.86%			1,716	1,716	1,716	1,716
Principal						100,000
Fair value:						
New discount rate (spot)			*5.75%*	*6.50%*	*7.50%*	*8.00%*
Interest	6,562		1,692	1,662	1,623	1,585
Principal	92,385					92,385[55]
Total	98,947					
Fair value at inception	100,000					
Fair value difference	(1,053)					

[55] Rs. 100,000 / (1 + [0.08 / 4])^4

Under Method A, a computation is made of the fair value in the new interest rate environment of debt that carries interest that is equal to the coupon interest rate that existed at the inception of the hedging relationship (6.86 per cent). This fair value is compared with the expected fair value as of the beginning of Period 2 that was calculated on the basis of the term structure of interest rates that existed at the inception of the hedging relationship, as illustrated above, to determine the change in the fair value. Note that the difference between the change in the fair value of the swap and the change in the expected fair value of the debt exactly offset in this example, since the terms of the swap and the forecast transaction match each other.

Method B – Compute change in fair value of cash flows

	Total					
Original forward periods		*1*	*2*	*3*	*4*	*5*
Remaining periods			*1*	*2*	*3*	*4*
Market rate at inception			6.86%	6.86%	6.86%	6.86%
Current forward rate			5.75%	7.25%	9.51%	9.50%
Rate difference			1.11%	(0.39%)	(2.64%)	(2.64%)
Cash flow difference (principal rate)			Rs. 279	(Rs. 97)	(Rs. 661)	(Rs. 660)
Discount rate (spot)			*5.75%*	*6.50%*	*7.50%*	*8.00%*
Fair value of difference	(Rs. 1,053)		Rs. 275	(Rs. 93)	(Rs. 625)	(Rs. 610)

Under Method B, the present value of the change in cash flows is computed on the basis of the difference between the forward interest rates for the applicable periods at the effectiveness measurement date and the interest rate that would have been obtained if the debt had been issued at the market rate that existed at the inception of the hedge. The market rate that existed at the inception of the hedge is the one-year forward coupon rate in three months. The present value of the change in cash flows is computed on the basis of the current spot rates that exist at the effectiveness measurement date for the applicable periods in which the cash flows are expected to occur. This method also could be referred to as the 'theoretical swap' method (or 'hypothetical derivative' method) because the comparison is between the hedged fixed rate on the debt and the current variable rate, which is the same as comparing cash flows on the fixed and variable rate legs of an interest rate swap.

As before, the difference between the change in the fair value of the swap and the change in the present value of the cash flows exactly offset in this example, since the terms match.

Other considerations

There is an additional computation that should be performed to compute ineffectiveness before the expected date of the forecast transaction that has not been considered for the purpose of this

PREVIOUS HOME NEXT

illustration. The fair value difference has been determined in each of the illustrations as of the expected date of the forecast transaction immediately before the forecast transaction, *i.e.*, at the beginning of Period 2. If the assessment of hedge effectiveness is done before the forecast transaction occurs, the difference should be discounted to the current date to arrive at the actual amount of ineffectiveness. For example, if the measurement date were one month after the hedging relationship was established and the forecast transaction is now expected to occur in two months, the amount would have to be discounted for the remaining two months before the forecast transaction is expected to occur to arrive at the actual fair value. This step would not be necessary in the examples provided above because there was no ineffectiveness. Therefore, additional discounting of the amounts, which net to zero, would not have changed the result.

Under Method B, ineffectiveness is computed on the basis of the difference between the forward coupon interest rates for the applicable periods at the effectiveness measurement date and the interest rate that would have been obtained if the debt had been issued at the market rate that existed at the inception of the hedge. Computing the change in cash flows based on the difference between the forward interest rates that existed at the inception of the hedge and the forward rates that exist at the effectiveness measurement date is inappropriate if the objective of the hedge is to establish a single fixed rate for a series of forecast interest payments. This objective is met by hedging the exposures with an interest rate swap as illustrated in the above example. The fixed interest rate on the swap is a blended interest rate composed of the forward rates over the life of the swap. Unless the yield curve is flat, the comparison between the forward interest rate exposures over the life of the swap and the fixed rate on the swap will produce different cash flows whose fair values are equal only at the inception of the hedging relationship. This difference is shown in the table below.

	Total				
Original forward periods	*1*	*2*	*3*	*4*	*5*
Remaining periods		*1*	*2*	*3*	*4*
Forward rate at inception		5.25%	7.51%	7.50%	7.25%
Current forward rate		5.75%	7.25%	9.51%	9.50%
Rate difference		(0.50%)	0.26%	(2.00%)	(2.25%)
Cash flow difference (principal rate)		(Rs. 125)	Rs. 64	(Rs. 501)	(Rs. 563)
Discount rate (spot)		5.75%	6.50%	7.50%	8.00%
Fair value of difference	(Rs. 1,055)	(Rs. 123)	Rs. 62	(Rs. 474)	(Rs. 520)
Fair value of interest rate swap	Rs. 1,053				
Ineffectiveness	(Rs. 2)				

If the objective of the hedge is to obtain the forward rates that existed at the inception of the hedge, the interest rate swap is ineffective because the swap has a single blended fixed coupon rate that does not offset a series of different forward interest rates. However, if the objective of the hedge is to obtain the forward coupon rate that existed at the inception of the hedge, the swap is effective, and the comparison based on differences in forward interest rates suggests ineffectiveness when none may exist. Computing ineffectiveness based on the difference between the forward interest rates that existed at the inception of the hedge and the forward rates that exist at the effectiveness measurement date would be an appropriate measurement of ineffectiveness if the hedging objective is to lock in those forward interest rates. In that case, the appropriate hedging instrument would be a series of forward contracts each of which matures on a repricing date that corresponds with the date of the forecast transactions.

It also should be noted that it would be inappropriate to compare only the variable cash flows on the interest rate swap with the interest cash flows in the debt that would be generated by the forward interest rates. That methodology has the effect of measuring ineffectiveness only on a portion of the derivative, and AS 30 does not permit the bifurcation of a derivative for the purposes of assessing effectiveness in this situation (paragraph 83 of AS 30). It is recognised, however, that if the fixed interest rate on the interest rate swap is equal to the fixed rate that would have been obtained on the debt at inception, there will be no ineffectiveness assuming that there are no differences in terms and no change in credit risk or it is not designated in the hedging relationship.

F.5.6 Cash flow hedges: firm commitment to purchase inventory in a foreign currency

Entity A has the Indian Rupees (Rs.) as its functional currency and reporting currency. On 30 June 20x7, it enters into a forward exchange contract to receive Foreign Currency (FC) 100,000 and deliver Rs. 109,600 on 30 June 20x8 at an initial cost and fair value of zero. It designates the forward exchange contract as a hedging instrument in a cash flow hedge of a firm commitment to purchase a certain quantity of paper on 31 March 20x8 and the resulting payable of FC100,000, which is to be paid on 30 June 20x8. All hedge accounting conditions in AS 30 are met. The financial year has been presumed to be the accounting year.

As indicated in the table below, on 30 June 20x7, the spot exchange rate is Rs. 1.072 to FC1, while the twelve-month forward exchange rate is Rs. 1.096 to FC1. On 31 December 20x7, the spot exchange rate is Rs. 1.080 to FC1, while the six-month forward exchange rate is Rs. 1.092 to FC1. On 31 March 20x8, the spot exchange rate is Rs. 1.074 to FC1, while the three-month forward rate is Rs. 1.076 to FC1. On 30 June 20x8, the spot exchange rate is Rs. 1.072 to FC1. The applicable yield curve in the local currency is flat at 6 per cent per year throughout the period. The fair value of the forward exchange contract is negative Rs. 388 on 31 December 20x7 $\{([1.092 \times 100{,}000] - 109{,}600)/1.06^{(6/12)}\}$, negative Rs. 1,971 on 31 March 20x8 $\{([1.076 \times 100{,}000] - 109{,}600)/1.06^{(3/12)}\}$, and negative Rs. 2,400 on 30 June 20x8 $\{1.072 \times 100{,}000 - 109{,}600\}$.

Date	Spot rate	Forward rate to 30 June 20x8	Fair value of forward contract
30 June 20x7	1.072	1.096	-
31 December	1.080	1.092	(388)

20x7			
31 March 20x8	1.074	1.076	(1,971)
30 June 20x8	1.072	-	(2,400)

Issue (a) - What is the accounting for these transactions if the hedging relationship is designated as being for changes in the fair value of the forward exchange contract and the entity's accounting policy is to apply basis adjustment to non-financial assets that result from hedged forecast transactions?

The accounting entries are as follows.

30 June 20x7

Dr	Forward	Rs. 0	
	Cr Cash		Rs. 0

To record the forward exchange contract at its initial amount of zero (paragraph 47 of AS 30). The hedge is expected to be fully effective because the critical terms of the forward exchange contract and the purchase contract and the assessment of hedge effectiveness are based on the forward price (Appendix A paragraph A133 of AS 30).

31 December 20x7

Dr	Appropriate equity account	Rs. 388	
	Cr Forward liability		Rs. 388

To record the change in the fair value of the forward exchange contract between 30 June 20x7 and 31 December 20x7, *i.e.*, Rs. 388 – 0 = Rs. 388, directly in the appropriate equity account (paragraph 106 of AS 30). The hedge is fully effective because the loss on the forward exchange contract (Rs. 388) exactly offsets the change in cash flows associated with the purchase contract based on the forward price [(Rs. 388) = {([1.092 x 100,000] – 109,600)/$1.06^{(6/12)}$} – {([1.096 x 100,000] – 109,600) / 1.06}].

31 March 20x8

Dr	Appropriate equity account	Rs. 1,583	
	Cr Forward liability		Rs. 1,583

To record the change in the fair value of the forward exchange contract between 1 January 20x8 and 31 March 20x8 (i.e., Rs. 1,971 – Rs. 388 = Rs. 1,583), directly in the appropriate equity account (paragraph 106 of AS 30). The hedge is fully effective because the loss on the forward exchange contract (Rs. 1,583) exactly offsets the change in cash flows associated with the purchase contract based on the forward price [(Rs. 1,583) = {([1.076 x 100,000] – 109,600)/$1.06^{(3/12)}$} – {([1.092 x 100,000] – 109,600) /$1.06^{(6/12)}$}].

Dr	Paper (purchase price)	Rs. 107,400	
Dr	Paper (hedging loss)	Rs. 1,971	
	Cr Appropriate equity account		Rs. 1,971
	Cr Payable		Rs. 107,400

To recognise the purchase of the paper at the spot rate (1.074 X FC 100,000) and remove the cumulative loss on the forward exchange contract that has been recognised directly in the equity account (Rs. 1,971) and include it in the initial measurement of the purchased paper. Accordingly, the initial measurement of the purchased paper is Rs. 109,371 consisting of a purchase consideration of Rs. 107,400 and a hedging loss of Rs. 1,971.

30 June 20x8

Dr	Payable	Rs. 107,400	
	Cr Cash		Rs. 107,200
	Cr Statement of profit and loss		Rs. 200

To record the settlement of the payable at the spot rate (FC 100,000 X 1.072 = 107,200) and the associated exchange gain of Rs. 200 (Rs. 107,400 – Rs. 107,200).

Dr	Statement of profit and loss	Rs. 429	
	Cr Forward liability		Rs. 429

To record the loss on the forward exchange contract between 1 April 20x8 and 30 June 20x8 (i.e., Rs. 2,400 – Rs. 1,971 = Rs. 429) in the statement of profit and loss. The hedge is regarded as fully effective because the loss on the forward exchange contract (Rs. 429) exactly offsets the change in the fair value of the payable based on the forward price (Rs. 429 = ([1.072 X 100,000] – 109,600 – {([1.076 X 100,000] – 109,600)/$1.06^{(3/12)}$}).

Dr	Forward liability	Rs. 2,400	
	Cr Cash		Rs. 2,400

To record the net settlement of the forward exchange contract.

Issue (b) – What is the accounting for these transactions if the hedging relationship instead is designated as being for changes in the spot element of the forward exchange contract and the interest element is excluded from the designated hedging relationship (paragraph 83 of AS 30)?

The accounting entries are as follows.

30 June 20x7

Dr	Forward	Rs. 0	
	Cr Cash		Rs. 0

To record the forward exchange contract at its initial amount of zero (paragraph 47 of AS 30). The hedge is expected to be fully effective because the critical terms of the forward exchange contract and the purchase contract are the same and the change in the premium or discount on the forward contract is excluded from the assessment of effectiveness (Appendix A paragraph A133 of AS 30).

31 December 20x7

Dr	Statement of profit and loss (interest element)	Rs. 1,165	
	Cr Appropriate equity account (spot element)		Rs. 777
	Cr Forward liability		Rs. 388

To record the change in the fair value of the forward exchange contract between 30 June 20x7 and 31 December 20x7, *i.e.*, Rs. 388 – 0 = Rs. 388. The change in the present value of spot settlement of the forward exchange contract is a gain of Rs. 777 ({([1.080 X 100,000] – 107,200)/1.06$^{(6/12)}$} – {([1.072 X 100,000] – 107,200)/1.06}), which is recognised directly in the appropriate equity account (paragraph 106(a) of AS 30). The change in the interest element of the forward exchange contract (the residual change in fair value) is a loss of Rs. 1,165 (388 + 777), which is recognised in the statement of profit and loss (paragraphs 83 and 61(a) of AS 30). The hedge is fully effective because the gain in the spot element of the forward contract (Rs. 777) exactly offsets the change in the purchase price at spot rates (Rs. 777 = {([1.080 X 100,000] – 107,200)/1.06$^{(6/12)}$} – {([1.072 X 100,000] – 107,200)/1.06}).

31 March 20x8

Dr	Appropriate equity account (spot element)	Rs. 580	
Dr	Statement of profit and loss (interest element)	Rs. 1,003	
	Cr Forward liability		Rs. 1,583

To record the change in the fair value of the forward exchange contract between 1 January 20x8 and 31 March 20x8, *i.e.*, Rs. 1,971 – Rs. 388 = Rs. 1,583. The change in the present value of the spot settlement of the forward exchange contract is a loss of Rs. 580 ({([1.074 X 100,000] – 107,200)/1.06$^{(3/12)}$} – {([1.080 X 100,000] – 107,200)/1.06$^{(6/12)}$}), which is recognised directly in the appropriate equity account (paragraph 106(a) of AS 30). The change in the interest element of the forward exchange contract (the residual change in fair value) is a loss of Rs. 1,003 (Rs. 1,583 – Rs. 580), which is recognised in statement of profit and loss (paragraphs 83 and 61(a) of AS 30). The hedge is fully effective because the loss in the spot element of the forward contract (Rs. 580) exactly offsets the change in the purchase price at spot rates [(580) = {([1.074 x 100,000] – 107,200)/1.06$^{(3/12)}$} – {([1.080 x 100,000] – 107,200)/1.06$^{(6/12)}$}].

Dr	Paper (purchase price)	Rs. 107,400	
Dr	Appropriate equity account	Rs. 197	
	Cr Paper (hedging gain)		Rs. 197
	Cr Payable		Rs. 107,400

To recognise the purchase of the paper at the spot rate (= 1.074 x FC 100,000) and remove the cumulative gain on the spot element of the forward exchange contract that has been recognised directly in the equity account (Rs. 777 – Rs. 580 = Rs. 197) and include it in the initial measurement of the purchased paper. Accordingly, the initial measurement of the purchased paper is Rs. 107,203, consisting of a purchase consideration of Rs. 107,400 and a hedging gain of Rs. 197.

30 June 20x8

Dr	Payable	Rs. 107,400	
	Cr Cash		Rs. 107,200
	Cr Statement of profit and loss		Rs. 200

To record the settlement of the payable at the spot rate (FC 100,000 x 1.072 = Rs. 107,200) and the associated exchange gain of Rs. 200 (– [1.072 – 1.074] x FC 100,000).

Dr	Statement of profit and loss (spot element)	Rs. 197	
Dr	Statement of profit and loss (interest element)	Rs. 232	
	Cr Forward liability		Rs. 429

To record the change in the fair value of the forward exchange contract between 1 April 20x8 and 30 June 20x8 (i.e., Rs. 2,400 – Rs. 1,971 = Rs. 429). The change in the present value of the spot settlement of the forward exchange contract is a loss of Rs. 197 ([1.072 x 100,000] – 107,200 – {([1.074 x 100,000] – 107,200)/1.06$^{(3/12)}$}), which is recognised in the statement of profit and loss. The change in the interest element of the forward exchange contract (the residual change in fair value) is a loss of Rs. 232 (Rs. 429 – Rs. 197), which is recognised in the statement of profit and loss. The hedge is fully effective because the loss in the spot element of the forward contract (Rs. 197) exactly offsets the change in the present value of the spot settlement of the payable [(Rs. 197) = {[1.072 x 100,000] – 107,200 – {([1.074 x 100,000] – 107,200)/1.06$^{(3/12)}$}].

Dr	Forward liability	Rs. 2,400	
	Cr Cash		Rs. 2,400

To record the net settlement of the forward exchange contract.

The following table provides an overview of the components of the change in fair value of the hedging instrument over the term of the hedging relationship. It illustrates that the way in which a hedging relationship is designated affects the subsequent accounting for that hedging relationship, including the assessment of hedge effectiveness and the recognition of gains and losses.

Period ending	**Change in spot settlement**	**Fair value of change in spot settlement**	**Change in forward settlement**	**Fair value of change in forward settlement**	**Fair value of change in interest element**
	Rs.	*Rs.*	*Rs.*	*Rs.*	*Rs.*
June 20x7	-	-	-	-	-
December 20x7	800	777	(400)	(388)	(1,165)
March 20x8	(600)	(580)	(1,600)	(1,583)	(1,003)
June 20x8	(200)	(197)	(400)	(429)	(232)
Total	-	-	(2,400)	(2,400)	(2,400)

F.6 Hedges: Other issues

F.6.1 Hedge accounting: management of interest rate risk in financial institutions

Some banks and other financial institutions manage their exposure to interest rate risk on a net basis for all or parts of their activities. They have systems to accumulate critical information throughout the entity about their financial assets, financial liabilities and forward commitments, including loan commitments. This information is used to estimate and aggregate cash flows and to schedule such estimated cash flows into the applicable future periods in which they are expected to be paid or received. The systems generate estimates of cash flows based on the contractual terms of the instruments and other factors, including estimates of prepayments and defaults. For risk management purposes, many financial institutions use derivative contracts to offset some or all exposure to interest rate risk on a net basis.

If a financial institution manages interest rate risk on a net basis, can its activities potentially qualify for hedge accounting under AS 30?

Yes. However, to qualify for hedge accounting the derivative hedging instrument that hedges the net position for risk management purposes must be designated for accounting purposes as a hedge of a gross position related to assets, liabilities, forecast cash inflows or forecast cash outflows giving rise to the net exposure (paragraph 94 and Appendix A paragraphs A125 and A136 of AS 30). It is not possible to designate a net position as a hedged item under AS 30 because of the inability to associate hedging gains and losses with a specific item being hedged and, correspondingly, to determine objectively the period in which such gains and losses should be recognised in the statement of profit and loss.

Hedging a net exposure to interest rate risk can often be defined and documented to meet the qualifying criteria for hedge accounting in paragraph 98 of AS 30 if the objective of the activity is to offset a specific, identified and designated risk exposure that ultimately affects the entity's profit or loss (Appendix A paragraph A135 of AS 30) and the entity designates and documents its interest rate risk exposure on a gross basis. Also, to qualify for hedge accounting the information systems must capture sufficient information about the amount and timing of cash flows and the effectiveness of the risk management activities in accomplishing their objective.

The factors an entity must consider for hedge accounting purposes if it manages interest rate risk on a net basis are discussed in Question F.6.2.

F.6.2 Hedge accounting considerations when interest rate risk is managed on a net basis

If an entity manages its exposure to interest rate risk on a net basis, what are the issues the entity should consider in defining and documenting its interest rate risk management activities to qualify for hedge accounting and in establishing and accounting for the hedge relationship?

Issues (a)-(l) below deal with the main issues. First, Issues (a) and (b) discuss the designation of derivatives used in interest rate risk management activities as fair value hedges or cash flow hedges. As noted there, hedge accounting criteria and accounting consequences differ between fair value hedges and cash flow hedges. Since it may be easier to achieve hedge accounting treatment if derivatives used in interest rate risk management activities are designated as cash flow hedging instruments, Issues (c)-(l) expand on various aspects of the accounting for cash flow hedges. Issues (c)-(f) consider the application of the hedge accounting criteria for cash flow hedges in AS 30, and Issues (g) and (h) discuss the required accounting treatment. Finally, Issues (i)-(l) elaborate on other specific issues relating to the accounting for cash flow hedges.

Issue (a) – Can a derivative that is used to manage interest rate risk on a net basis be designated under AS 30 as a hedging instrument in a fair value hedge or a cash flow hedge of a gross exposure?

Both types of designation are possible under AS 30. An entity may designate the derivative used in interest rate risk management activities either as a fair value hedge of assets, liabilities and firm commitments or as a cash flow hedge of forecast transactions, such as the anticipated reinvestment of cash inflows, the anticipated refinancing or rollover of a financial liability, and the cash flow consequences of the resetting of interest rates for an asset or a liability.

In economic terms, it does not matter whether the derivative instrument is regarded as a fair value hedge or as a cash flow hedge. Under either perspective of the exposure, the derivative has the same economic effect of reducing the net exposure. For example, a receive-fixed, pay-variable interest rate swap can be considered to be a cash flow hedge of a variable rate asset or a fair value hedge of a fixed rate liability. Under either perspective, the fair value or cash flows of the interest rate swap offset the exposure to interest rate changes. However, accounting consequences differ depending on whether the derivative is designated as a fair value hedge or a cash flow hedge, as discussed in Issue (b).

To illustrate: a bank has the following assets and liabilities with a maturity of two years.

	Variable interest Rs.	**Fixed interest Rs.**
Assets	60	100
Liabilities	(100)	(60)
Net	(40)	40

The bank takes out a two-year swap with a notional principal of Rs. 40 to receive a variable interest rate and pay a fixed interest rate to hedge the net exposure. As discussed above, this may be regarded and designated either as a fair value hedge of Rs. 40 of the fixed rate assets or as a cash flow hedge of Rs. 40 of the variable rate liabilities.

Issue (b) – What are the critical considerations in deciding whether a derivative that is used to manage interest rate risk on a net basis should be designated as a hedging instrument in a fair value hedge or a cash flow hedge of a gross exposure?

Critical considerations include the assessment of hedge effectiveness in the presence of prepayment risk and the ability of the information systems to attribute fair value or cash flow changes of hedging instruments to fair value or cash flow changes, respectively, of hedged items, as discussed below.

For accounting purposes, the designation of a derivative as hedging a fair value exposure or a cash flow exposure is important because both the qualification requirements for hedge accounting and the recognition of hedging gains and losses for these categories are different. It is often easier to demonstrate high effectiveness for a cash flow hedge than for a fair value hedge.

Effects of prepayments

Prepayment risk inherent in many financial instruments affects the fair value of an instrument and the timing of its cash flows and impacts on the effectiveness test for fair value hedges and the highly probable test for cash flow hedges, respectively.

Effectiveness is often more difficult to achieve for fair value hedges than for cash flow hedges when the instrument being hedged is subject to prepayment risk. For a fair value hedge to qualify for hedge accounting, the changes in the fair value of the derivative hedging instrument must be expected to be highly effective in offsetting the changes in the fair value of the hedged item (paragraph 98(b) of AS 30). This test may be difficult to meet if, for example, the derivative hedging instrument is a forward contract having a fixed term and the financial assets being hedged are subject to prepayment by the borrower. Also, it may be difficult to conclude that, for a portfolio of fixed rate assets that are subject to prepayment, the changes in the fair value for each individual item in the group will be expected to be approximately proportional to the overall changes in fair value attributable to the hedged risk of the group. Even if the risk being hedged is a benchmark interest rate, to be able to conclude that fair value changes will be proportional for each item in the portfolio, it may be necessary to disaggregate the asset portfolio into categories based on term, coupon, credit, type of loan and other characteristics.

In economic terms, a forward derivative instrument could be used to hedge assets that are subject to prepayment but it would be effective only for small movements in interest rates. A reasonable estimate of prepayments can be made for a given interest rate environment and the derivative position can be adjusted as the interest rate environment changes. If an entity's risk management strategy is to adjust the amount of the hedging instrument periodically to reflect changes in the hedged position, the entity needs to demonstrate that the hedge is expected to be highly effective only for the period until the amount of the hedging instrument is next adjusted. However, for that period, the expectation of effectiveness has to be based on existing fair value exposures and the potential for interest rate movements without consideration of future adjustments to those positions. Furthermore, the fair value exposure attributable to prepayment risk can generally be hedged with options.

For a cash flow hedge to qualify for hedge accounting, the forecast cash flows, including the reinvestment of cash inflows or the refinancing of cash outflows, must be highly probable (paragraph 98(c) of AS 30) and the hedge expected to be highly effective in achieving offsetting changes in the cash flows of the hedged item and hedging instrument (paragraph 98(b) of AS 30). Prepayments affect the timing of cash flows and, therefore, the probability of occurrence of the forecast transaction. If the hedge is established for risk management purposes on a net basis, an entity may have sufficient levels of highly probable cash flows on a gross basis to support the designation for accounting purposes of forecast transactions associated with a portion of the gross cash flows as the hedged item. In this case, the portion of the gross cash flows designated as being hedged may be chosen to be equal to the amount of net cash flows being hedged for risk management purposes.

Systems considerations

The accounting for fair value hedges differs from that for cash flow hedges. It is usually easier to use existing information systems to manage and track cash flow hedges than it is for fair value hedges.

Under fair value hedge accounting, the assets or liabilities that are designated as being hedged are remeasured for those changes in fair values during the hedge period that are attributable to the risk being hedged. Such changes adjust the carrying amount of the hedged items and, for interest sensitive assets and liabilities, may result in an adjustment of the effective interest rate of the hedged item (paragraph 99 of AS 30). As a consequence of fair value hedging activities, the changes in fair value have to be allocated to the assets or liabilities being hedged in order for the entity to be able to recompute their effective interest rate, determine the subsequent amortisation of the fair value adjustment to the statement of profit and loss, and determine the amount that should be recognised in the statement of profit and loss when assets are sold or liabilities extinguished (paragraphs 99 and 103 of AS 30). To comply with the requirements for fair value hedge accounting, it will generally be necessary to establish a system to track the changes in the fair value attributable to the hedged risk, associate those changes with individual hedged items, recompute the effective interest rate of the hedged items, and amortise the changes to the statement of profit and loss over the life of the respective hedged item.

Under cash flow hedge accounting, the cash flows relating to the forecast transactions that are designated as being hedged reflect changes in interest rates. The adjustment for changes in the fair value of a hedging derivative instrument is initially recognised in the appropriate equity account (paragraph 106 of AS 30). To comply with the requirements for cash flow hedge accounting, it is necessary to determine when the adjustments to the equity account from changes in the fair value of a hedging instrument should be recognised in the statement of profit and loss (paragraphs 111 and 112 of AS 30). For cash flow hedges, it is not necessary to create a separate system to make this determination. The system used to determine the extent of the net exposure provides the basis for scheduling the changes in the cash flows of the derivative and the recognition of such changes in the statement of profit and loss.

The timing of the recognition in the statement of profit and loss can be predetermined when the hedge is associated with the exposure to changes in cash flows. The forecast transactions that are being hedged can be associated with a specific principal amount in specific future periods composed of variable rate assets and cash inflows being reinvested or variable rate liabilities and cash outflows being refinanced, each of which creates a cash flow exposure to changes in interest rates. The specific principal amounts in specific future periods are equal to the notional amount of the derivative hedging instruments and are hedged only for the period that corresponds to the repricing or maturity of the derivative hedging instruments so that the cash flow changes resulting from changes in interest rates are matched with the derivative hedging instrument. Paragraph 111 of AS 30 specifies that the amounts recognised in the equity account should be reclassified into, *i.e.*, recognised in the statement of profit and loss in the same period or periods during which the hedged item affects profit or loss.

Issue (c) – If a hedging relationship is designated as a cash flow hedge relating to changes in cash flows resulting from interest rate changes, what would be included in the documentation required by paragraph 98(a) of AS 30?

The following would be included in the documentation.

The hedging relationship – The maturity schedule of cash flows used for risk management purposes to determine exposures to cash flow mismatches on a net basis would provide part of the documentation of the hedging relationship.

The entity's risk management objective and strategy for undertaking the hedge - The entity's overall risk management objective and strategy for hedging exposures to interest rate risk would provide part of the documentation of the hedging objective and strategy.

The type of hedge - The hedge is documented as a cash flow hedge.

The hedged item - The hedged item is documented as a group of forecast transactions (interest cash flows) that are expected to occur with a high degree of probability in specified future periods, for example, scheduled on a monthly basis. The hedged item may include interest cash flows resulting from the reinvestment of cash inflows, including the resetting of interest rates on assets, or from the refinancing of cash outflows, including the resetting of interest rates on liabilities and rollovers of financial liabilities. As discussed in Issue (e), the forecast transactions meet the probability test if there are sufficient levels of highly probable cash flows in the specified future periods to encompass the amounts designated as being hedged on a gross basis.

The hedged risk - The risk designated as being hedged is documented as a portion of the overall exposure to changes in a specified market interest rate, often the risk-free interest rate or an interbank offered rate, common to all items in the group. To help ensure that the hedge effectiveness test is met at inception of the hedge and subsequently, the designated hedged portion of the interest rate risk could be documented as being based on the same yield curve as the derivative hedging instrument.

The hedging instrument - Each derivative hedging instrument is documented as a hedge of specified amounts in specified future time periods corresponding with the forecast transactions occurring in the specified future time periods designated as being hedged.

The method of assessing effectiveness - The effectiveness test is documented as being measured by comparing the changes in the cash flows of the derivatives allocated to the applicable periods in which they are designated as a hedge to the changes in the cash flows of the forecast transactions being hedged. Measurement of the cash flow changes is based on the applicable yield curves of the derivatives and hedged items.

PREVIOUS HOME NEXT

Issue (d) – If the hedging relationship is designated as a cash flow hedge, how does an entity satisfy the requirement for an expectation of high effectiveness in achieving offsetting changes in paragraph 98(b) of AS 30?

An entity may demonstrate an expectation of high effectiveness by preparing an analysis demonstrating high historical and expected future correlation between the interest rate risk designated as being hedged and the interest rate risk of the hedging instrument. Existing documentation of the hedge ratio used in establishing the derivative contracts may also serve to demonstrate an expectation of effectiveness.

Issue (e) – If the hedging relationship is designated as a cash flow hedge, how does an entity demonstrate a high probability of the forecast transactions occurring as required by paragraph 98(c) of AS 30?

An entity may do this by preparing a cash flow maturity schedule showing that there exist sufficient aggregate gross levels of expected cash flows, including the effects of the resetting of interest rates for assets or liabilities, to establish that the forecast transactions that are designated as being hedged are highly probable to occur. Such a schedule should be supported by management's stated intentions and past practice of reinvesting cash inflows and refinancing cash outflows.

For example, an entity may forecast aggregate gross cash inflows of Rs. 100 and aggregate gross cash outflows of Rs. 90 in a particular time period in the near future. In this case, it may wish to designate the forecast reinvestment of gross cash inflows of Rs. 10 as the hedged item in the future time period. If more than Rs. 10 of the forecast cash inflows are contractually specified and have low credit risk, the entity has strong evidence to support an assertion that gross cash inflows of Rs. 10 are highly probable to occur and to support the designation of the forecast reinvestment of those cash flows as being hedged for a particular portion of the reinvestment period. A high probability of the forecast transactions occurring may also be demonstrated under other circumstances.

Issue (f) – If the hedging relationship is designated as a cash flow hedge, how does an entity assess and measure effectiveness under paragraphs 98(d) and 98(e) of AS 30?

Effectiveness is required to be measured at a minimum at the time an entity prepares its annual or interim financial reports. However, an entity may wish to measure it more frequently on a specified periodic basis, at the end of each month or other applicable reporting period. It is also measured whenever derivative positions designated as hedging instruments are changed or hedges are terminated to ensure that the recognition in the statement of profit and loss of the changes in the fair value amounts on assets and liabilities and the recognition of changes in the fair value of derivative instruments designated as cash flow hedges are appropriate.

Changes in the cash flows of the derivative are computed and allocated to the applicable periods in which the derivative is designated as a hedge and are compared with computations of changes in the cash flows of the forecast transactions. Computations are based on yield curves applicable to the hedged items and the derivative hedging instruments and applicable interest rates for the specified periods being hedged.

The schedule used to determine effectiveness could be maintained and used as the basis for determining the period in which the hedging gains and losses recognised initially in the appropriate equity account are reclassified out of the equity account and recognised in the statement of profit and loss.

Issue (g) – If the hedging relationship is designated as a cash flow hedge, how does an entity account for the hedge?

The hedge is accounted for as a cash flow hedge in accordance with the provisions in paragraphs 106-111 of AS 30, as follows:

(i) the portion of gains and losses on hedging derivatives determined to result from effective hedges is recognised in the appropriate equity account whenever effectiveness is measured; and

(ii) the portion of gains and losses resulting from hedging derivatives that is determined to be an ineffective hedge is recognised in the statement of profit and loss.

Paragraph 111 of AS 30 specifies that the amounts recognised in the equity account should be reclassified into, i.e., recognised in the statement of profit and loss in the same period or periods during which the hedged item affects profit or loss. Accordingly, when the forecast transactions occur, the amounts previously recognised in the equity account are recognised in the statement of profit and loss. For example, if an interest rate swap is designated as a hedging instrument of a series of forecast cash flows, the changes in the cash flows of the swap are recognised in the statement of profit and loss in the periods when the forecast cash flows and the cash flows of the swap offset each other.

Issue (h) – If the hedging relationship is designated as a cash flow hedge, what is the treatment of any net cumulative gains and losses recognised in the appropriate equity account if the hedging instrument is terminated prematurely, the hedge accounting criteria are no longer met, or the hedged forecast transactions are no longer expected to take place?

If the hedging instrument is terminated prematurely or the hedge no longer meets the criteria for qualification for hedge accounting, for example, the forecast transactions are no longer highly probable, the net cumulative gain or loss recognised in the equity account remains in the equity account until the forecast transaction occurs (paragraphs 112(a) and 112(b) of AS 30). If the hedged forecast transactions are no longer expected to occur, the net cumulative gain or loss is recognised in the statement of profit and loss (paragraph 112(c) of AS 30).

Issue (i) – Paragraph 84 of AS 30 states that a hedging relationship may not be designated for only a portion of the time period in which a hedging instrument is outstanding. If the hedging relationship is designated as a cash flow hedge, and the hedge subsequently fails the test for being highly effective, does paragraph 84 of AS 30 preclude redesignating the hedging instrument?

No. Paragraph 84 of AS 30 indicates that a derivative instrument may not be designated as a hedging instrument for only a portion of its remaining period to maturity. Paragraph 84 does not refer to the derivative instrument's original period to maturity. If there is a hedge effectiveness failure, the portion of the gain or loss on the derivative instrument that is determined to be an ineffective hedge is recognised immediately in the statement of profit and loss (paragraph 106(b) of AS 30) and hedge accounting based on the previous designation of the hedge relationship cannot be continued (paragraph 112 of AS 30). In this case, the derivative instrument may be redesignated prospectively as a hedging instrument in a new hedging relationship provided this hedging relationship satisfies the necessary conditions. The derivative instrument must be redesignated as a hedge for the entire time period it remains outstanding.

Issue (j) – For cash flow hedges, if a derivative is used to manage a net exposure to interest rate risk and the derivative is designated as a cash flow hedge of forecast interest cash flows or portions of them on a gross basis, does the occurrence of the hedged forecast transaction give rise to an asset or liability that will result in a portion of the hedging gains and losses that were recognised in the appropriate equity account remaining in the equity account?

No. In the hedging relationship described in Issue (c) above, the hedged item is a group of forecast transactions consisting of interest cash flows in specified future periods. The hedged forecast transactions do not result in the recognition of assets or liabilities and the effect of interest rate changes that are designated as being hedged is recognised in the statement of profit and loss in the period in which the forecast transactions occur. Although this is not relevant for the types of hedges described here, if instead the derivative is designated as a hedge of a forecast purchase of a financial asset or issue of a financial liability, the associated gains or losses that were recognised directly in the equity account are reclassified into, i.e., recognised in, the statement of profit and loss in the same period or periods during which the asset acquired or liability incurred affects the statement of profit and loss (such as in the periods that interest expenses are recognised). However, if an entity expects at any time that all or a portion of a net loss recognised directly in the equity account will not be recovered in one or more future periods, it should immediately reclassify into, i.e., recognise in, the statement of profit and loss the amount that is not expected to be recovered.

Issue (k) – In the answer to Issue (c) above it was indicated that the designated hedged item is a portion of a cash flow exposure. Does AS 30 permit a portion of a cash flow exposure to be designated as a hedged item?

Yes. AS 30 does not specifically address a hedge of a portion of a cash flow exposure for a forecast transaction. However, AS 30 paragraph 90 specifies that a financial asset or liability may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value, if effectiveness can be measured. The ability to hedge a portion of a cash flow exposure resulting from the resetting of interest rates for assets and liabilities suggests that a portion of a cash flow exposure resulting from the forecast reinvestment of cash inflows or the refinancing or rollover of financial liabilities can also be hedged. The basis for qualification as a hedged item of a portion of an exposure is the ability to measure effectiveness. This is further supported by AS 30 paragraph 92, which specifies that a non-financial asset or liability can be hedged only in its entirety or for foreign currency risk but not for a portion of other risks because of the difficulty of isolating and measuring the appropriate portion of the cash flows or fair value changes attributable to a specific risk. Accordingly, assuming effectiveness can be measured, a portion of a cash flow exposure of forecast transactions associated with, for example, the resetting of interest rates for a variable rate asset or liability can be designated as a hedged item.

Issue (l) – In the answer to Issue (c) above it was indicated that the hedged item is documented as a group of forecast transactions. Since these transactions will have different terms when they occur, including credit exposures, maturities and option features, how can an entity satisfy the tests in paragraphs 87 and 93 of AS 30 requiring the hedged group to have similar risk characteristics?

Paragraph 87 of AS 30 provides for hedging a group of assets, liabilities, firm commitments or forecast transactions with similar risk characteristics. Paragraph 93 of AS 30 provides additional guidance and specifies that portfolio hedging is permitted if two conditions are met, namely: the individual items in the portfolio share the same risk for which they are designated, and the change in the fair value attributable to the hedged risk for each individual item in the group will be expected to be approximately proportional to the overall change in fair value.

When an entity associates a derivative hedging instrument with a gross exposure, the hedged item typically is a group of forecast transactions. For hedges of cash flow exposures relating to a group of forecast transactions, the overall exposure of the forecast transactions and the assets or liabilities that are repriced may have very different risks. The exposure from forecast transactions may differ depending on the terms that are expected as they relate to credit exposures, maturities, options and other features. Although the overall risk exposures may be different for the individual items in the group, a specific risk inherent in each of the items in the group can be designated as being hedged.

The items in the portfolio do not necessarily have to have the same overall exposure to risk, provided they share the same risk for which they are designated as being hedged. A common risk typically shared by a portfolio of financial instruments is exposure to changes in the risk-free or benchmark interest rate or to changes in a specified rate that has a credit exposure equal to the highest credit-rated instrument in the portfolio (*i.e.*, the instrument with the lowest credit risk). If the instruments that are grouped into a portfolio have different credit exposures, they may be hedged as a group for a portion of the exposure. The risk they have in common that is designated as being hedged is the exposure to interest rate changes from the highest credit rated instrument in the portfolio. This ensures that the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group. It is likely there will be some ineffectiveness if the hedging instrument has a credit quality that is inferior to the credit quality of the highest credit-rated instrument being hedged, since a hedging relationship is designated for a hedging instrument in its entirety (paragraph 83 of AS 30). For example, if a portfolio of assets consists of assets rated A, BB and B, and the current market interest rates for these assets are LIBOR+20 basis points, LIBOR+40 basis points and LIBOR+60 basis points, respectively, an entity may use a swap that pays fixed interest rate and for which variable interest payments based on LIBOR are made to hedge the exposure to variable interest rates. If LIBOR is designated as the risk being hedged, credit spreads above LIBOR on the hedged items are excluded from the designated hedge relationship and the assessment of hedge effectiveness.

F.6.3 Illustrative example of applying the approach in Question F.6.2

The purpose of this example is to illustrate the process of establishing, monitoring and adjusting hedge positions and of qualifying for cash flow hedge accounting in applying the approach to hedge accounting described in Question F.6.2 when a financial institution manages its interest rate risk on an entity-wide basis. To this end, this example identifies a methodology that allows for the use of hedge accounting and takes advantage of existing risk management systems so as to avoid unnecessary changes to it and to avoid unnecessary bookkeeping and tracking.

The approach illustrated here reflects only one of a number of risk management processes that could be employed and could qualify for hedge accounting. Its use is not intended to suggest that other alternatives could not or should not be used. The approach being illustrated could also be applied in other circumstances (such as for cash flow hedges of commercial entities), for example, hedging the rollover of commercial paper financing.

Identifying, assessing and reducing cash flow exposures

The discussion and illustrations that follow focus on the risk management activities of a financial institution that manages its interest rate risk by analysing expected cash flows in Indian Rupees on an entity-wide basis. The cash flow analysis forms the basis for identifying the interest rate risk of the entity, entering into hedging transactions to manage the risk, assessing the effectiveness of risk management activities, and qualifying for and applying cash flow hedge accounting.

The illustrations that follow assume that an entity, a financial institution, had the following expected future net cash flows and hedging positions outstanding in Indian Rupees, consisting of interest rate swaps, at the beginning of Period X0. The cash flows shown are expected to occur at the end of the period and, therefore, create a cash flow interest exposure in the following period as a result of the reinvestment or repricing of the cash inflows or the refinancing or repricing of the cash outflows.

The illustrations assume that the entity has an ongoing interest rate risk management programme. Schedule I shows the expected cash flows and hedging positions that existed at the beginning of Period X0. It is included here to provide a starting point in the analysis. It provides a basis for considering existing hedges in connection with the evaluation that occurs at the beginning of Period X1.

Schedule I – End of period – Expected cash flows and hedging positions

Quarterly period (units)	*X0* *Rs.*	*X1* *Rs.*	*X2* *Rs.*	*X3* *Rs.*	*X4* *Rs.*	*X5* *Rs.*	*…n* *Rs.*
Expected net cash flows		1,100	1,500	1,200	1,400	1,500	x,xxx
Outstanding interest rate swaps:							
Receive-fixed, pay-variable (notional amounts)	2,000	2,000	2,000	1,200	1,200	1,200	x,xxx
Pay-fixed, receive-variable (notional amounts)	(1,000)	(1,000)	(1,000)	(500)	(500)	(500)	x,xxx
Net exposure after outstanding swaps		100	500	500	700	800	x,xxx

The schedule depicts five quarterly periods. The actual analysis would extend over a period of many years, represented by the notation '…n'. A financial institution that manages its interest rate risk on an entity-wide basis re-evaluates its cash flow exposures periodically. The frequency of the evaluation depends on the entity's risk management policy.

For the purposes of this illustration, the entity is re-evaluating its cash flow exposures at the end of Period X0. The first step in the process is the generation of forecast net cash flow exposures from existing interest-earning assets and interest-bearing liabilities, including the rollover of short-term assets and short-term liabilities. Schedule II below illustrates the forecast of net cash flow exposures. A common technique for assessing exposure to interest rates for risk management purposes is an interest rate sensitivity gap analysis showing the gap between interest rate-sensitive assets and interest rate-sensitive liabilities over different time intervals.

Such an analysis could be used as a starting point for identifying cash flow exposures to interest rate risk for hedge accounting purposes.

Schedule II – Forecast net cash flow and repricing exposures

Quarterly period	*Notes*	*X1*	*X2*	*X3*	*X4*	*X5*	*...n*
Units		*Rs.*	*Rs.*	*Rs.*	*Rs.*	*Rs.*	*Rs.*
CASH INFLOW AND REPRICING EXPOSURES - from assets							
Principal and interest payments:							
Long-term fixed rate	(1)	2,400	3,000	3,000	1,000	1,200	x,xxx
Short-term (roll over)	(1)(2)	1,575	1,579	1,582	1,586	1,591	x,xxx
Variable rate – principal payments	(1)	2,000	1,000	-	500	500	x,xxx
Variable rate - estimated interest	(2)	125	110	105	114	118	x,xxx
Total expected cash inflows		*6,100*	*5,689*	*4,687*	*3,200*	*3,409*	*x,xxx*
Variable rate asset balances	(3)	8,000	7,000	7,000	6,500	6,000	x,xxx
Cash inflows and repricings	**(4)**	**14,100**	**12,689**	**11,687**	**9,700**	**9,409**	**x,xxx**
CASH OUTFLOW AND REPRICING EXPOSURES - from liabilities							
Principal and interest payments:							
Long-term fixed rate	(1)	2,100	400	500	500	301	x,xxx
Short-term (roll over)	(1)(2)	735	737	738	740	742	x,xxx
Variable rate – principal payments	(1)	-	-	2,000	-	1,000	x,xxx
Variable rate - estimated interest	(2)	100	110	120	98	109	x,xxx
Total expected cash outflows		2,935	1,247	3,358	1,338	2,152	x,xxx
Variable rate liability balances	(3)	8,000	8,000	6,000	6,000	5,000	x,xxx

Cash outflows and repricings	**(4)**	**10,935**	**9,247**	**9,358**	**7,338**	**7,152**	**x,xxx**
NET EXPOSURES	(5)	3,165	3,442	2,329	2,362	2,257	x,xxx

(1) The cash flows are estimated using contractual terms and assumptions based on management's intentions and market factors. It is assumed that short-term assets and liabilities will continue to be rolled over in succeeding periods. Assumptions about prepayments and defaults and the withdrawal of deposits are based on market and historical data. It is assumed that principal and interest inflows and outflows will be reinvested and refinanced, respectively, at the end of each period at the then current market interest rates and share the benchmark interest rate risk to which they are exposed.

(2) Forward interest rates obtained from Schedule VI are used to forecast interest payments on variable rate financial instruments and expected rollovers of short-term assets and liabilities. All forecast cash flows are associated with the specific time periods (3 months, 6 months, 9 months and 12 months) in which they are expected to occur. For completeness, the interest cash flows resulting from reinvestments, refinancings and repricings are included in the schedule and shown gross even though only the net margin may actually be reinvested. Some entities may choose to disregard the forecast interest cash flows for risk management purposes because they may be used to absorb operating costs and any remaining amounts would not be significant enough to affect risk management decisions.

(3) The cash flow forecast is adjusted to include the variable rate asset and liability balances in each period in which such variable rate asset and liability balances are repriced. The principal amounts of these assets and liabilities are not actually being paid and, therefore, do not generate a cash flow. However, since interest is computed on the principal amounts each period based on the then current market interest rate, such principal amounts expose the entity to the same interest rate risk as if they were cash flows being reinvested or refinanced.

(4) The forecast cash flow and repricing exposures that are identified in each period represent the principal amounts of cash inflows that will be reinvested or repriced and cash outflows that will be refinanced or repriced at the market interest rates that are in effect when those forecast transactions occur.

(5) The net cash flow and repricing exposure is the difference between the cash inflow and repricing exposures from assets and the cash outflow and repricing exposures from liabilities. In the illustration, the entity is exposed to interest rate declines because the exposure from assets exceeds the exposure from liabilities

and the excess (i.e., the net amount) will be reinvested or repriced at the current market rate and there is no offsetting refinancing or repricing of outflows.

Note that some banks regard some portion of their non-interest bearing demand deposits as economically equivalent to long-term debt. However, these deposits do not create a cash flow exposure to interest rates and would therefore be excluded from this analysis for accounting purposes.

Schedule II *Forecast net cash flow and repricing exposures* provides no more than a starting point for assessing cash flow exposure to interest rates and for adjusting hedging positions. The complete analysis includes outstanding hedging positions and is shown in Schedule III *Analysis of expected net exposures and hedging positions*. It compares the forecast net cash flow exposures for each period (developed in Schedule II) with existing hedging positions (obtained from Schedule I), and provides a basis for considering whether adjustment of the hedging relationship should be made.

Schedule III – Analysis of expected net exposures and hedging positions

Quarterly period (units)	*X1* Rs.	*X2* Rs.	*X3* Rs.	*X4* Rs.	*X5* Rs.	*…n* Rs.
Net cash flow and repricing exposures (Schedule II)	3,165	3,442	2,329	2,362	2,257	x,xxx
Pre-existing swaps outstanding:						
Receive-fixed, pay-variable (notional amounts)	2,000	2,000	1,200	1,200	1,200	x,xxx
Pay-fixed, receive-variable (notional amounts)	(1,000)	(1,000)	(500)	(500)	(500)	x,xxx
Net exposure after pre- existing swaps	*2,165*	*2,442*	*1,629*	*1,662*	*1,557*	*x,xxx*
Transactions to adjust outstanding hedging positions:						
Receive-fixed, pay variable swap 1 (notional amount, 10-years)	2,000	2,000	2,000	2,000	2,000	x,xxx
Pay-fixed, receive-variable swap 2 (notional amount, 3-years)			(1,000)	(1,000)	(1,000)	x,xxx
Swaps …X						x,xxx
Unhedged cash flow and repricing exposure	*165*	*442*	*629*	*662*	*557*	*x,xxx*

The notional amounts of the interest rate swaps that are outstanding at the analysis date are included in each of the periods in which the interest rate swaps are outstanding to illustrate the impact of the outstanding interest rate swaps on the identified cash flow exposures. The notional amounts of the outstanding interest rate swaps are included in each period because interest is computed on the notional amounts each period, and the variable rate components of the outstanding swaps are repriced to the current market rate quarterly. The notional amounts create an exposure to interest rates that in part is similar to the principal balances of variable rate assets and variable rate liabilities.

The exposure that remains after considering the existing positions is then evaluated to determine the extent to which adjustments of existing hedging positions are necessary. The bottom portion of Schedule III shows the beginning of Period X1 using interest rate swap transactions to reduce the net exposures further to within the tolerance levels established under the entity's risk management policy.

Note that in the illustration, the cash flow exposure is not entirely eliminated. Many financial institutions do not fully eliminate risk but rather reduce it to within some tolerable limit.

Various types of derivative instruments could be used to manage the cash flow exposure to interest rate risk identified in the schedule of forecast net cash flows (Schedule II). However, for the purpose of the illustration, it is assumed that interest rate swaps are used for all hedging activities. It is also assumed that in periods in which interest rate swaps should be reduced, rather than terminating some of the outstanding interest rate swap positions, a new swap with the opposite return characteristics is added to the portfolio.

In the illustration in Schedule III above, swap 1, a receive-fixed, pay-variable swap, is used to reduce the net exposure in Periods X1 and X2. Since it is a 10-year swap, it also reduces exposures identified in other future periods not shown. However, it has the effect of creating an over-hedged position in Periods X3-X5. Swap 2, a forward starting pay-fixed, receive-variable interest rate swap, is used to reduce the notional amount of the outstanding receive-fixed, pay-variable interest rate swaps in Periods X3-X5 and thereby reduce the over-hedged positions.

It also is noted that in many situations, no adjustment or only a single adjustment of the outstanding hedging position is necessary to bring the exposure to within an acceptable limit. However, when the entity's risk management policy specifies a very low tolerance of risk a greater number of adjustments to the hedging positions over the forecast period would be needed to further reduce any remaining risk.

To the extent that some of the interest rate swaps fully offset other interest rate swaps that have been entered into for hedging purposes, it is not necessary to include them in a designated hedging relationship for hedge accounting purposes. These offsetting positions can be combined, de-designated as hedging instruments, if necessary, and reclassified for accounting purposes from the hedging portfolio to the trading portfolio. This procedure limits the extent to which the gross swaps must continue to be designated and tracked in a hedging relationship for accounting purposes. For the purposes of this illustration it is assumed that Rs. 500 of the pay-fixed, receive-variable interest rate swaps fully offset Rs. 500 of the receive-fixed, pay-variable interest rate swaps at the beginning of Period X1 and for Periods X1-X5, and are de-designated as hedging instruments and reclassified to the trading account.

PREVIOUS HOME NEXT

After reflecting these offsetting positions, the remaining gross interest rate swap positions from Schedule III are shown in Schedule IV as follows.

Schedule IV – Interest rate swaps designated as hedges

Quarterly period (units)	*X1 Rs.*	*X2 Rs.*	*X3 Rs.*	*X4 Rs.*	*X5 Rs.*	*...n Rs.*
Receive-fixed, pay-variable (notional amounts)	3,500	3,500	2,700	2,700	2,700	x,xxx
Pay-fixed, receive-variable (notional amounts)	(500)	(500)	(1,000)	(1,000)	(1,000)	x,xxx
Net outstanding swaps positions	*3,000*	*3,000*	*1,700*	*1,700*	*1,700*	*x,xxx*

For the purposes of the illustrations, it is assumed that Swap 2, entered into at the beginning of Period X1, only partially offsets another swap being accounted for as a hedge and therefore continues to be designated as a hedging instrument.

Hedge accounting considerations

Illustrating the designation of the hedging relationship

The discussion and illustrations thus far have focused primarily on economic and risk management considerations relating to the identification of risk in future periods and the adjustment of that risk using interest rate swaps. These activities form the basis for designating a hedging relationship for accounting purposes.

The examples in AS 30 focus primarily on hedging relationships involving a single hedged item and a single hedging instrument, but there is little discussion and guidance on portfolio hedging relationships for cash flow hedges when risk is being managed centrally. In this illustration, the general principles are applied to hedging relationships involving a component of risk in a portfolio having multiple risks from multiple transactions or positions.

Although designation is necessary to achieve hedge accounting, the way in which the designation is described also affects the extent to which the hedging relationship is judged to be effective for accounting purposes and the extent to which the entity's existing system for managing risk will be required to be modified to track hedging activities for accounting purposes. Accordingly, an entity may wish to designate the hedging relationship in a manner that avoids unnecessary systems changes by taking advantage of the information already generated by the risk management system and avoids unnecessary bookkeeping and tracking. In designating hedging relationships, the entity may also consider the extent to which ineffectiveness is expected to be recognised for accounting purposes under alternative designations.

The designation of the hedging relationship needs to specify various matters. These are illustrated and discussed here from the perspective of the hedge of the interest rate risk associated with the cash inflows, but the guidance can also be applied to the hedge of the risk associated with the cash outflows. It is fairly obvious that only a portion of the gross exposures relating to the cash inflows is being hedged by the interest rate swaps. Schedule V *The general hedging relationship* illustrates the designation of the portion of the gross reinvestment risk exposures identified in Schedule II as being hedged by the interest rate swaps.

Schedule V – The general hedging relationship

Quarterly period (*units*)	*X1* *Rs.*	*X2* *Rs.*	*X3* *Rs.*	*X4* *Rs.*	*X5* *Rs.*	*...n* *Rs.*
Cash inflow repricing exposure (Schedule II)	14,100	12,689	11,687	9,700	9,409	x,xxx
Receive-fixed, pay-variable swaps (Schedule IV)	3,500	3,500	2,700	2,700	2,700	x,xxx
Hedged exposure percentage	*24.8%*	*27.6%*	*23.1%*	*27.8%*	*28.7%*	*xx.x%*

The hedged exposure percentage is computed as the ratio of the notional amount of the receive-fixed, pay-variable swaps that are outstanding divided by the gross exposure. Note that in Schedule V there are sufficient levels of forecast reinvestments in each period to offset more than the notional amount of the receive-fixed, pay-variable swaps and satisfy the accounting requirement that the forecast transaction is highly probable.

It is not as obvious, however, how the interest rate swaps are specifically related to the cash flow interest risks designated as being hedged and how the interest rate swaps are effective in reducing that risk. The more specific designation is illustrated in Schedule VI *The specific hedging relationship* below. It provides a meaningful way of depicting the more complicated narrative designation of the hedge by focusing on the hedging objective to eliminate the cash flow variability associated with future changes in interest rates and to obtain an interest rate equal to the fixed rate inherent in the term structure of interest rates that exists at the commencement of the hedge.

The expected interest from the reinvestment of the cash inflows and repricings of the assets is computed by multiplying the gross amounts exposed by the forward rate for the period. For example, the gross exposure for Period X2 of Rs. 14,100 is multiplied by the forward rate for Periods X2-X5 of 5.50 per cent, 6.00 per cent, 6.50 per cent and 7.25 per cent, respectively, to compute the expected interest for those quarterly periods based on the current term structure of interest rates. The hedged expected interest is computed by multiplying the expected interest for the applicable three-month period by the hedged exposure percentage.

Schedule VI – The specific hedging relationship

			Term structure of interest rates					
Quarterly period			*X1*	*X2*	*X3*	*X4*	*X5*	*...n*
Spot rates			5.00%	5.25%	5.50%	5.75%	6.05%	x.xx%
Forward rates[56]			5.00%	5.50%	6.00%	6.50%	7.25%	x.xx%
Cash flow exposures and expected interest amounts								
Repricing period	Time to forecast transaction	Gross amounts exposed	**Expected interest**					
			Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
2	3 months	14,100	→	**194**	212	229	256	
3	6 months	12,689			**190**	206	230	xxx
4	9 months	11,687				**190**	212	xxx
5	12 months	9,700					**176**	xxx
6	15 months	9,409						**xxx**
Hedged percentage (Schedule V) in the previous period				24.8%	27.6%	23.1%	27.8%	xx.x%
Hedged expected interest				48	52	44	49	xx

It does not matter whether the gross amount exposed is reinvested in long-term fixed rate debt or variable rate debt, or in short-term debt that is rolled over in each subsequent period. The exposure to changes in the forward interest rate is the same. For example, if the Rs. 14,100 is reinvested at a fixed rate at the beginning of Period X2 for six months, it will be reinvested at 5.75 per cent. The expected interest is based on the forward interest rates for Period X2 of 5.50 per cent and for Period X3 of 6.00 per cent, equal to a blended rate of 5.75 per cent $(1.055 \times 1.060)^{0.5}$, which is the Period X2 spot rate for the next six months.

However, only the expected interest from the reinvestment of the cash inflows or repricing of the gross amount for the first three-month period after the forecast transaction occurs is designated as being hedged. The expected interest being hedged is represented by the shaded cells. The exposure for the subsequent periods is not hedged. In the example, the portion of the interest rate exposure being hedged is the forward rate of 5.50 per cent for Period X2. In order to assess hedge effectiveness and compute actual hedge ineffectiveness on an ongoing basis, the entity may use the information on hedged interest cash inflows in Schedule VI and compare it with updated estimates of expected interest cash inflows (for example, in a table that looks like

[56] The forward interest rates are computed from the spot interest rates and rounded for the purposes of the presentation. Computations that are based on the forward interest rates are made based on the actual computed forward rate and then rounded for the purposes of the presentation.

Schedule II). As long as expected interest cash inflows exceed hedged interest cash inflows, the entity may compare the cumulative change in the fair value of the hedged cash inflows with the cumulative change in the fair value of the hedging instrument to compute actual hedge effectiveness. If there are insufficient expected interest cash inflows, there will be ineffectiveness. It is measured by comparing the cumulative change in the fair value of the expected interest cash flows to the extent they are less than the hedged cash flows with the cumulative change in the fair value of the hedging instrument.

Describing the designation of the hedging relationship

As mentioned previously, there are various matters that should be specified in the designation of the hedging relationship that complicate the description of the designation but are necessary to limit ineffectiveness to be recognised for accounting purposes and to avoid unnecessary systems changes and bookkeeping. The example that follows describes the designation more fully and identifies additional aspects of the designation not apparent from the previous illustrations.

Example designation

Hedging objective

The hedging objective is to eliminate the risk of interest rate fluctuations over the hedging period, which is the life of the interest rate swap, and in effect obtain a fixed interest rate during this period that is equal to the fixed interest rate on the interest rate swap.

Type of hedge

Cash flow hedge.

Hedging instrument

The receive-fixed, pay-variable swaps are designated as the hedging instrument. They hedge the cash flow exposure to interest rate risk.

Each repricing of the swap hedges a three-month portion of the interest cash inflows that results from:

- the forecast reinvestment or repricing of the principal amounts shown in Schedule V.
- unrelated investments or repricings that occur after the repricing dates on the swap over its life and involve different borrowers or lenders.

The hedged item – General

The hedged item is a portion of the gross interest cash inflows that will result from the reinvestment or repricing of the cash flows identified in Schedule V and are expected to occur within the periods shown on such schedule. The portion of the interest cash inflow that is being hedged has three components:

- the principal component giving rise to the interest cash inflow and the period in which it occurs,
- the interest rate component, and
- the time component or period covered by the hedge.

The hedged item – The principal component

The portion of the interest cash inflows being hedged is the amount that results from the first portion of the principal amounts being invested or repriced in each period:

- that is equal to the sum of the notional amounts of the received-fixed, pay-variable interest rate swaps that are designated as hedging instruments and outstanding in the period of the reinvestment or repricing, and
- that corresponds to the first principal amounts of cash flow exposures that are invested or repriced at or after the repricing dates of the interest rate swaps.

The hedged item – The interest rate component

The portion of the interest rate change that is being hedged is the change in both of the following:

- the credit component of the interest rate being paid on the principal amount invested or repriced that is equal to the credit risk inherent in the interest rate swap. It is that portion of the interest rate on the investment that is equal to the interest index of the interest rate swap, such as LIBOR, and
- the yield curve component of the interest rate that is equal to the repricing period on the interest rate swap designated as the hedging instrument.

The hedged item – The hedged period

The period of the exposure to interest rate changes on the portion of the cash flow exposures being hedged is:

- the period from the designation date to the repricing date of the interest rate swap that occurs within the quarterly period in which, but not before, the forecast transactions occur, and

❑	its effects for the period after the forecast transactions occur equal to the repricing interval of the interest rate swap.

It is important to recognise that the swaps are not hedging the cash flow risk for a single investment over its entire life. The swaps are designated as hedging the cash flow risk from different principal investments and repricings that are made in each repricing period of the swaps over their entire term. The swaps hedge only the interest accruals that occur in the first period following the reinvestment. They are hedging the cash flow impact resulting from a change in interest rates that occurs up to the repricing of the swap. The exposure to changes in rates for the period from the repricing of the swap to the date of the hedged reinvestment of cash inflows or repricing of variable rate assets is not hedged. When the swap is repriced, the interest rate on the swap is fixed until the next repricing date and the accrual of the net swap settlements is determined. Any changes in interest rates after that date that affect the amount of the interest cash inflow are no longer hedged for accounting purposes.

Designation objectives

Systems considerations

Many of the tracking and bookkeeping requirements are eliminated by designating each repricing of an interest rate swap as hedging the cash flow risk from forecast reinvestments of cash inflows and repricings of variable rate assets for only a portion of the lives of the related assets. Much tracking and book-keeping would be necessary if the swaps were instead designated as hedging the cash flow risk from forecast principal investments and repricings of variable rate assets over the entire lives of these assets.

This type of designation avoids keeping track of gains and losses recognised directly in the appropriate equity account after the forecast transactions occur (paragraphs 108 and 109 of AS 30) because the portion of the cash flow risk being hedged is that portion that will be recognised in the statement of profit and loss in the period immediately following the forecast transactions that corresponds with the periodic net cash settlements on the swap. If the hedge were to cover the entire life of the assets being acquired, it would be necessary to associate a specific interest rate swap with the asset being acquired. If a forecast transaction is the acquisition of a fixed rate instrument, the fair value of the swap that hedged that transaction would be reclassified out of the equity account to adjust the interest income on the asset when the interest income is recognised. The swap would then have to be terminated or redesignated in another hedging relationship. If a forecast transaction is the acquisition of a variable rate asset, the swap would continue in the hedging relationship but it would have to be tracked back to the asset acquired so that any fair value amounts on the swap recognised in the equity account could be recognised in the statement of profit and loss upon the subsequent sale of the asset.

It also avoids the necessity of associating with variable rate assets any portion of the fair value of the swaps that is recognised in the equity account. Accordingly, there is no portion of the fair value of the swap that is recognised in the equity account that should be reclassified out of the equity account when a forecast transaction occurs or upon the sale of a variable rate asset.

This type of designation also permits flexibility in deciding how to reinvest cash flows when they occur. Since the hedged risk relates only to a single period that corresponds with the repricing period of the interest rate swap designated as the hedging instrument, it is not necessary to determine at the designation date whether the cash flows will be reinvested in fixed rate or variable rate assets or to specify at the date of designation the life of the asset to be acquired.

Effectiveness considerations

Ineffectiveness is greatly reduced by designating a specific portion of the cash flow exposure as being hedged.

- Ineffectiveness due to credit differences between the interest rate swap and hedged forecast cash flow is eliminated by designating the cash flow risk being hedged as the risk attributable to changes in the interest rates that correspond with the rates inherent in the swap, such as the AA rate curve. This type of designation prevents changes resulting from changes in credit spreads from being considered as ineffectiveness.

- Ineffectiveness due to duration differences between the interest rate swap and hedged forecast cash flow is eliminated by designating the interest rate risk being hedged as the risk relating to changes in the portion of the yield curve that corresponds with the period in which the variable rate leg of the interest rate swap is repriced.

- Ineffectiveness due to interest rate changes that occur between the repricing date of the interest rate swap and the date of the forecast transactions is eliminated by simply not hedging that period of time. The period from the repricing of the swap and the occurrence of the forecast transactions in the period immediately following the repricing of the swap is left unhedged. Therefore, the difference in dates does not result in ineffectiveness.

Accounting considerations

The ability to qualify for hedge accounting using the methodology described here is founded on provisions in AS 30 and on interpretations of its requirements. Some of those are described in the answer to Question F.6.2 *Hedge accounting considerations when interest rate risk is managed on a net basis*. Some additional and supporting provisions and interpretations are identified below.

Hedging a portion of the risk exposure

The ability to identify and hedge only a portion of the cash flow risk exposure resulting from the reinvestment of cash flows or repricing of variable rate instruments is found in paragraph 90 of AS 30 as interpreted in the answers to Questions F.6.2 Issue (k) and F.2.17 *Partial term hedging*.

Hedging multiple risks with a single instrument

The ability to designate a single interest rate swap as a hedge of the cash flow exposure to interest rates resulting from various reinvestments of cash inflows or repricings of variable rate assets that occur over the life of the swap is founded on paragraph 85 of AS 30 as interpreted in the answer to Question F.1.12 *Hedges of more than one type of risk*.

Hedging similar risks in a portfolio

The ability to specify the forecast transaction being hedged as a portion of the cash flow exposure to interest rates for a portion of the duration of the investment that gives rise to the interest payment without specifying at the designation date the expected life of the instrument and whether it pays a fixed or variable rate is founded on the answer to Question F.6.2 Issue (l), which specifies that the items in the portfolio do not necessarily have to have the same overall exposure to risk, providing they share the same risk for which they are designated as being hedged.

Hedge terminations

The ability to de-designate the forecast transaction (the cash flow exposure on an investment or repricing that will occur after the repricing date of the swap) as being hedged is provided for in paragraph 112 of AS 30 dealing with hedge terminations. While a portion of the forecast transaction is no longer being hedged, the interest rate swap is not de-designated, and it continues to be a hedging instrument for the remaining transactions in the series that have not occurred. For example, assume that an interest rate swap having a remaining life of one year has been designated as hedging a series of three quarterly reinvestments of cash flows. The next forecast cash flow reinvestment occurs in three months. When the interest rate swap is repriced in three months at the then current variable rate, the fixed rate and the variable rate on the interest rate swap become known and no longer provide hedge protection for the next three months. If the next forecast transaction does not occur until three months and ten days, the ten-day period that remains after the repricing of the interest rate swap is not hedged.

F.6.4 Hedge accounting: premium or discount on forward exchange contract

A forward exchange contract is designated as a hedging instrument, for example, in a hedge of a net investment in a non-integral foreign operation. Is it permitted to amortise the discount or premium on the forward exchange contract to the statement of profit and loss over the term of the contract?

No. The premium or discount on a forward exchange contract may not be amortised to the statement of profit and loss under AS 30. Derivatives are always measured at fair value in the balance sheet. The gain or loss resulting from a change in the fair value of the forward exchange contract is always recognised in the statement of profit and loss unless the forward exchange contract is designated and effective as a hedging instrument in a cash flow hedge or in a hedge of a net investment in a non-integral foreign operation, in which case the effective portion of the gain or loss is recognised in the appropriate equity account. In that case, the amounts recognised in the equity account are released to the statement of profit and loss when the hedged future cash flows occur or on the disposal of the net investment, as appropriate. Under paragraph 83(b) of AS 30, the interest element (time value) of the fair value of a forward may be excluded from the designated hedge relationship. In that case, changes in the interest element portion of the fair value of the forward exchange contract are recognised in the statement of profit and loss.

F.6.5 AS 30 and AS 11 – Fair value hedge of asset measured at cost

If the future sale of a ship carried at historical cost is hedged against the exposure to currency risk by foreign currency borrowing, does AS 30 require the ship to be remeasured for changes in the exchange rate even though the basis of measurement for the asset is historical cost?

No. In a fair value hedge, the hedged item is remeasured. However, a foreign currency borrowing cannot be classified as a fair value hedge of a ship since a ship does not contain any separately measurable foreign currency risk. If the hedge accounting conditions in paragraph 98 of AS 30 are met, the foreign currency borrowing may be classified as a cash flow hedge of an anticipated sale in that foreign currency. In a cash flow hedge, the hedged item is not remeasured.

To illustrate: a shipping entity in India has a US subsidiary that has the same functional currency (the Indian Rupees). The shipping entity measures its ships at historical cost less depreciation in the consolidated financial statements. In accordance with AS 11, the ships are recognised in Indian Rupees using the historical exchange rate. To hedge, fully or partly, the potential currency risk on the ships at disposal in US dollars, the shipping entity normally finances its purchases of ships with loans denominated in US dollars.

In this case, a US dollar borrowing (or a portion of it) may be designated as a cash flow hedge of the anticipated sale of the ship financed by the borrowing provided the sale is highly probable, for example, because it is expected to occur in the immediate future, and the amount of the sales proceeds designated as being hedged is equal to the amount of the foreign currency borrowing designated as the hedging instrument. The gains and losses on the currency borrowing that are determined to constitute an effective hedge of the anticipated sale are recognised directly in the appropriate equity account in accordance with paragraph 106(a) of AS 30.

Section G: Other

G.1 Disclosure of changes in fair value

AS 30 requires financial assets classified as available for sale (AFS) and financial assets and financial liabilities at fair value through profit or loss to be remeasured to fair value. Unless a financial asset or a financial liability is designated as a cash flow hedging instrument, fair value changes for financial assets and financial liabilities at fair value through profit or loss are recognised in the statement of profit and loss, and fair value changes for AFS assets are recognised in the appropriate equity account. What disclosures are required regarding the amounts of the fair value changes during a reporting period?

AS 32, *Financial Instruments: Disclosures*[57] requires material items of income, expense and gains and losses to be disclosed whether included in the statement of profit and loss or in the appropriate equity account. This disclosure requirement encompasses material items of income, expense and gains and losses that arise on remeasurement to fair value. Therefore, an entity provides disclosures of material fair value changes, distinguishing between changes that are recognised in the statement of profit and loss and changes that are recognised in the equity account. Further breakdown is provided of changes that relate to:

(a) AFS assets;

(b) financial assets and financial liabilities at fair value through profit or loss; and

(c) hedging instruments.

AS 32 neither requires nor prohibits disclosure of components of the change in fair value by the way items are classified for internal purposes. For example, an entity may choose to disclose separately the change in fair value of those derivatives that AS 30 classifies as held for trading but the entity classifies as part of risk management activities outside the trading portfolio.

In addition, AS 32 requires disclosure of the carrying amounts of financial assets and financial liabilities that: (i) are classified as held for trading and (ii) were, upon initial recognition, designated by the entity as financial assets and financial liabilities at fair value through profit or loss (i.e., those not financial instruments classified as held for trading).

[57] AS 32 *Financial Instruments: Disclosures* has been formulated and published elsewhere in this Compendium.

G.2 AS 30 and AS 3 – Hedge accounting: cash flow statements

How should cash flows arising from hedging instruments be classified in cash flow statements?

Cash flows arising from hedging instruments are classified as operating, investing or financing activities, on the basis of the classification of the cash flows arising from the hedged item. While the terminology in AS 3 has not been updated to reflect AS 30, the classification of cash flows arising from hedging instruments in the cash flow statement should be consistent with the classification of these instruments as hedging instruments under AS 30.

Appendix D

Comparison with IAS 39, *Financial Instruments: Recognition and Measurement*

<u>Note</u>: This Appendix is not a part of this Accounting Standard. The purpose of this appendix is only to bring out differences between the Accounting Standard and the corresponding International Accounting Standard (IAS) 39.

Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* is based on International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement* and incorporates IFRIC 9, *Reassessment of Embedded Derivatives* (Re. IAS 39, *Financial Instruments: Recognition and Measurement*), issued by the International Financial Reporting Interpretation Committee (IFRIC) of the International Accounting Standards Board (IASB). There are no material differences between AS 30, and IAS 39 and IFRIC 9.

Appendix E

Consequential amendments to other Accounting Standards

Limited Revision to AS 2, *Valuation of Inventories*

Limited Revision to AS 11 (revised 2003), *The Effects of Changes in Foreign Exchange Rates*

Limited Revision to AS 21, *Consolidated Financial Statements*

Limited Revision to AS 23, *Accounting for Investments in Associates in Consolidated Financial Statements*

Limited Revision to AS 26, *Intangible Assets*

Limited Revision to AS 27, *Financial Reporting of Interests in Joint Ventures*

Limited Revision to AS 28, *Impairment of Assets*

Limited Revision to AS 29, *Provisions, Contingent Assets and Contingent Liabilities*

Limited Revision to Accounting Standard (AS) 2 (revised 1999)

Valuation of Inventories

The following is the text of the limited revision to AS 2, Valuation of Inventories, issued by the Institute of Chartered Accountants of India..

In view of Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*, AS 2 (revised 1999) is modified as under (modifications are shown as double-underline/ strike-through):

After the existing paragraph 12, new paragraph 12A is added as below:

12A. An enterprise may purchase inventories on deferred settlement terms. When the arrangement effectively contains a financing element, that element, for example a difference between the purchase price for normal credit terms and the amount paid, is recognised as interest expense over the period of the financing.

The limited revision comes into effect in respect of accounting periods commencing on or after the date on which Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* comes into effect.

Limited Revision to
Accounting Standard (AS) 11 (revised 2003)

The Effects of Changes in Foreign Exchange Rates

The following is the text of the limited revision to AS 11 (revised 2003), The Effects of Changes in Foreign Exchange Rates, issued by the Institute of Chartered Accountants of India.

In view of Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* AS 11 (revised 2003) is modified as under (modifications are shown as double-underline/strike-through):

1. Scope Paragraphs of the Standard are amended as follows:

Scope

1. This Statement should be applied:

(a) in accounting for transactions <u>and balances</u> in foreign currencies<u>, except for those derivative transactions and balances that are within the scope of AS 30, Financial Instruments: Recognition and Measurement</u>; 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.~~[1]

<u>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</u>

~~[1] 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.]~~

scope of AS 30 (e.g., some foreign currency derivatives that are embedded in other contracts) are within the scope of this Statement.

2A. This Statement does not apply to hedge accounting for foreign currency items, including the hedging of a net investment in a foreign operation. AS 30 applies to hedge accounting.

3. This Statement does not specify the currency in which an enterprise presents its financial statements. However, an enterprise normally uses the currency of the country in which it is domiciled. If it uses a different currency, this Statement requires disclosure of the reason for using that currency. This Statement also requires disclosure of the reason for any change in the reporting currency.

4. This Statement does not deal with the restatement of an enterprise's financial statements from its reporting currency into another currency for the convenience of users accustomed to that currency or for similar purposes.

5. This Statement does not deal with the presentation in a cash flow statement of cash flows arising from transactions in a foreign currency and the translation of cash flows of a foreign operation (see AS 3, *Cash Flow Statements*).

6. This Statement does not deal with exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs (see paragraph 4(e) of AS 16, *Borrowing Costs*).

2. From the definition paragraph, the definitions the terms 'Forward exchange contract' and 'Forward rate' are deleted.

3. Paragraph 8 is amended as follows:

8. A foreign currency transaction is a transaction which is denominated in or requires settlement in a foreign currency, including transactions arising when an enterprise either:

(a) buys or sells goods or services whose price is denominated in a foreign currency;

(b) borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency; or

~~(c) 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 added under the existing heading 'Recognition of Exchange Differences'. This is the first paragraph under this heading and appears as follows:

PREVIOUS HOME NEXT

12A. As noted in paragraph 2A, AS 30 applies to hedge accounting for foreign currency items. The application of hedge accounting requires an enterprise to account for some exchange differences differently from the treatment of exchange differences required by this Statement. For example, AS 30 requires that exchange differences on monetary items that qualify as hedging instruments in a cash flow hedge are reported initially in an appropriate equity account, e.g., Hedging Reserve Account, to the extent that the hedge is effective.

5. The heading 'Forward Exchange Contracts' and paragraphs 36 to 39, given under the heading, are deleted.

6. Paragraph 40, given under the heading 'Disclosures', is amended as follows:

40. An enterprise should disclose:

(a) the amount of exchange differences included in the net profit or loss for the period except for those arising on financial instruments measured at fair value through profit or loss in accordance with AS 30; and

(b) net exchange differences accumulated in foreign currency translation reserve as a separate component of shareholders' funds, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

7. The name of AS 21, appearing in paragraphs 29 and 30 of the Standard, is changed to reflect the new name of AS 21, viz., the following:

AS 21, Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements

8. The name of AS 23, appearing in paragraph 30 of the Standard, is changed to reflect the new name of AS 23, viz., the following:

AS 23, Accounting for Investments in Associates

9. Alongwith the proposed Limited Revision to AS 11 (revised 2003), Comparison with IAS 21, *The Effects of Changes in Foreign Exchange Rates* (revised 1993), contained in Appendix to AS 11 (revised 2003) is replaced by the following Comparison with IAS 21, *The Effects of Changes in Foreign Exchange Rates* (revised 2003):

Appendix

Note: This Appendix is not a part of the Accounting Standard. The purpose of this appendix is only to bring out the major differences between Accounting Standard 11 (revised 2003) and corresponding International Accounting Standard (IAS) 21 (revised 2003).

Comparison with IAS 21, *The Effects of Changes in Foreign Exchange Rates* (revised 2003)

AS 11 (revised 2003) is based on the integral and non-integral foreign operations approach, *i.e.*, the approach which was followed in the earlier IAS 21 (revised 1993). The International Accounting Standards Board (IASB) has, in 2003, revised IAS 21 to adopt the functional currency approach. It has been observed that in all except one of the situations there is effectively no difference between the financial statements prepared under IAS 21 and AS 11. The only difference is that IAS 21 also lays down the method where the reporting enterprise's functional currency, *i.e.*, the currency of the primary economic environment in which the enterprise operates, is different as compared to its presentation currency, i.e., the currency in which financial statements are presented, whereas AS 11 only requires certain disclosures in such a case. However, it may be mentioned that in the context of most of the Indian enterprises, the functional currency and the presentation currency will be the same, i.e., the rupees, except there may be some Indian enterprises which are an integral foreign operation of a foreign enterprise. Therefore, only in very limited cases the application of the principles of IAS 21 will make a difference as compared to AS 11.

AS 11 (revised 2003) has recently become effective, i.e., from 1-4-2004. The Indian corporates have recently started applying this Standard. It is, therefore, felt that it is not appropriate to totally revise AS 11 (revised 2003) at this stage to adopt the IAS 21 which became effective from 1-1-2005.

The limited revision comes into effect in respect of accounting periods commencing on or after the date on which Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* comes into effect.

Limited Revision to Accounting Standard (AS) 21 (issued 2001)

The following is the text of the limited revision to AS 21, Consolidated Financial Statements, issued by the Institute of Chartered Accountants of India.

In view of the proposed Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*, AS 21 (issued 2001) is modified as under (modifications are shown as double-underline/strike-through):

1. The name of the Standard is modified as below:

Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements

2. The 'Applicability' paragraph of the Standard is amended as follows:

Accounting Standard (AS) 21 (issued 2001), *Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements*, issued by the Council of the Institute of Chartered Accountants of India, ~~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 the date on which Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*, comes into effect. In respect of separate financial statements of an enterprise, this limited revision comes into effect from the same date. In respect of consolidated financial statements, this Accounting Standard is mandatory[2] 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

[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.

accordance with this Standard.~~An enterprise that presents consolidated financial statements should prepare and present these statements in accordance with this Standard.~~[3]

The following is the text of the Accounting Standard.

3. The 'Objective' paragraph of the Standard is amended as follows:

The objective of this Statement is to lay down principles and procedures for preparation and presentation of consolidated financial statements and for accounting for investments in subsidiaries in separate financial statements. Consolidated financial statements are presented by a parent (also known as holding enterprise) to provide financial information about the economic activities of its group. These statements are intended to present financial information about a parent and its subsidiary(ies) as a single economic entity to show the economic resources controlled by the group, the obligations of the group and results the group achieves with its resources.

4. The 'Scope' paragraphs of the Standard are amended as follows:

Scope

1. This Statement should be applied in the preparation and presentation of consolidated financial statements for a group of enterprises under the control of a parent.

2. This Statement should also be applied in accounting for investments in subsidiaries in the separate financial statements of a parent.

3. In the preparation of consolidated financial statements, other Accounting Standards also apply in the same manner as they apply to the separate financial statements.

4. This Statement does not deal with:

(a) methods of accounting for amalgamations and their effects on consolidation, including goodwill arising on amalgamation (see AS 14, *Accounting for Amalgamations*);

(b) accounting for investments in associates (~~at present governed by~~ see AS ~~13~~23, *Accounting for Investments in Associates*[4]); and

[3] ~~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).~~

[4] ~~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.~~

(c) accounting for ~~investments~~ interests in joint ventures (~~at present governed by~~ see AS ~~13~~27, ~~Accounting for Investments~~*Financial Reporting of Interests in Joint Ventures*[5]).

5.	**Paragraph 11 is amended as follows:**

11. A subsidiary should be excluded from consolidation when:

(a) control is intended to be temporary because the subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future; 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 added. New paragraph 11A is as follows:**

11A. A subsidiary is not excluded from consolidation simply because the parent is a venture capital organisation or a similar entity.

7.	**Paragraphs 23 and 24 are amended as follows:**

23. An investment in an enterprise should be accounted for in accordance with Accounting Standard (AS) ~~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~~.

~~[5] 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.~~

~~[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.~~

8. Paragraph 28, appearing under the heading 'Accounting for Investments in Subsidiaries in a Parent's Separate Financial Statements' is amended. New paragraph 28A is added. Amended paragraph 28 and new paragraph 28A are as follows:

Accounting for Investments in Subsidiaries in a Parent's Separate Financial Statements

28. In a parent's separate financial statements, investments in subsidiaries, except investments in subsidiaries covered under paragraph 11 of this Statement, should be accounted for either: ~~in accordance with Accounting Standard (AS) 13, Accounting for Investments~~

(a) at cost, or

(b) in accordance with AS 30, Financial Instruments: Recognition and Measurement.

The same accounting should be applied for each category of investments. Investments in subsidiaries covered under paragraph 11 of this Statement should be accounted for in accordance with Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement.

28A. To determine whether an investment in a subsidiary accounted for at cost in accordance with paragraph 28 is impaired, an enterprise applies AS 28, *Impairment of Assets*. AS 28 which explains how an enterprise reviews the carrying amount of its assets, how it determines the recoverable amount of an asset, and when it recognises, or reverses the recognition of, an impairment loss is also applicable to impairment of an investment in a subsidiary.

Limited Revision to Accounting Standard (AS) 23 (issued 2001)

The following is the text of the limited revision to AS 23, Accounting for Investments in Associates in Consolidated Financial Statements, issued by the Institute of Chartered Accountants of India.

In view of Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*, AS 23 (issued 2001) is modified as under (modifications are shown as double-underline/ strike-through):

1. The name of the Standard is modified as below:

Accounting for Investments in Associates ~~in Consolidated Financial Statements~~

2. The 'Applicability' paragraph of the Standard is 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 the date on which Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* comes into effect. In respect of separate financial statements of an enterprise, this limited revision comes into effect from the same date. In respect of consolidated financial statements, this Standard is mandatory[7] 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.~~[8]~~

[7] 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.

~~[8] 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).~~

The following is the text of the Accounting Standard.

3. The 'Objective' paragraph of the Standard is amended as follows:

The objective of this Statement is to set out principles and procedures for recognising~~, in the consolidated financial statements,~~ the effects of the investments 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 amended as follows:

1. This Statement should be applied in accounting for investments in associates in the preparation and presentation of *separate as well as* ***consolidated financial statements by an investor.*** *However, it does not apply to investments in associates held by:*

(a) venture capital organisations, or

(b) mutual funds, unit trusts and similar entities including investment-linked insurance funds

that upon initial recognition are designated as at fair value through profit or loss and accounted for in accordance with AS 30, Financial Instruments: Recognition and Measurement. Such investments should be measured at fair value in accordance with AS 30, with changes in fair value recognised in the statement of profit and loss in the period of the change.

2. The requirements relating to accounting for investments in associates in consolidated financial statements, contained in this Statement, are applicable only where consolidated financial statements are prepared and presented by the investor. ~~This Statement does not deal with accounting for investments in associates in the preparation and presentation of separate financial statements by an investor.~~[9]

5. Paragraph 7 is amended as follows:

7. An investment in an associate should be accounted for in consolidated financial statements under the equity method except when:

(a) the investment is acquired and held exclusively with a view to its subsequent disposal in the near future; or

~~[9] Accounting Standard (AS) 13, 'Accounting for Investments', is applicable for accounting for investments in associates in the separate financial statements of an investor.~~

(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 amended as follows:

9. An investor should discontinue the use of the equity method from the date that:

(a) ***it ceases to have significant influence in an associate but retains, either in whole or in part, its investment; or***

(b) ***the use of the equity method is no longer appropriate because the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor.***

From the date of discontinuing the use of the equity method, investments in such associates should be accounted for in accordance with Accounting Standard (AS) ~~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 deleted. After the existing paragraph 19, new paragraphs 20, 20A, 20B and 20C under the heading 'Impairment Loss' and new paragraphs 20D and 20E under the heading 'Separate Financial Statements of an Investor' are added. New paragraphs are as follows:

~~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 either:

(a) at cost, or

(b) in accordance with AS 30, Financial Instruments: Recognition and Measurement.

The same accounting should be applied for each category of investments. Investments in associates covered under paragraph 7 of this Statement should be accounted for in accordance with Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement.

20E. To determine whether an investment in an associate accounted for at cost in accordance with paragraph 20D is impaired, an enterprise applies AS 28, *Impairment of Assets*. AS 28 which explains how an enterprise reviews the carrying amount of its assets, how it determines the recoverable amount of an asset, and when it recognises, or reverses the recognition of, an impairment loss is also applicable to impairment of an investment in an associate.

8. Paragraph 21 is amended as follows:

21. In accordance with Accounting Standard (AS) ~~4~~29, *Provisions, Contingent Liabilities and Contingent Assets*~~Contingencies and Events Occurring After the Balance Sheet Date~~~~[10]~~, 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 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

~~[10] 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.~~

Limited Revision to
Accounting Standard (AS) 26 (issued 2002)

Intangible Assets

The following is the text of the limited revision to AS 26, Intangible Assets, issued by the Institute of Chartered Accountants of India.

In view of Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*, AS 26 (issued 2002) is modified as under (modifications are shown as double-underline/ strike-through):

After the existing paragraph 25, new paragraph 25A is added as below:

25A. If payment for an intangible asset is deferred beyond normal credit terms, its cost is the cash price equivalent. The difference between this amount and the total payments is recognised as interest expense over the period of credit unless it is capitalised in accordance with AS 16, *Borrowing Costs*.

The limited revision comes into effect in respect of accounting periods commencing on or after the date on which Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* comes into effect.

Limited Revision to Accounting Standard (AS) 27 (issued 2002)

Financial Reporting of Interests in Joint Ventures

The following is the text of the limited revision to AS 27, Financial Reporting of Interests in Joint Ventures, issued by the Institute of Chartered Accountants of India.

In view of Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*, AS 27 (issued 2002) is modified as under (modifications are shown as double-underline/ strike-through):

1. The 'Scope' paragraphs of the Standard are amended as follows:

Scope

1. This Statement should be applied in accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors, regardless of the structures or forms under which the joint venture activities take place. ***However, it does not apply to venturer's interests in jointly controlled entities held by:***

(a) venture capital organisations, or

(b) mutual funds, unit trusts and similar entities including investment-linked insurance funds

that upon initial recognition are designated as at fair value through profit or loss and accounted for in accordance with AS 30, Financial Instruments: Recognition and Measurement. Such investments should be measured at fair value in accordance with AS 30, with changes in fair value recognised in the statement of profit and loss in the period of the change.

2. The requirements relating to accounting for joint ventures in consolidated financial statements, contained in this Statement, are applicable only where consolidated financial statements are prepared and presented by the venturer.

2. Paragraph 27, appearing under the heading 'Separate Financial Statements of a Venturer' is amended. New paragraphs 28A is added. Amended paragraph 27 and new paragraphs 28A are as follows:

Separate Financial Statements of a Venturer

27. In a venturer's separate financial statements, interests in ~~a~~ jointly controlled ~~entity~~entities, except interests covered under paragraph 29 of this Statement, should be accounted for either:

(a) at cost, or

(b) in accordance with AS 30, Financial Instruments: Recognition and Measurement.

The same accounting should be applied for each category of interest in jointly controlled entities. Interests in jointly controlled entities covered under paragraph 29 of this Statement should be accounted for as an investment in accordance with Accounting Standard (AS) ~~13~~30, ~~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. To determine whether an interest in a jointly controlled entity accounted for at cost in accordance with paragraph 27 is impaired, an enterprise applies AS 28, *Impairment of Assets*. AS 28 which explains how an enterprise reviews the carrying amount of its assets, how it determines the recoverable amount of an asset, and when it recognises, or reverses the recognition of, an impairment loss is also applicable to impairment of an interest in a jointly controlled entity.

3. Paragraph 29 is amended as follows:

29. In its consolidated financial statements, a venturer should report its interest in a jointly controlled entity using proportionate consolidation except

(a) an interest in a jointly controlled entity which is acquired and held exclusively with a view to its subsequent disposal in the near future; 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) ~~13~~30, ~~Accounting for Investments~~Financial Instruments: Recognition and Measurement.

4. Paragraph 40 is amended as follows:

40. From the date of discontinuing the use of the proportionate consolidation, interest in a jointly controlled entity should be accounted for:

(a) in accordance with Accounting Standard (AS) 21, Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements, if the venturer acquires unilateral control over the entity and becomes parent within the meaning of that Standard; and

(b) in all other cases, as an investment in accordance with Accounting Standard (AS) ~~13~~30, ~~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 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) ~~13~~30, ~~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) ~~13~~30, Financial Instruments: Recognition and Measurement~~Accounting for Investments~~.

6. The name of AS 21, appearing in paragraphs 6 and 31 of the Standard, is changed to reflect the new name of AS 21, viz., the following:

AS 21, Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements

7. The name of AS 23, appearing in paragraph 5 of the Standard, is changed to reflect the new name of AS 23, viz., the following:

AS 23, Accounting for Investments in Associates

The limited revision comes into effect in respect of accounting periods commencing on or after the date on which Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* comes into effect.

Limited Revision to
Accounting Standard (AS) 28 (issued 2002)

Impairment of Assets

The following is the text of the limited revision to AS 28, Impairment of Assets, issued by the Institute of Chartered Accountants of India.

Accounting Standard (AS) 13, *Accounting for Investments*, which deals with accounting for investments including an investment in a subsidiary, associate or joint venture, also contains specific requirements for recognising impairment on such investments. On **Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*,** becoming mandatory, AS 13 would stand withdrawn except to the extent it relates to accounting for investment properties. Thus, accounting for an investment in a subsidiary, associate and joint venture would no longer be covered by AS 13. The same would be dealt with in AS 21, AS 23 and AS 27. Accordingly, with the issuance of AS 30, Limited Revisions are also made to AS 21, AS 23 and AS 27. The impairment of an investment in a subsidiary, associate or joint venture in separate financial statements would be covered under AS 28, *Impairment of Assets*. With a view to require the same, AS 28 (issued 2002) is modified as under (modifications are shown as double-underline/ strike-through):

Under the heading 'Scope', paragraph 1 is amended and a new paragraph 2A is added after paragraph 2 as below:

1. This Statement should be applied in accounting for the impairment of all assets, other than:

(a) ***inventories (see AS 2, Valuation of Inventories);***

(b) ***assets arising from construction contracts (see AS 7, Accounting for Construction Contracts[6]);***

(c) ***financial assets[7], ~~including investments~~ that are ~~included in~~ within the scope of AS ~~13, Accounting for Investments~~30, Financial Instruments: Recognition and Measurement; and***

[6] This Standard has been revised and titled as 'Construction Contacts'. The revised AS 7 is published elsewhere in this Compendium.

~~[7] A financial asset is any asset that is:~~

~~(a) cash;~~

(d) ***deferred tax assets (see AS 22, Accounting for Taxes on Income).***

2A. This Statement applies to financial assets classified as investments in:

(a) subsidiaries, as defined in AS 21, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements*;

(b) associates, as defined in AS 23, *Accounting for Investments in Associates*; and

(c) joint ventures, as defined in AS 27, *Financial Reporting of Interests in Joint Ventures.*

For impairment of other financial assets, refer to AS 30, *Financial Instruments: Recognition and Measurement*.

The limited revision comes into effect in respect of accounting periods commencing on or after the date on which Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* comes into effect.

~~(b) a contractual right to receive cash or another financial asset from another enterprise;~~
~~(c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or~~
~~(d) an ownership interest in another enterprise.~~

Limited Revision to Accounting Standard (AS) 29 (issued 2003)

Provisions, Contingent Liabilities and Contingent Assets

The following is the text of the limited revision to AS 29, Provisions, Contingent Liabilities and Contingent Assets, issued by the Institute of Chartered Accountants of India.

In view of Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*, AS 29 (issued 2003) is modified as under (modifications are shown as double-underline/ strike-through):

1. Paragraphs 1 and 2, given under the heading 'Scope', are amended as below:

1. This Statement should be applied in accounting for provisions and contingent liabilities and in dealing with contingent assets, except:

(a) ~~those resulting from financial instruments~~[11] ~~that are carried at fair value~~[Deleted];

(b) those resulting from executory contracts, except where the contract is onerous[12];

(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~~.

2. Example 7: A Single Guarantee, given in Appendix C is deleted.

The limited revision comes into effect in respect of accounting periods commencing on or after the date on which Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* comes into effect.

[11] ~~For the purpose of this Statement, the term 'financial instruments' shall have the same meaning as in Accounting Standard (AS) 20, Earnings Per Share.~~

[12] The meaning of the term 'onerous contracts' and the application of the recognition and measurement principles of this Statement to such contracts are given in the Accounting Standards Interpretation (ASI) 30 on 'Applicability of AS 29 to Onerous Contracts'.

Accounting Standard (AS) 31

Financial Instruments: Presentation

Paragraphs

Contents

APPENDICES

Accounting Standard (AS) 31

Financial Instruments: Presentation

*(This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective and the Preface to the Statements of Accounting Standards [1].)*

Accounting Standard (AS) 31, *Financial Instruments: Presentation*, issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years. This Accounting Standard will become mandatory[2] in respect of accounting periods commencing on or after 1-4-2011 for all commercial, industrial and business entities except to a Small and Medium-sized Entity, as defined below:

(i) Whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

(ii) which is not a bank (including co-operative bank), financial institution or any entity carrying on insurance business;

(iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;

(iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and

(v) which is not a holding or subsidiary entity of an entity which is not a small and medium-sized entity.

For the above purpose, an entity would qualify as a Small and Medium-sized Entity, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

Where, in respect of an entity there is a statutory requirement for presenting any financial instrument in a particular manner as liability or equity and/ or for presenting interest, dividend, losses and gains relating to a financial instrument in a particular manner as income/ expense or as distribution of profits, the entity should present that instrument and/ or interest, dividend,

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[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.

losses and gains relating to the instrument in accordance with the requirements of the statute governing the entity. Until the relevant statute is amended, the entity presenting that instrument and/ or interest, dividend, losses and gains relating to the instrument in accordance with the requirements thereof will be considered to be complying with this Accounting Standard, in view of paragraph 4.1 of the *Preface to the Statements of Accounting Standards* which recognises that where a requirement of an Accounting Standard is different from the applicable law, the law prevails[3].

The following is the text of the Accounting Standard.

Objective

1. The objective of this Standard is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset.

2. The principles in this Standard complement the principles for recognising and measuring financial assets and financial liabilities in Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement* and for disclosing information about them in Accounting Standard (AS) 32, *Financial Instruments: Disclosures*[4].

Scope

3. This Standard should be applied by all entities to all types of financial instruments except:

> ***(a) those interests in subsidiaries, associates and joint ventures that are accounted for in accordance with AS 21, Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements, AS 23, Accounting for Investments in Associates, or AS 27, Financial Reporting of Interests in Joint Ventures. However, in some cases, AS 21, AS 23***

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[3] To illustrate, as per paragraph 35(a) of the Standard, a preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, is a financial liability. However, the relevant Schedule prescribing the format of balance sheet under the Companies Act, *inter alia*, requires that all preference shares should be disclosed as a part of the 'Share Capital'. Untill relevant Schedule 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 of a co-operative entity those requirements of paragraphs 40 to 47 and Appendix B to the Standard would not apply which are contrary to the law governing such an entity.

[4] AS 32 *Financial Instruments: Disclosures* has been formulated and published elsewhere in this Compendium.

or AS 27 permits or requires an entity to account for an interest in a subsidiary, associate or joint venture using Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement[5]*; in those cases, entities should apply the disclosure requirements in AS 21, AS 23 or AS 27 in addition to those in this Standard. Entities should also apply this Standard to all derivatives linked to interests in subsidiaries, associates or joint ventures.*

(b) employers' rights and obligations under employee benefit plans, to which AS 15, Employee Benefits, applies.

(c) contracts for contingent consideration in a business combination[6]*. This exemption applies only to the acquirer.*

(d) insurance contracts as defined in the Accounting Standard on Insurance Contracts[7]*. However, this Standard applies to derivatives that are embedded in insurance contracts if Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement requires the entity to account for them separately. Moreover, an issuer should apply this 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[8] *because they contain a discretionary participation feature. The issuer of these instruments is exempt from applying to these features paragraphs 32-67 of this Standard regarding the distinction between financial liabilities and equity instruments. However, these instruments are subject to all other requirements of this Standard. Furthermore, this Standard applies to derivatives that are embedded in these instruments (see Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement).*

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[5] It may be noted that AS 21, AS 23 and AS 27, at present, make reference to Accounting Standard (AS) 13, *Accounting for Investments*, with regard to the accounting for an investment in a subsidiary, associate and joint venture, respectively. On Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* becoming mandatory, AS 13 would stand withdrawn except to the extent it relates to accounting for investment properties. In other words, accounting for investments in a subsidiary, associate and joint venture would no longer be covered by AS 13. Keeping this in view, with the issuance of the proposed AS 30, Limited Revisions have been made to AS 21, AS 23 and AS 27 to replace the references to AS 13 with those to AS 30. Pursuant to these Limited Revisions, the titles of AS 21 and AS 23 are also modified.

[6] '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.

[7] A separate Accounting Standard on *Insurance Contracts* will specify the requirements relating to insurance contracts.

[8] See footnote 7.

(f) ***financial instruments, contracts and obligations under share-based payment transactions[9] except for***

(i) contracts within the scope of paragraphs 4-6 of this Standard, to which this Standard applies.

(ii) paragraphs 68, 69 and 70 of this Standard, which should be applied to treasury shares, purchased, sold, issued or cancelled in connection with employee share option plans, employees share purchase plans, and all other share-based payment arrangements.

4. This Standard should be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements.

5. There are various ways in which a contract to buy or sell a non-financial item can be settled net in cash or another financial instrument or by exchanging financial instruments. These include:

(a) when the terms of the contract permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments;

(b) when the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument, or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse);

(c) when, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and

(d) when the non-financial item that is the subject of the contract is readily convertible to cash.

A contract to which (b) or (c) applies is not entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements, and, accordingly, is within the scope of this Standard. Other contracts to which paragraph 4 applies are evaluated to determine whether they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirement, and accordingly, whether they are within the scope of this Standard.

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[9] 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*.

6. A written option to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, in accordance with paragraph 5(a) or (d) is within the scope of this Standard. Such a contract cannot be entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements.

Definitions

7. The following terms are used in this Standard with the meanings specified:

7.1 A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

7.2 A financial asset is any asset that is:

(a) cash;

(b) an equity instrument of another entity;

(c) a contractual right:

- ***(i) to receive cash or another financial asset from another entity; or***
- ***(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or***

(d) a contract that will or may be settled in the entity's own equity instruments and is:

- ***(i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or***
- ***(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.***

7.3 A financial liability is any liability that is:

(a) a contractual obligation:

- ***(i) to deliver cash or another financial asset to another entity; or***
- ***(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or***

(b) a contract that will or may be settled in the entity's own equity instruments and is

- ***(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or***

(ii) ***a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity 's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.***

7.4 An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

7.5 Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

8. The following terms are defined in paragraph 8 of Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement* and are used in this Standard with the meaning specified in AS 30.

- amortised cost of a financial asset or financial liability
- available-for-sale financial assets
- derecognition
- derivative
- effective interest method
- financial asset or financial liability at fair value through profit or loss
- financial guarantee contract
- firm commitment
- forecast transaction
- hedge effectiveness
- hedged item
- hedging instrument
- held-to-maturity investments
- loans and receivables
- regular way purchase or sale
- transaction costs.

9. In this Standard, 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.

10. In this Standard, 'entity' includes individuals, partnerships, incorporated bodies, trusts and government agencies.

Financial Assets and Financial Liabilities

11. Currency (cash) is a financial asset because it represents the medium of exchange and is therefore the basis on which all transactions are measured and recognised in financial statements. A deposit of cash with a bank or similar financial institution is a financial asset because it represents the contractual right of the depositor to obtain cash from the institution or to draw a cheque or similar instrument against the balance in favour of a creditor in payment of a financial liability.

12. Common examples of financial assets representing a contractual right to receive cash in the future and corresponding financial liabilities representing a contractual obligation to deliver cash in the future are:

(a) trade accounts receivable and payable;

(b) bills receivable and payable;

(c) loans receivable and payable;

(d) bonds receivable and payable; and

(e) deposits and advances.

In each case, one party's contractual right to receive (or obligation to pay) cash is matched by the other party's corresponding obligation to pay (or right to receive).

13. Another type of financial instrument is one for which the economic benefit to be received or given up is a financial asset other than cash. For example, a promissory note payable in government bonds gives the holder the contractual right to receive and the issuer the contractual obligation to deliver government bonds, not cash. The bonds are financial assets because they represent obligations of the issuing government to pay cash. The promissory note is, therefore, a financial asset of the promissory note holder and a financial liability of the promissory note issuer.

14. 'Perpetual' debt instruments normally provide the holder with the contractual right to receive payments on account of interest at fixed dates extending into the indefinite future, either with no right to receive a return of principal or a right to a return of principal under terms that make it very unlikely or very far in the future. For example, an entity may issue a financial instrument requiring it to make annual payments in perpetuity equal to a stated interest rate of 8 per cent applied to a stated par or principal amount of Rs. 1,000. Assuming 8 per cent to be the market rate of interest for the instrument when issued, the issuer assumes a contractual obligation to make a stream of future interest payments having a fair value (present value) of Rs. 1,000 on initial recognition. The holder and issuer of the instrument have a financial asset and a financial liability, respectively.

15. A contractual right or contractual obligation to receive, deliver or exchange financial instruments is itself a financial instrument. A chain of contractual rights or contractual obligations meets the definition of a financial instrument if it will ultimately lead to the receipt or payment of cash or to the acquisition or issue of an equity instrument.

16. The ability to exercise a contractual right or the requirement to satisfy a contractual obligation may be absolute, or it may be contingent on the occurrence of a future event. For example, a financial guarantee is a contractual right of the lender to receive cash from the guarantor, and a corresponding contractual obligation of the guarantor to pay the lender, if the borrower defaults. The contractual right and obligation exist because of a past transaction or event (assumption of the guarantee), even though the lender's ability to exercise its right and the requirement for the guarantor to perform under its obligation are both contingent on a future act of default by the borrower. A contingent right and obligation meet the definition of a financial asset and a financial liability, even though such assets and liabilities are not always recognised in the financial statements. Some of the contingents rights and obligations may be insurance contracts within the scope of the Accounting Standard on *Insurance Contracts*[10].

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, property, plant and equipment), leased assets and intangible assets (such as patents and trademarks) are not financial assets. Control of such physical and intangible assets creates an opportunity to generate an inflow of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset.

19. Assets (such as prepaid expenses) for which the future economic benefit is the receipt of goods or services, rather than the right to receive cash or another financial asset, are not financial assets. Similarly, items such as deferred revenue and most warranty obligations are not financial liabilities because the outflow of economic benefits associated with them is the delivery of goods and services rather than a contractual obligation to pay cash or another financial asset.

20. Liabilities or assets that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial liabilities or financial assets. Accounting for income taxes is dealt with in AS 22, *Accounting for Taxes on Income*.

Equity Instruments

21. Examples of equity instruments include non-puttable equity shares, some types of preference shares (see paragraphs 38 and 39) and warrants or written call options that allow the holder to subscribe for or purchase a fixed number of non-puttable equity shares in the issuing

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[10] See footnote 7.

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entity in exchange for a fixed amount of cash or another financial asset. An obligation of an entity to issue or purchase a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument of the entity. However, if such a contract contains an obligation for the entity to pay cash or another financial asset, it also gives rise to a liability for the present value of the redemption amount (see paragraph 52(a)). An issuer of non-puttable equity shares assumes a liability when it formally acts to make a distribution and becomes legally obligated to the shareholders to do so. This may be the case following the declaration of a dividend or when the entity is being wound up and any assets remaining after the satisfaction of liabilities become distributable to shareholders.

22. A purchased call option or other similar contract acquired by an entity that gives it the right to reacquire a fixed number of its own equity instruments in exchange for delivering a fixed amount of cash or another financial asset is not a financial asset of the entity. Instead, any consideration paid for such a contract is deducted from equity.

Derivative Financial Instruments

23. Financial instruments include primary instruments (such as receivables, payables and equity instruments) and derivative financial instruments (such as financial options, futures and forwards, interest rate swaps and currency swaps). Derivative financial instruments meet the definition of a financial instrument and, accordingly, are within the scope of this Standard.

24. Derivative financial instruments create rights and obligations that have the effect of transferring between the parties to the instrument one or more of the financial risks inherent in an underlying primary financial instrument. On inception, derivative financial instruments give one party a contractual right to exchange financial assets or financial liabilities with another party under conditions that are potentially favourable, or a contractual obligation to exchange financial assets or financial liabilities with another party under conditions that are potentially unfavourable. However, they generally[11] do not result in a transfer of the underlying primary financial instrument on inception of the contract, nor does such a transfer necessarily take place on maturity of the contract. Some instruments embody both a right and an obligation to make an exchange. Because the terms of the exchange are determined on inception of the derivative instrument, as prices in financial markets change those terms may become either favourable or unfavourable.

25. A put or call option to exchange financial assets or financial liabilities (i.e. financial instruments other than an entity's own equity instruments) gives the holder a right to obtain potential future economic benefits associated with changes in the fair value of the financial instrument underlying the contract. Conversely, the writer of an option assumes an obligation to forgo potential future economic benefits or bear potential losses of economic benefits associated with changes in the fair value of the underlying financial instrument. The contractual right of the holder and obligation of the writer meet the definition of a financial asset and a financial liability, respectively. The financial instrument underlying an option contract may be any

[11] 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).

financial asset, including shares in other entities and interest-bearing instruments. An option may require the writer to issue a debt instrument, rather than transfer a financial asset, but the instrument underlying the option would constitute a financial asset of the holder if the option were exercised. The option-holder's right to exchange the financial asset under potentially favourable conditions and the writer's obligation to exchange the financial asset under potentially unfavourable conditions are distinct from the underlying financial asset to be exchanged upon exercise of the option. The nature of the holder's right and of the writer's obligation are not affected by the likelihood that the option will be exercised.

26. Another example of a derivative financial instrument is a forward contract to be settled in six months' time in which one party (the purchaser) promises to deliver 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.

27. Many other types of derivative instruments embody a right or obligation to make a future exchange, including interest rate and currency swaps, interest rate caps, collars and floors, loan commitments[12], 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

28. Contracts to buy or sell non-financial items do not meet the definition of a financial instrument because the contractual right of one party to receive a non-financial asset or service and the corresponding obligation of the other party do not establish a present right or obligation of either party to receive, deliver or exchange a financial asset. For example, contracts that provide for settlement only by the receipt or delivery of a non-financial item (e.g. an option, futures or forward contract on silver) are not financial instruments. Many commodity contracts

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[12] Loan commitment is firm commitment of an entity to provide credit under pre-specified terms and conditions.

are of this type. Some are standardised in form and traded on organised markets in much the same fashion as some derivative financial instruments. For example, a commodity futures contract may be bought and sold readily for cash because it is listed for trading on an exchange and may change hands many times. However, the parties buying and selling the contract are, in effect, trading the underlying commodity. The ability to buy or sell a commodity contract for cash, the ease with which it may be bought or sold and the possibility of negotiating a cash settlement of the obligation to receive or deliver the commodity do not alter the fundamental character of the contract in a way that creates a financial instrument. Nevertheless, some contracts to buy or sell non-financial items that can be settled net or by exchanging financial instruments, or in which the non-financial item is readily convertible to cash, are within the scope of the Standard as if they were financial instruments (see paragraph 4).

29. A contract that involves the receipt or delivery of physical assets does not give rise to a financial asset of one party and a financial liability of the other party unless any corresponding payment is deferred past the date on which the physical assets are transferred. Such is the case with the purchase or sale of goods on trade credit.

30. Some contracts are commodity-linked, but do not involve settlement through the physical receipt or delivery of a commodity. They specify settlement through cash payments that are determined according to a formula in the contract, rather than through payment of fixed amounts. For example, the principal amount of a bond may be calculated by applying the market price of oil prevailing at the maturity of the bond to a fixed quantity of oil. The principal is indexed by reference to a commodity price, but is settled only in cash. Such a contract constitutes a financial instrument.

31. The definition of a financial instrument also encompasses a contract that gives rise to a non-financial asset or non-financial liability in addition to a financial asset or financial liability. Such financial instruments often give one party an option to exchange a financial asset for a non-financial asset. For example, an oil-linked bond may give the holder the right to receive a stream of fixed periodic interest payments and a fixed amount of cash on maturity, with the option to exchange the principal amount for a fixed quantity of oil. The desirability of exercising this option will vary from time to time depending on the fair value of oil relative to the exchange ratio of cash for oil (the exchange price) inherent in the bond. The intentions of the bondholder concerning the exercise of the option do not affect the substance of the component assets. The financial asset of the holder and the financial liability of the issuer make the bond a financial instrument, regardless of the other types of assets and liabilities also created.

Presentation

Liabilities and Equity

32. The issuer of a financial instrument should classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.

33. When an issuer applies the definitions in paragraph 7 to determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met.

(a) The instrument includes no contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.

(b) If the instrument will or may be settled in the issuer's own equity instruments, it is

(i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or

(ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose the issuer's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the issuer's own equity instruments.

A contractual obligation, including one arising from a derivative financial instrument that will or may result in the future receipt or delivery of the issuer's own equity instruments, but does not meet conditions (a) and (b) above, is not an equity instrument.

No Contractual Obligation to Deliver Cash or Another Financial Asset (paragraph 33(a))

34. A critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of one party to the financial instrument (the issuer) either to deliver cash or another financial asset to the other party (the holder) or to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer. Although the holder of an equity instrument may be entitled to receive a pro rata share of any dividends or other distributions of equity, the issuer does not have a contractual obligation to make such distributions because it cannot be required to deliver cash or another financial asset to another party.

35. The substance of a financial instrument, rather than its legal form, governs its classification on the entity's balance sheet. Substance and legal form are commonly consistent, but not always. Some financial instruments take the legal form of equity but are liabilities in substance and others may combine features associated with equity instruments and features associated with financial liabilities. For example:

(a) a preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, is a financial liability.

(b) a financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability. This is so even when the amount of cash or other financial assets is determined on the basis of an index or other item that has the potential to increase or decrease, or when the legal form of the puttable instrument gives the holder a right to a residual interest in the assets of an issuer. The existence of an option for the holder to put the instrument back to the issuer for cash or another financial asset means that the puttable instrument meets the definition of a financial liability. For example, open-ended mutual funds, unit trusts and some co-operative entities may provide their unitholders or members with a right to redeem their interests in the issuer at any time for cash equal to their proportionate share of the asset value of the issuer. However, classification as a financial liability does not preclude the use of descriptors such as 'net asset value attributable to unitholders' and 'change in net asset value attributable to unitholders' on the face of the financial statements of an entity that has no equity capital (such as some mutual funds and unit trusts, see Illustrative Example 1 of Appendix A) or the use of additional disclosure to show that total members' interests comprise items such as reserves that meet the definition of equity and puttable instruments that do not (see Illustrative Example 2 of Appendix A).

36. If an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability. For example:

(a) a restriction on the ability of an entity to satisfy a contractual obligation, such as lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, does not negate the entity's contractual obligation or the holder's contractual right under the instrument.

(b) a contractual obligation that is conditional on a counterparty exercising its right to redeem is a financial liability because the entity does not have the unconditional right to avoid delivering cash or another financial asset.

37. A financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may establish an obligation indirectly through its terms and conditions. For example:

(a) a financial instrument may contain a non-financial obligation that must be settled if, and only if, the entity fails to make distributions or to redeem the instrument. If the entity can avoid a transfer of cash or another financial asset only by settling the non-financial obligation, the financial instrument is a financial liability.

(b) a financial instrument is a financial liability if it provides that on settlement the entity will deliver either:

(i) cash or another financial asset; or

(ii) its own shares whose value is determined to exceed substantially the value of the cash or other financial asset.

Although the entity does not have an explicit contractual obligation to deliver cash or another financial asset, the value of the share settlement alternative is such that the entity will settle in cash. In any event, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option (see paragraph 53).

38. Preference shares may be issued with various rights. In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability. For example, a preference share that provides for redemption on a specific date or at the option of the holder contains a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share. The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves, does not negate the obligation. An option of the issuer to redeem the shares for cash does not satisfy the definition of a financial liability because the issuer does not have a present obligation to transfer financial assets to the shareholders. In this case, redemption of the shares is solely at the discretion of the issuer. An obligation may arise, however, when the issuer of the shares exercises its option, usually by formally notifying the shareholders of an intention to redeem the shares.

39. When preference shares are non-redeemable, the appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument. When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments. The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:

(a) a history of making distributions;

(b) an intention to make distributions in the future;

(c) a possible negative impact on the price of equity shares of the issuer if distributions are not made (because of restrictions on paying dividends on the equity shares if dividends are not paid on the preference shares);

(d) the amount of the issuer's reserves;

(e) an issuer's expectation of a profit or loss for a period; or

(f) an ability or inability of the issuer to influence the amount of its profit or loss for the period.

40. The contractual right of the holder of a financial instrument (including members' shares in co-operative entities) to request redemption does not, in itself, require that financial instrument to be classified as a financial liability. Rather, the entity must consider all of the terms and conditions of the financial instrument in determining its classification as a financial liability or equity. Those terms and conditions include relevant laws, regulations and the governing rules or bye-laws of the entity in effect at the date of classification, but not expected future amendments to those laws, regulations or bye-laws.

41. Members' shares in co-operative entities that would be classified as equity if the members did not have a right to request redemption are equity if either of the conditions described in paragraphs 42 and 43 is present. Demand deposits, including current accounts, deposit accounts and similar contracts that arise when members act as customers are financial liabilities of the entity.

42. Members' shares are equity if the entity has an unconditional right to refuse redemption of the members' shares.

43. Law, regulation or the governing rules or bye-laws of the entity can impose various types of prohibitions on the redemption of members' shares, *e.g.*, unconditional prohibitions or prohibitions based on liquidity criteria. If redemption is unconditionally prohibited by law, regulation or the governing rules or bye-laws of the entity, members' shares are equity. However, provisions in law, regulation or the governing rules or bye-laws of the entity that prohibit redemption only if conditions — such as liquidity constraints — are met (or are not met) do not result in members' shares being equity.

44. An unconditional prohibition may be absolute, in that all redemptions are prohibited. An unconditional prohibition may be partial, in that it prohibits redemption of members' shares if redemption would cause the number of members' shares or amount of paid-up capital from members' shares to fall below a specified level. Members' shares in excess of the prohibition against redemption are liabilities, unless the entity has the unconditional right to refuse redemption as described in paragraph 42. In some cases, the number of shares or the amount of paid-up capital subject to a redemption prohibition may change from time to time. Such a change in the redemption prohibition leads to a transfer between financial liabilities and equity. In such a case, the entity should disclose separately the amount, timing and reason for the transfer.

45. Equity is the residual interest in the assets after deducting all liabilities. Therefore, at initial recognition, the entity should measure the equity component in the member's shares at the residual amount after deducting from the total amount of the shares as a whole the value separately determined for its financial liabilities for redemption. The entity measures its financial liability for redemption at fair value. In the case of members' shares with a redemption feature, the fair value of the financial liability for redemption is measured at no less than the maximum amount payable under the redemption provisions of its governing bye-laws or applicable law discounted from the first date that the amount could be required to be paid (see Example 3 of Appendix B).

46. As required by paragraph 71, distributions to holders of equity instruments (net of any income tax benefits) are recognised directly in the revenue reserves and surplus. Interest, dividends and other returns relating to financial instruments classified as financial liabilities are expenses, regardless of whether those amounts paid are legally characterised as dividends, interest or otherwise.

47. Appendix B, which is an integral part of the Standard, illustrates the application of paragraphs 40 to 46.

Settlement in the Entity's Own Equity Instruments (paragraph 33(b))

48. A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. An entity may have a contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instruments to be received or delivered equals the amount of the contractual right or obligation. Such a contractual right or obligation may be for a fixed amount or an amount that fluctuates in part or in full in response to changes in a variable other than the market price of the entity's own equity instruments (e.g. an interest rate, a commodity price or a financial instrument price). Two examples are (a) a contract to deliver as many of the entity's own equity instruments as are equal in value to Rs.100, and (b) a contract to deliver as many of the entity's own equity instruments as are equal in value to the value of 100 grams of gold. Such a contract is a financial liability of the entity even though the entity must or can settle it by delivering its own equity instruments. It is not an equity instrument because the entity uses a variable number of its own equity instruments as a means to settle the contract. Accordingly, the contract does not evidence a residual interest in the entity's assets after deducting all of its liabilities.

49. A contract that will be settled by the entity (receiving or) delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument. For example, an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond is an equity instrument. Changes in the fair value of a contract arising from variations in market interest rates that do not affect the amount of cash or other financial assets to be paid or received, or the number of equity instruments to be received or delivered, on settlement of the contract do not preclude the contract from being an equity instrument. Any consideration received (such as the premium received for a written option or warrant on the entity's own shares) is added directly to equity in an appropriate account. Any consideration paid (such as the premium paid for a purchased option) is deducted directly from an appropriate equity account. Changes in the fair value of an equity instrument are not recognised in the financial statements.

50. A contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability for the present value of the redemption amount (for example, for the present value of the forward repurchase price, option exercise price or other redemption amount). This is the case even if the contract itself is an equity instrument. One example is an entity's obligation under a forward contract to purchase its own equity instruments for cash. When the financial liability is recognised initially under AS 30, its fair value (the present value of the redemption amount) is reclassified from equity. Subsequently, the financial liability is measured in accordance with AS 30. If the contract expires without delivery, the carrying amount of the financial liability is reclassified to equity. An entity's contractual obligation to purchase its own equity instruments gives rise to a financial liability for the present value of the redemption amount even if the obligation to purchase is conditional on the counterparty exercising a right to redeem (eg a written put option that gives the counterparty the right to sell an entity's own equity instruments to the entity for a fixed price).

51. A contract that will be settled by the entity delivering or receiving a fixed number of its own equity instruments in exchange for a variable amount of cash or another financial asset is a financial asset or financial liability. An example is a contract for the entity to deliver 100 of its

own equity instruments in return for an amount of cash calculated to equal the value of 100 grams of gold.

52. The following examples illustrate how to classify different types of contracts on an entity's own equity instruments:

(a) A contract that will be settled by the entity receiving or delivering a fixed number of its own shares for no future consideration, or exchanging a fixed number of its own shares for a fixed amount of cash or another financial asset, is an equity instrument. Accordingly, any consideration received or paid for such a contract is added directly to or deducted directly from equity. One example is an issued share option that gives the counterparty a right to buy a fixed number of the entity 's shares for a fixed amount of cash. However, if the contract requires the entity to purchase (redeem) its own shares for cash or another financial asset at a fixed or determinable date or on demand, the entity also recognises a financial liability for the present value of the redemption amount. One example is an entity' s obligation under a forward contract to repurchase a fixed number of its own shares for a fixed amount of cash.

(b) An entity' s obligation to purchase its own shares for cash gives rise to a financial liability for the present value of the redemption amount even if the number of shares that the entity is obliged to repurchase is not fixed or if the obligation is conditional on the counterparty exercising a right to redeem. One example of a conditional obligation is an issued option that requires the entity to repurchase its own shares for cash if the counterparty exercises the option.

(c) A contract that will be settled in cash or another financial asset is a financial asset or financial liability even if the amount of cash or another financial asset that will be received or delivered is based on changes in the market price of the entity's own equity. One example is a net cash-settled share option.

(d) A contract that will be settled in a variable number of the entity's own shares whose value equals a fixed amount or an amount based on changes in an underlying variable (eg a commodity price) is a financial asset or a financial liability. An example is a written option to buy gold that, if exercised, is settled net in the entity's own instruments by the entity delivering as many of those instruments as are equal to the value of the option contract. Such a contract is a financial asset or financial liability even if the underlying variable is the entity's own share price rather than gold. Similarly, a contract that will be settled in a fixed number of the entity's own shares, but the rights attaching to those shares will be varied so that the settlement value equals a fixed amount or an amount based on changes in an underlying variable, is a financial asset or a financial liability.

Contingent Settlement Provisions

53. A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, or the issuer's future revenues, net income or debt-to-equity ratio). The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer unless:

(a) the part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not genuine; or

(b) the issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer.

54. Paragraph 53 requires that if a part of a contingent settlement provision that could require settlement in cash or another financial asset (or in another way that would result in the instrument being a financial liability) is not genuine, the settlement provision does not affect the classification of a financial instrument. Thus, a contract that requires settlement in cash or a variable number of the entity's own shares only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur is an equity instrument. Similarly, settlement in a fixed number of an entity's own shares may be contractually precluded in circumstances that are outside the control of the entity, but if these circumstances have no genuine possibility of occurring, classification as an equity instrument is appropriate.

Settlement Options

55. When a derivative financial instrument gives one party a choice over how it is settled (eg the issuer or the holder can choose settlement net in cash or by exchanging shares for cash), it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument.

56. An example of a derivative financial instrument with a settlement option that is a financial liability is a share option that the issuer can decide to settle net in cash or by exchanging its own shares for cash. Similarly, some contracts to buy or sell a non-financial item in exchange for the entity' s own equity instruments are within the scope of this Standard because they can be settled either by delivery of the non-financial item or net in cash or another financial instrument (see paragraphs 4-6). Such contracts are financial assets or financial liabilities and not equity instruments.

Treatment in Consolidated Financial Statements

57. In consolidated financial statements, an entity presents minority interests - i.e. the interests of other parties in the equity and income of its subsidiaries in accordance with AS 1 (revised)[13], *Presentation of Financial Statements*, and AS 21, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements*[14]. When classifying a financial instrument (or a component of it) in consolidated financial statements, an entity considers all terms and conditions agreed between members of the group and the holders of the instrument in determining whether the group as a whole has an obligation to deliver cash or another financial asset in respect of the instrument or to settle it in a manner that results in liability classification. When a subsidiary in a group issues a financial instrument and a parent or other group entity agrees additional terms directly with the holders of the instrument (e.g. a guarantee), the group may not have discretion over distributions or redemption. Although the subsidiary may appropriately classify the instrument without regard to these additional terms in its individual financial statements, the effect of other agreements between members of the group and the holders of the instrument is considered in order to ensure that consolidated financial statements reflect the contracts and transactions entered into by the group as a whole. To the extent that there is such an obligation or settlement provision, the instrument (or the component of it that is subject to the obligation) is classified as a financial liability in consolidated financial statements.

Compound Financial Instruments

(see also Illustrative Examples 3-6 of Appendix A)

58. The issuer of a non-derivative financial instrument should evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components should be classified separately as financial liabilities or equity instruments in accordance with paragraph 32.

59. Paragraph 58 applies only to issuers of non-derivative compound financial instruments. Paragraph 58 does not deal with compound financial instruments from the perspective of holders. Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement* deals with the separation of embedded derivatives from the perspective of holders of compound financial instruments that contain debt and equity features.

60. An entity recognises separately the components of a financial instrument that (a) creates a financial liability of the entity and (b) grants an option to the holder of the instrument to convert it into an equity instrument of the entity. For example, a debenture or similar instrument convertible by the holder into a fixed number of equity shares of the entity is a compound financial instrument. From the perspective of the entity, such an instrument comprises two

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[13] AS 1 is presently under revision.

[14] A limited revision has been made to AS 21 with the issuance of the Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*. Pursuant to the limited revision, the title of AS 21 is also modified.

components: a financial liability (a contractual arrangement to deliver cash or another financial asset) and an equity instrument (a call option granting the holder the right, for a specified period of time, to convert it into a fixed number of equity shares of the entity). The economic effect of issuing such an instrument is substantially the same as issuing simultaneously a debt instrument with an early settlement provision and warrants to purchase equity shares, or issuing a debt instrument with detachable share purchase warrants. Accordingly, in all cases, the entity presents the liability and equity components separately on its balance sheet.

61. Classification of the liability and equity components of a convertible instrument is not revised as a result of a change in the likelihood that a conversion option will be exercised, even when exercise of the option may appear to have become economically advantageous to some holders. Holders may not always act in the way that might be expected because, for example, the tax consequences resulting from conversion may differ among holders. Furthermore, the likelihood of conversion will change from time to time. The entity's contractual obligation to make future payments remains outstanding until it is extinguished through conversion, maturity of the instrument or some other transaction.

62. Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement* deals with the measurement of financial assets and financial liabilities. Equity instruments are instruments that evidence a residual interest in the assets of an entity after deducting all of its liabilities. Therefore, when the initial carrying amount of a compound financial instrument is allocated to its equity and liability components, the equity component is assigned the residual amount after deducting from the fair value of the instrument as a whole the amount separately determined for the liability component. The value of any derivative features (such as a call option) embedded in the compound financial instrument other than the equity component (such as an equity conversion option) is included in the liability component. The sum of the carrying amounts assigned to the liability and equity components on initial recognition is always equal to the fair value that would be ascribed to the instrument as a whole. No gain or loss arises from initially recognising the components of the instrument separately.

63. A common form of compound financial instrument is a debt instrument with an embedded conversion option, such as a debenture convertible into equity shares of the issuer, and without any other embedded derivative features. Paragraph 58 requires the issuer of such a financial instrument to present the liability component and the equity component separately on the balance sheet, as follows:

(a) The issuer's obligation to make scheduled payments of interest and principal is a financial liability that exists as long as the instrument is not converted. Accordingly, the issuer of a debenture convertible into equity shares first determines the carrying amount of the liability component by measuring the fair value of a similar liability (including any embedded non-equity derivative features) that does not have an associated equity component. Thus, on initial recognition, the fair value of the liability component is the present value of the contractually determined stream of future cash flows discounted at the rate of interest applied at that time by the market to instruments of comparable credit status and providing substantially the same cash flows, on the same terms, but without the conversion option.

(b) The equity instrument is an embedded option to convert the liability into equity of the issuer. The fair value of the option comprises its time value and its intrinsic value, if any. This option has value on initial recognition even when it is out of the money. The carrying amount of the equity instrument represented by such option is determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole.

64. On conversion of a convertible instrument at maturity, the entity derecognises the liability component and recognises it as equity. The original equity component remains as equity (although it may be transferred from one line item within equity to another). There is no gain or loss on conversion at maturity.

65. When an entity extinguishes a convertible instrument before maturity through an early redemption or repurchase in which the original conversion privileges are unchanged, the entity allocates the consideration paid and any transaction costs for the repurchase or redemption to the liability and equity components of the instrument at the date of the transaction. The method used in allocating the consideration paid and transaction costs to the separate components is consistent with that used in the original allocation to the separate components of the proceeds received by the entity when the convertible instrument was issued, in accordance with paragraphs 58-63.

66. Once the allocation of the consideration is made, any resulting gain or loss is treated in accordance with accounting principles applicable to the related component, as follows:

(a) the amount of gain or loss relating to the liability component is recognised in the statement of profit and loss; and

(b) the amount of consideration relating to the equity component is adjusted in equity against the original equity component and the balance, if any, against the reserves and surplus.

67. An entity may amend the terms of a convertible instrument to induce early conversion, for example by offering a more favourable conversion ratio or paying other additional consideration in the event of conversion before a specified date. The difference, at the date the terms are amended, between the fair value of the consideration the holder receives on conversion of the instrument under the revised terms and the fair value of the consideration the holder would have received under the original terms is recognised as a loss in the statement of profit and loss.

Treasury shares

68. If an entity reacquires its own equity instruments, those instruments ('treasury shares') should be deducted from equity. No gain or loss should be recognised in statement of profit and loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. Such treasury shares may be acquired and held by the entity or by other members of the consolidated group. Consideration paid or received should be recognised directly in equity.

69. The amount of treasury shares held is disclosed separately either on the face of the balance sheet or in the notes, in accordance with AS 1[15] (Revised), *Presentation of Financial Statements*. An entity provides disclosure in accordance with AS 18, *Related Party Disclosures,* if the entity reacquires its own equity instruments from related parties.

70. An entity's own equity instruments are not recognised as a financial asset regardless of the reason for which they are reacquired. Paragraph 68 requires an entity that reacquires its own equity instruments to deduct those equity instruments from equity. However, when an entity holds its own equity on behalf of others, eg, a financial institution holding its own equity on behalf of a client, there is an agency relationship and as a result those holdings are not included in the entity's balance sheet.

Interest, Dividends, Losses and Gains

71. ***Interest, dividends, losses and gains relating to a financial instrument or a component of financial instrument that is a financial liability should be recognised as income or expense in the statement of profit and loss. Distributions to holders of an equity instrument should be debited by the entity directly to an appropriate equity account, net of any related income tax benefit. Transaction costs of an equity transaction should be accounted for as a deduction from equity net of any related income tax benefit.***

72. The classification of a financial instrument as a financial liability or an equity instrument determines whether interest, dividends, losses and gains relating to that instrument are recognised as expense or income in the statement of profit and loss or are recognised directly in the revenue reserves and surplus. Thus, dividend payments on shares wholly recognised as liabilities are recognised as expenses in the same way as interest on a bond/ debenture. Similarly, gains and losses associated with redemptions or refinancings of financial liabilities are recognised in the statement of profit and loss, whereas redemptions or refinancings of equity instruments are recognised as changes in equity. Changes in the fair value of an equity instrument are not recognised in the financial statements.

73. An entity typically incurs various costs in issuing or acquiring its own equity instruments. Those costs might include regulatory fees, amounts paid to legal, accounting and other professional advisers, printing costs and stamp duties. The transaction costs (net of any related income tax benefit) of an equity transaction are recognised directly in the appropriate equity account to the extent they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided. The costs of an equity transaction that is abandoned are recognised as an expense.

74. Transaction costs that relate to the issue of a compound financial instrument are allocated to the liability and equity components of the instrument in proportion to the allocation of proceeds. Transaction costs that relate jointly to more than one transaction are allocated to those transactions using a basis of allocation that is rational and consistent with similar transactions.

[15] See footnote 13.

75. The amount of transaction costs recognised in the revenue reserves and surplus is disclosed separately under AS 1 (revised)[16].

76. The following example illustrates the application of paragraph 71 to a compound financial instrument. Assume that a non-cumulative preference share is mandatorily redeemable for cash in five years, but that dividends are payable at the discretion of the entity before the redemption date. Such an instrument is a compound financial instrument, with the liability component being the present value of the redemption amount. The unwinding of the discount on this component is recognised in statement of profit and loss and classified as interest expense. Any dividends paid relate to the equity component and, accordingly, are recognised directly in the revenue reserves and surplus. A similar treatment would apply if the redemption was not mandatory but at the option of the holder, or if the share was mandatorily convertible into a variable number of equity shares calculated to equal a fixed amount or an amount based on changes in an underlying variable (e.g., commodity). However, if any unpaid dividends are added to the redemption amount, the entire instrument is a liability. In such a case, any dividends are classified as interest expense.

77. Dividends classified as an expense are presented in the statement of profit and loss as a separate item. In addition to the requirements of this Standard, disclosure of interest and dividends is subject to the requirements of AS 1 (revised)[17] and Accounting Standard (AS) 32, *Financial Instruments: Disclosures*[18].

78. Gains and losses related to changes in the carrying amount of a financial liability are recognised as income or expense in the statement of profit and loss even when they relate to an instrument that includes a right to the residual interest in the assets of the entity in exchange for cash or another financial asset (see paragraph 35(b)). Under AS 1 (revised)[19], the entity presents any gain or loss arising from remeasurement of such an instrument separately on the face of the statement of profit and loss when it is relevant in explaining the entity's performance.

Offsetting a Financial Asset and a Financial Liability

79. A financial asset and a financial liability should be offset and the net amount presented in the balance sheet when, and only when, an entity:

(a) currently has a legally enforceable right to set off the recognised amounts; and

(b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

In accounting for a transfer of a financial asset that does not qualify for derecognition, the entity should not offset the transferred asset and the associated liability (see Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement).

80. This Standard requires the presentation of financial assets and financial liabilities on a net basis when doing so reflects an entity's expected future cash flows from settling two or more

[16] See footnote 13.

[17] See footnote 13.

[18] See footnote 4.

[19] See footnote 13.

separate financial instruments. When an entity has the right to receive or pay a single net amount and intends to do so, it has, in effect, only a single financial asset or financial liability. In other circumstances, financial assets and financial liabilities are presented separately from each other consistently with their characteristics as resources or obligations of the entity.

81. Offsetting a recognised financial asset and a recognised financial liability and presenting the net amount differs from the derecognition of a financial asset or a financial liability. Although offsetting does not give rise to recognition of a gain or loss, the derecognition of a financial instrument not only results in the removal of the previously recognised item from the balance sheet but also may result in recognition of a gain or loss.

82. A right of set-off is a debtor's legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor. In unusual circumstances, a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor provided that there is an agreement between the three parties that clearly establishes the debtor's right of set-off. Because the right of set-off is a legal right, the conditions supporting the right may vary from one legal jurisdiction to another and the laws applicable to the relationships between the parties need to be considered.

83. The existence of an enforceable right to set off a financial asset and a financial liability affects the rights and obligations associated with a financial asset and a financial liability and may affect an entity's exposure to credit and liquidity risk. However, the existence of the right, by itself, is not a sufficient basis for offsetting. In the absence of an intention to exercise the right or to settle simultaneously, the amount and timing of an entity's future cash flows are not affected. When an entity intends to exercise the right or to settle simultaneously, presentation of the asset and liability on a net basis reflects more appropriately the amounts and timing of the expected future cash flows, as well as the risks to which those cash flows are exposed. An intention by one or both parties to settle on a net basis without the legal right to do so is not sufficient to justify offsetting because the rights and obligations associated with the individual financial asset and financial liability remain unaltered.

84. An entity's intentions with respect to settlement of particular assets and liabilities may be influenced by its normal business practices, the requirements of the financial markets and other circumstances that may limit the ability to settle net or to settle simultaneously. When an entity has a right of set-off, but does not intend to settle net or to realise the asset and settle the liability simultaneously, the effect of the right on the entity's credit risk exposure is disclosed in accordance with Accounting Standard (AS) 32, *Financial Instruments: Disclosures*[20].

85. Simultaneous settlement of two financial instruments may occur through, for example, the operation of a clearing house in an organised financial market or a face-to-face exchange. In these circumstances the cash flows are, in effect, equivalent to a single net amount and there is no exposure to credit or liquidity risk. In other circumstances, an entity may settle two instruments by receiving and paying separate amounts, becoming exposed to credit risk for the full amount of the asset or liquidity risk for the full amount of the liability. Such risk exposures

[20]See footnote 4.

may be significant even though relatively brief. Accordingly, realisation of a financial asset and settlement of a financial liability are treated as simultaneous only when the transactions occur at the same moment.

86. The conditions set out in paragraph 79 are generally not satisfied and offsetting is usually inappropriate when:

(a) several different financial instruments are used to emulate the features of a single financial instrument (a 'synthetic instrument');

(b) financial assets and financial liabilities arise from financial instruments having the same primary risk exposure (for example, assets and liabilities within a portfolio of forward contracts or other derivative instruments) but involve different counterparties;

(c) financial or other assets are pledged as collateral for non-recourse financial liabilities;

(d) financial assets are set aside in trust by a debtor for the purpose of discharging an obligation without those assets having been accepted by the creditor in settlement of the obligation (for example, a sinking fund arrangement); or

(e) obligations incurred as a result of events giving rise to losses are expected to be recovered from a third party by virtue of a claim made under an insurance contract.

87. To offset a financial asset and a financial liability, an entity must have a currently enforceable legal right to set off the recognised amounts. An entity may have a conditional right to set off recognised amounts. An entity that undertakes a number of financial instrument transactions with a single counterparty may enter into a 'master netting arrangement' with that counterparty. Such an agreement provides for a single net settlement of all financial instruments covered by the agreement in the event of default on, or termination of, any one contract. These arrangements are commonly used by financial institutions to provide protection against loss in the event of bankruptcy or other circumstances that result in a counterparty being unable to meet its obligations. A master netting arrangement commonly creates a right of set-off that becomes enforceable and affects the realisation or settlement of individual financial assets and financial liabilities only following a specified event of default or in other circumstances not expected to arise in the normal course of business. A master netting arrangement does not provide a basis for offsetting unless both of the criteria in paragraph 79 are satisfied. When financial assets and financial liabilities subject to a master netting arrangement are not offset, the effect of the arrangement on an entity's exposure to credit risk is disclosed in accordance with Accounting Standard (AS) 32, *Financial Instruments: Disclosures*[21].

88. The Standard does not provide special treatment for so-called 'synthetic instruments', which are groups of separate financial instruments acquired and held to emulate the characteristics of another instrument. For example, a floating rate long-term debt combined with an interest rate swap that involves receiving floating payments and making fixed payments

[21] See footnote 4.

synthesises a fixed rate long-term debt. Each of the individual financial instruments that together constitute a 'synthetic instrument' represents a contractual right or obligation with its own terms and conditions and each may be transferred or settled separately. Each financial instrument is exposed to risks that may differ from the risks to which other financial instruments are exposed. Accordingly, when one financial instrument in a 'synthetic instrument' is an asset and another is a liability, they are not offset and presented on an entity's balance sheet on a net basis unless they meet the criteria for offsetting in paragraph 79.

Appendix A

Illustrative Examples

These examples accompany, but are not part of the Accounting Standard (AS) 31, *Financial Instruments: Presentation*.

Entities such as Mutual Funds and Co-operatives whose Share Capital is not Equity as defined in AS 31

Example 1: Entities with no equity

A1. The following example illustrates a statement of profit and loss and balance sheet format that may be used by entities such as mutual funds that do not have equity as defined in AS 31. Other formats are possible.

Statement of profit and loss for the year ended 31 March 20x6

	20x5-20x6	***20x4-20x5***
	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

Example 2: Entities with some equity

A2. The following example illustrates a statement of profit and loss and balance sheet format that may be used by entities whose share capital is not equity as defined in AS 31, because the entity has an obligation to repay the share capital on demand. Other formats are possible.

Statement of profit and loss for the year ended 31 March 20x6

	20x5-20x6	*20x4-20x5*
	Rs.	Rs.
Revenue	472	498
Expenses (appropriately classified)	(367)	(396)
Profit from operating activities	105	102
Finance costs – distributions to members	(50)	(50)
– other finance costs	(4)	(4)
Change in net assets attributable to members	51	48

Balance sheet at 31 March 20x6

		20x5-20x6		*20x4-20x5*
	Rs.	Rs.	Rs.	Rs.
ASSETS				
Non-current assets (appropriately classified)	908		830	
Total non-current assets		908		830
Current assets (appropriately classified)	383		350	
Total current assets		383		350

Total assets		1,291		1,180
LIABILITIES				
Current liabilities (appropriately classified)	372		338	
Share capital repayable on demand	202		161	
Total current liabilities		(574)		(499)
Total assets less current liabilities		717		681
Non-current liabilities (appropriately classified)	187		196	
		187		196
RESERVES[22]				
Reserves e.g. revaluation reserve, retained earnings etc	530		485	
		530		485
		717		681
MEMORANDUM NOTE - TOTAL MEMBERS' INTERESTS				
Share capital repayable on demand		202		161
Reserves		530		485
		732		646

Accounting for Compound Financial Instruments

Example 3: Separation of a compound financial instrument on initial recognition

A3. Paragraph 58 describes how the components of a compound financial instrument are separated by the entity on initial recognition. The following example illustrates how such a separation is made.

A4. An entity issues 2,000 convertible debentures at the start of year 1. The debentures have a three-year term, and are issued at par with a face value of 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.

[22] In this example, the entity has no obligation to deliver a share of its reserves to its members.

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

A6. The following example illustrates the application of paragraph 62 to the separation of the liability and equity components of a compound financial instrument with multiple embedded derivative features.

A7. Assume that the proceeds received on the issue of a callable convertible debenture are 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 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 62 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

A8. The following example illustrates how an entity accounts for a repurchase of a convertible instrument. For simplicity, at inception, the face amount of the instrument is assumed to be equal to the aggregate carrying amount of its liability and equity components in the financial statements, i.e. no original issue premium or discount exists. Also, for simplicity, tax considerations have been omitted from the example.

A9. On 1 January 1999, Entity A issued a 10 per cent convertible debenture with a face value of Rs. 1,000 maturing on 31 December 2008. The debenture is convertible into equity shares of Entity A at a conversion price of Rs.25 per share. Interest is payable half-yearly in cash. At the date of issue, Entity A could have issued non-convertible debt with a ten-year term bearing a coupon interest rate of 11 per cent.

A10. In the financial statements of Entity A the carrying amount of the debenture was allocated on issue as follows:

	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

A11. On 1 January 2004, the convertible debenture has a fair value of Rs. 1,700.

A12. 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, Entity A could have issued non-convertible debt with a five-year term bearing a coupon interest rate of 8 per cent.

A13. The repurchase price is allocated as follows:

	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[23]	(559)
Total	1,022	1,700	(678)

A14. 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.		

[23] This amount represents the difference between the fair value amount allocated to the liability component and the repurchase price of Rs. 1,700.

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

A15. The following example illustrates how an entity accounts for the additional consideration paid when the terms of a convertible instrument are amended to induce early conversion.

A16. On 1 January 2005, Entity A issued a 10 per cent convertible debenture with a face value of 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, Entity A reduces the conversion price to Rs.20 if the debenture is converted before 1 March 2006 (i.e. within 60 days).

A17. Assume the market price of Entity A's equity shares on the date the terms are amended is Rs.40 per share. The fair value of the incremental consideration paid by Entity A is calculated as follows:

*Number of equity shares to be issued to debenture holders under **amended** conversion terms:*

Face amount	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

A18. The incremental consideration of Rs. 400 is recognised as a loss in the statement of profit and loss.

Appendix B

Examples of Application of Paragraphs 40-46

This appendix is an integral part of AS 31.

B1. This appendix sets out seven examples of the application of paragraphs 40-46. The examples do not constitute an exhaustive list; other fact patterns are possible. Each example assumes that there are no conditions other than those set out in the facts of the example that would require the financial instrument to be classified as a financial liability.

Unconditional Right to Refuse Redemption (Paragraph 42)

Example 1

Facts

B2. The governing bye-laws of the entity state that redemptions are made at the sole discretion of the entity. The bye-laws do not provide further elaboration or limitation on that discretion. In its history, the entity has never refused to redeem members' shares, although the governing board of the entity has the right to do so.

Classification

B3. The entity has the unconditional right to refuse redemption and the members' shares are equity. The Standard establishes principles for classification that are based on the terms of the financial instrument and notes that a history of, or intention to make, discretionary payments does not trigger liability classification. Paragraph 39 of the Standard states:

> "When preference shares are non-redeemable, the appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument. When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments. The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:
>
> (a) a history of making distributions;
>
> (b) an intention to make distributions in the future;

(c) a possible negative impact on the price of equity shares of the issuer if distributions are not made (because of restrictions on paying dividends on the equity shares if dividends are not paid on the preference shares);

(d) the amount of the issuer's reserves;

(e) an issuer's expectation of a profit or loss for a period; or

(f) an ability or inability of the issuer to influence the amount of its profit or loss for the period."

Example 2

Facts

B4. The governing bye-laws of the entity state that redemptions are made at the sole discretion of the entity. However, the bye-laws further state that approval of a redemption request is automatic unless the entity is unable to make payments without violating regulations regarding liquidity or reserves.

Classification

B5. The entity does not have the unconditional right to refuse redemption and the members' shares are a financial liability. The restrictions described above are based on the entity's ability to settle its liability. They restrict redemptions only if the liquidity or reserve requirements are not met and then only until such time as they are met. Hence, they do not, under the principles established in the Standard, result in the classification of the financial instrument as equity. Paragraph 38 of the Standard states:

> "Preference shares may be issued with various rights. In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability. For example, a preference share that provides for redemption on a specific date or at the option of the holder is a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share. *The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves, does not negate the obligation.* [Emphasis added]"

Prohibitions Against Redemption (Paragraphs 43 and 44)

Example 3

Facts

B6. A co-operative entity has issued shares to its members at different dates and for different amounts in the past as follows:

(a) 1 January 20X1: 100,000 shares at 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.

PREVIOUS HOME NEXT

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 35(b) of the Standard states in part:

> "…a financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability. This is so even when the amount of cash or other financial assets is determined on the basis of an index or other item that has the potential to increase or decrease, or when the legal form of the puttable instrument gives the holder a right to a residual interest in the assets of an issuer. The existence of an option for the holder to put the instrument back to the issuer for cash or another financial asset means that the puttable instrument meets the definition of a financial liability. …"

B13. The redemption prohibition described in this example is different from the restrictions described in paragraphs 36 and 38 of the Standard. Those restrictions are limitations on the ability of the entity to pay the amount due on a financial liability, *i.e.*, they prevent payment of the liability only if specified conditions are met. In contrast, this example describes an unconditional prohibition on redemptions beyond a specified amount, regardless of the entity's ability to redeem members' shares (*e.g.*, given its cash resources, profits or distributable reserves). In effect, the prohibition against redemption prevents the entity from incurring any financial liability to redeem more than a specified amount of paid-up capital. Therefore, the portion of shares subject to the redemption prohibition is not a financial liability. While each member's shares may be redeemable individually, a portion of the total shares outstanding is not redeemable in any circumstances other than liquidation of the entity.

Example 5

Facts

B14. The facts of this example are as stated in example 4. In addition, at the balance sheet date, liquidity requirements imposed in the jurisdiction prevent the entity from redeeming any members' shares unless its holdings of cash and short-term investments are greater than a specified amount. The effect of these liquidity requirements at the balance sheet date is that the entity cannot pay more than 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 36 and 38 of the Standard apply in this case.

Example 6

Facts

B16. The governing bye-laws of the entity prohibit it from redeeming members' shares, except to the extent of proceeds received from the issue of additional members' shares to new or existing members during the preceding three years. Proceeds from issuing members' shares must be applied to redeem shares for which members have requested redemption. During the three preceding years, the proceeds from issuing members' shares have been 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 36 and 38 of the Standard. The restriction is a conditional limitation on the ability of the entity to pay the amount due on a financial liability, *i.e.*, they prevent payment of the liability only if specified conditions are met. More specifically, the entity could be required to redeem the entire amount of members' shares (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., repayment of other liabilities. Members' shares in this example are not subject to an unconditional prohibition against redemption and are therefore classified as financial liabilities.

Appendix C

Comparison with IAS 32, *Financial Instruments: Presentation*

Note: This Appendix is not a part of Accounting Standard (AS) 31, Financial Instruments: Presentation. The purpose of this appendix is only to bring out the major differences between AS 31 and the corresponding International Accounting Standard (IAS) 32.

The Accounting Standard is based on International Accounting Standard (IAS) 32, *Financial Instruments: Presentation* and incorporates IFRIC 2, *Members' Shares in Co-operative Entities and Similar Instruments* (Re. IAS 32, *Financial Instruments: Presentation*), issued by the International Financial Reporting Interpretation Committee (IFRIC) of the International Accounting Standards Board (IASB). There is no major difference between AS 31, and IAS 32 and IFRIC 2.

Accounting Standard (AS) 32

Financial Instruments: Disclosures

Contents

Accounting Standard (AS) 32

<u>Financial Instruments: Disclosures</u>

*(This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective and the Preface to the Statements of Accounting Standards[1].)*

Accounting Standard (AS) 32, *Financial Instruments: Disclosures*, issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years. This Accounting Standard will become mandatory[2] in respect of accounting periods commencing on or after 1-4-2011 for all commercial, industrial and business entities except to a Small and Medium-sized Entity, as defined below:

(i) Whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

(ii) which is not a bank (including a co-operative bank), financial institution or any entity carrying on insurance business;

(iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;

(iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and

(v) which is not a holding or subsidiary entity of an entity which is not a small and medium-sized entity.

For the above purpose an entity would qualify as a Small and Medium-sized Entity, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

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[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.

PREVIOUS HOME NEXT

Where in respect of an entity there is a statutory requirement for disclosing any financial instrument in a particular manner as asset, liability or equity and/or for disclosing income, expenses, gains or losses relating to a financial instrument in a particular manner as income/expense or as distribution of profits, the entity should disclose that instrument and/or income, expenses, gains or losses relating to the instrument in accordance with the requirements of the statute governing the entity. Until the relevant statute is amended, the entity disclosing that instrument and/ or income, expenses, gains or losses relating to the instrument in accordance with the requirements thereof will be considered to be complying with this Accounting Standard, in view of paragraph 4.1 of the *Preface to the Statements of Accounting Standards* which recognises that where a requirement of an Accounting Standard is different from the applicable law, the law prevails.

The following is the text of the Accounting Standard.

Objective

1. The objective of this Standard is to require entities to provide disclosures in their financial statements that enable users to evaluate:

(a) the significance of financial instruments for the entity's financial position and performance; and

(b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.

2. The principles in this Accounting Standard complement the principles for recognising, measuring and presenting financial assets and financial liabilities in Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement* and Accounting Standard (AS) 31, *Financial Instruments: Presentation*.

Scope

3. This Accounting Standard should be applied by all entities to all types of financial instruments, except:

(a) those interests in subsidiaries, associates and joint ventures that are accounted for in accordance with AS 21, *Consolidated Financial Statements and Accounting for Investment in Subsidiaries in Separate Financial Statements*, AS 23, *Accounting for Investments in Associates*[3], or AS 27, *Financial Reporting of Interests in Joint Ventures*. However, in some cases, AS 21, AS

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[3] The titles of AS 21 and AS 23 have been changed by making Limited Revisions thereto pursuant to the issuance of AS 30, *Financial Instruments: Recognition and Measurement*.

23 or AS 27 permits or requires an entity to account for an interest in a subsidiary, associate or joint venture using Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*; in those cases, entities should apply the disclosure requirements in AS 21, AS 23 or AS 27 in addition to those in this Accounting Standard. Entities should also apply this Accounting Standard to all derivatives linked to interests in subsidiaries, associates or joint ventures unless the derivative meets the definition of an equity instrument in AS 31.

(b) employers' rights and obligations arising from employee benefit plans, to which AS 15, *Employee Benefits,* applies.

(c) contracts for contingent consideration in a business combination[4]. This exemption applies only to the acquirer.

(d) insurance contracts as defined in Accounting Standard on Insurance Contracts[5]. However, this Accounting Standard applies to derivatives that are embedded in insurance contracts if Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement,* requires the entity to account for them separately. Moreover, an issuer should apply this Accounting Standard to *financial guarantee contracts* if the issuer applies AS 30 in recognising and measuring the contracts, but should apply the Accounting Standard on *Insurance Contracts* if the issuer elects, in accordance with the Accounting Standard on *Insurance Contracts*, to apply that Accounting Standard in recognising and measuring them.

(e) financial instruments, contracts and obligations under share-based payment transactions[6] except that this Accounting Standard applies to contracts within the scope of paragraphs 4 to 6 of AS 30.

4. This Accounting Standard applies to recognised and unrecognised financial instruments. Recognised financial instruments include financial assets and financial liabilities that are within the scope of AS 30. Unrecognised financial instruments include some financial instruments that, although outside the scope of AS 30, are within the scope of this Accounting Standard (such as some loan commitments).

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[4] '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.

[5] A separate Accounting Standard on *Insurance Contracts*, which is being formulated, will specify the requirements relating to insurance contracts.

[6] Employee share based payment, which is one of the share-based payment transactions, is accounted for as per the Guidance Note on Accounting for Employee Share-based Payments, issued by the ICAI. Further, some other pronouncements of the ICAI deal with other share-based payments, e.g., AS 10, *Accounting for Fixed Assets*.

5. This Accounting Standard applies to contracts to buy or sell a non-financial item that are within the scope of AS 30 (see paragraphs 4-6 of AS 30).

Classes of financial instruments and level of disclosure

6. When this Accounting Standard requires disclosures by class of financial instrument, an entity should group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. An entity should provide sufficient information to permit reconciliation to the line items presented in the balance sheet.

Significance of financial instruments for financial position and performance

7. An entity should disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance.

Balance sheet

Categories of financial assets and financial liabilities

8. The carrying amounts of each of the following categories, as defined in AS 30, should be disclosed either on the face of the balance sheet or in the notes:

(a) financial assets at fair value through profit or loss, showing separately (i) those designated as such upon initial recognition and (ii) those classified as held for trading in accordance with AS 30;

(b) held-to-maturity investments;

(c) loans and receivables;

(d) available-for-sale financial assets;

(e) financial liabilities at fair value through profit or loss, showing separately (i) those designated as such upon initial recognition and (ii) those classified as held for trading in accordance with AS 30; and

(f) financial liabilities measured at amortised cost.

Financial assets or financial liabilities at fair value through profit or loss

9. If the entity has designated a loan or receivable (or group of loans or receivables) as at fair value through profit or loss, it should disclose:

(a) the maximum exposure to *credit risk* (see paragraph 36(a)) of the loan or receivable (or group of loans or receivables) at the reporting date.

(b) the amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk.

(c) the amount of change, during the period and cumulatively, in the fair value of the loan or receivable (or group of loans or receivables) that is attributable to changes in the credit risk of the financial asset determined either:

(i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to *market risk*; or

(ii) using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset.

Changes in market conditions that give rise to market risk include changes in an observed (benchmark) interest rate, commodity price, foreign exchange rate or index of prices or rates.

(d) the amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the loan or receivable was designated.

10. If the entity has designated a financial liability as at fair value through profit or loss in accordance with paragraph 8.2 of AS 30, it should disclose:

(a) the amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability determined either:

(i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk (See Appendix B, paragraph B4); or

(ii) using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the liability.

Changes in market conditions that give rise to market risk include changes in a benchmark interest rate, the price of another entity's financial instrument, a commodity price, a foreign exchange rate or an index of prices or rates. For contracts that include a unit-linking feature, changes in market conditions include changes in the performance of the related internal or external investment fund.

(b) the difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

11. The entity should disclose:

(a) the methods used to comply with the requirements in paragraphs 9(c) and 10(a).

(b) if the entity believes that the disclosure it has given to comply with the requirements in paragraph 9(c) or 10(a) does not faithfully represent the change in the fair value of the financial asset or financial liability attributable to changes in its credit risk, the reasons for reaching this conclusion and the factors it believes are relevant.

Reclassification

12. If the entity has reclassified a financial asset as one measured:

(a) at cost or amortised cost, rather than at fair value; or

(b) at fair value, rather than at cost or amortised cost,

it should disclose the amount reclassified into and out of each category and the reason for that reclassification (see paragraphs 57-60 of AS 30).

Derecognition

13. An entity may have transferred financial assets in such a way that part or all of the financial assets do not qualify for derecognition (see paragraphs 15-37 of AS 30). The entity should disclose for each class of such financial assets:

(a) the nature of the assets;

(b) the nature of the risks and rewards of ownership to which the entity remains exposed;

(c) when the entity continues to recognise all of the assets, the carrying amounts of the assets and of the associated liabilities; and

(d) when the entity continues to recognise the assets to the extent of its continuing involvement, the total carrying amount of the original assets, the amount of the assets that the entity continues to recognise, and the carrying amount of the associated liabilities.

Collateral

14. An entity should disclose:

(a) the carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities, including amounts that have been reclassified in accordance with paragraphs 37(a) of AS 30; and

(b) the terms and conditions relating to its pledge.

15. When an entity holds collateral (of financial or non-financial assets) and is permitted to sell or repledge the collateral in the absence of default by the owner of the collateral, it should disclose:

(a) the fair value of the collateral held;

(b) the fair value of any such collateral sold or repledged, and whether the entity has an obligation to return it; and

(c) the terms and conditions associated with its use of the collateral.

Allowance account for credit losses

16. When financial assets are impaired by credit losses and the entity records the impairment in a separate account (eg an allowance account used to record individual impairments or a similar account used to record a collective impairment of assets) rather than directly reducing the carrying amount of the asset, it should disclose a reconciliation of changes in that account during the period for each class of financial assets.

Compound financial instruments with multiple embedded derivatives

17. If an entity has issued an instrument that contains both a liability and an equity component (see paragraph 58 of AS 31) and the instrument has multiple embedded derivatives whose values are interdependent (such as a callable convertible debt instrument), it should disclose the existence of those features.

Defaults and breaches

18. For *loans payable* recognised at the reporting date, an entity should disclose:

(a) details of any defaults during the period of principal, interest, sinking fund, or redemption terms of those loans payable;

(b) the carrying amount of the loans payable in default at the reporting date; and

(c) whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue.

19. If, during the period, there were breaches of loan agreement terms other than those described in paragraph 18, an entity should disclose the same information as required by paragraph 18 if those breaches permitted the lender to demand accelerated repayment (unless the breaches were remedied, or the terms of the loan were renegotiated, on or before the reporting date).

Statement of profit and loss and equity

Items of income, expense, gains or losses

20. An entity should disclose the following items of income, expense, gains or losses either on the face of the financial statements or in the notes:

(a) net gains or net losses on:

(i) financial assets or financial liabilities at fair value through profit or loss, showing separately those on financial assets or financial liabilities designated as such upon initial recognition, and those on financial assets or financial liabilities that are classified as held for trading in accordance with AS 30;

(ii) available-for-sale financial assets, showing separately the amount of gain or loss recognised directly in equity during the period and the amount removed from equity and recognised in the statement of profit and loss for the period;

(iii) held-to-maturity investments;

(iv) loans and receivables; and

(v) financial liabilities measured at amortised cost.

(b) total interest income and total interest expense (calculated using the effective interest method) for financial assets or financial liabilities that are not at fair value through profit or loss;

(c) fee income and expense (other than amounts included in determining the effective interest rate) arising from:

(i) financial assets or financial liabilities that are not at fair value through profit or loss; and

(ii) trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions;

(d) interest income on impaired financial assets accrued in accordance with paragraph A113 of AS 30; and

(e) the amount of any impairment loss for each class of financial asset.

Other disclosures

Accounting policies

21. In accordance with AS 1, *Presentation of Financial Statements*[7], an entity discloses, in the summary of significant accounting policies, the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements.

Hedge accounting

22. An entity should disclose the following separately for each type of hedge described in AS 30 (i.e. fair value hedges, cash flow hedges, and hedges of net investments in foreign operations):

(a) a description of each type of hedge;

(b) a description of the financial instruments designated as hedging instruments and their fair values at the reporting date; and

(c) the nature of the risks being hedged.

23. For cash flow hedges, an entity should disclose:

(a) the periods when the cash flows are expected to occur and when they are expected to affect profit or loss;

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[7] Revised AS 1 is under preparation.

(b) a description of any forecast transaction for which hedge accounting had previously been used, but which is no longer expected to occur;

(c) the amount that was recognised in the appropriate equity account (Hedging Reserve Account) during the period;

(d) the amount that was removed from the appropriate equity account (Hedging Reserve Account) and included in the statement of profit and loss for the period, showing the amount included in each line item in the statement; and

(e) the amount that was removed from appropriate equity account (Hedging Reserve Account) during the period and included in the initial cost or other carrying amount of a non-financial asset or non-financial liability whose acquisition or incurrence was a hedged highly probable forecast transaction.

24. An entity should disclose separately:

(a) in fair value hedges, gains or losses:

(i) on the hedging instrument; and

(ii) on the hedged item attributable to the hedged risk.

(b) the ineffectiveness recognised in the statement of profit and loss that arises from cash flow hedges; and

(c) the ineffectiveness recognised in the statement of profit and loss that arises from hedges of net investments in foreign operations.

Fair value

25. Except as set out in paragraph 29, for each class of financial assets and financial liabilities (see paragraph 6), an entity should disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount.

26. In disclosing fair values, an entity should group financial assets and financial liabilities into classes, but should offset them only to the extent that their carrying amounts are offset in the balance sheet.

27. An entity should disclose:

(a) the methods and, when a valuation technique is used, the assumptions applied in determining fair values of each class of financial assets or financial liabilities. For example, if applicable, an entity discloses information about the assumptions relating to prepayment rates, rates of estimated credit losses, and interest rates or discount rates.

(b) whether fair values are determined, in whole or in part, directly by reference to published price quotations in an active market or are estimated using a valuation technique (see paragraphs A90 –A99 of AS 30).

(c) whether the fair values recognised or disclosed in the financial statements are determined in whole or in part using a valuation technique based on assumptions that are not supported by prices from observable current market transactions in the same instrument (i.e. without modification or repackaging) and not based on available observable market data. For fair values that are recognised in the financial statements, if changing one or more of those assumptions to reasonably possible alternative assumptions would change fair value significantly, the entity should state this fact and disclose the effect of those changes. For this purpose, significance should be judged with respect to profit or loss, and total assets or total liabilities, or, when changes in fair value are recognised in equity, total equity.

(d) if (c) applies, the total amount of the change in fair value estimated using such a valuation technique that was recognised in the statement of profit and loss during the period.

28. If the market for a financial instrument is not active, an entity establishes its fair value using a valuation technique (see paragraphs A93-A99 of AS 30). Nevertheless, the best evidence of fair value at initial recognition is the transaction price (i.e. the fair value of the consideration given or received), unless conditions described in paragraph A95 of AS 30 are met. It follows that there could be a difference between the fair value at initial recognition and the amount that would be determined at that date using the valuation technique. If such a difference exists, an entity should disclose, by class of financial instrument:

(a) its accounting policy for recognising that difference in the statement of profit and loss to reflect a change in factors (including time) that market participants would consider in setting a price (see paragraph A96 of AS 30); and

(b) the aggregate difference yet to be recognised in the statement of profit and loss at the beginning and end of the period and a reconciliation of changes in the balance of this difference.

29. Disclosures of fair value are not required:

(a) when the carrying amount is a reasonable approximation of fair value, for example, for financial instruments such as short-term trade receivables and payables;

(b) for an investment in equity instruments that do not have a quoted market price in an active market, or derivatives linked to such equity instruments, that is measured at cost in accordance with AS 30 because its fair value cannot be measured reliably; or

(c) for a contract containing a discretionary participation feature (as described in the Accounting Standard on *Insurance Contracts*[8]) if the fair value of that feature cannot be measured reliably.

30. In the cases described in paragraph 29(b) and (c), an entity should disclose information to help users of the financial statements make their own judgments about the extent of possible differences between the carrying amount of those financial assets or financial liabilities and their fair value, including:

(a) the fact that fair value information has not been disclosed for these instruments because their fair value cannot be measured reliably;

(b) a description of the financial instruments, their carrying amount, and an explanation of why fair value cannot be measured reliably;

(c) information about the market for the instruments;

(d) information about whether and how the entity intends to dispose of the financial instruments; and

(e) if financial instruments whose fair value previously could not be reliably measured are derecognised, that fact, their carrying amount at the time of derecognition, and the amount of gain or loss recognised.

Nature and extent of risks arising from financial instruments

31. An entity should disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the reporting date.

32. The disclosures required by paragraphs 33–42 focus on the risks that arise from financial instruments and how they have been managed. These risks typically include, but are not limited to, credit risk, *liquidity risk* and market risk.

Qualitative disclosures

33. For each type of risk arising from financial instruments, an entity should disclose:

(a) the exposures to risk and how they arise;

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[8] See footnote 5.

(b) its objectives, policies and processes for managing the risk and the methods used to measure the risk; and

(c) any changes in (a) or (b) from the previous period.

Quantitative disclosures

34. For each type of risk arising from financial instruments, an entity should disclose:

(a) summary quantitative data about its exposure to that risk at the reporting date. This disclosure should be based on the information provided internally to key management personnel of the entity (as defined in AS 18 *Related Party Disclosures*), for example the entity's board of directors or chief executive officer.

(b) the disclosures required by paragraphs 36–42, to the extent not provided in (a), unless the risk is not material (see AS 1 (Revised)[9] for a discussion of materiality).

(c) Concentrations of risk if not apparent from (a) and (b).

35. If the quantitative data disclosed as at the reporting date are unrepresentative of an entity's exposure to risk during the period, an entity should provide further information that is representative.

Credit risk

36. An entity should disclose by class of financial instrument:

(a) the amount that best represents its maximum exposure to credit risk at the reporting date without taking account of any collateral held or other credit enhancements (eg netting agreements that do not qualify for offset in accordance with AS 31);

(b) in respect of the amount disclosed in (a), a description of collateral held as security and other credit enhancement;

(c) information about the credit quality of financial assets that are neither *past due* nor impaired; and

(d) the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated.

[9] See footnote 7.

Financial assets that are either past due or impaired

37. An entity should disclose by class of financial asset:

(a) an analysis of the age of financial assets that are past due as at the reporting date but not impaired;

(b) an analysis of financial assets that are individually determined to be impaired as at the reporting date, including the factors the entity considered in determining that they are impaired; and

(c) for the amounts disclosed in (a) and (b), a description of collateral held by the entity as security and other credit enhancements and, unless impracticable, an estimate of their fair value.

Collateral and other credit enhancements obtained

38. When an entity obtains financial or non-financial assets during the period by taking possession of collateral it holds as security or calling on other credit enhancements (eg guarantees), and such assets meet the recognition criteria in other Standards, an entity should disclose:

(a) the nature and carrying amount of the assets obtained; and

(b) when the assets are not readily convertible into cash, its policies for disposing of such assets or for using them in its operations.

Liquidity risk

39. An entity should disclose:

(a) a maturity analysis for financial liabilities that shows the remaining contractual maturities; and

(b) a description of how it manages the liquidity risk inherent in (a).

Market risk

Sensitivity analysis

40. Unless an entity complies with paragraph 41, it should disclose:

(a) a sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date;

(b) the methods and assumptions used in preparing the sensitivity analysis; and

(c) changes from the previous period in the methods and assumptions used, and the reasons for such changes.

41. If an entity prepares a sensitivity analysis, such as value-at-risk, that reflects interdependencies between risk variables (eg interest rates and exchange rates) and uses it to manage financial risks, it may use that sensitivity analysis in place of the analysis specified in paragraph 40. The entity should also disclose:

(a) an explanation of the method used in preparing such a sensitivity analysis, and of the main parameters and assumptions underlying the data provided; and

(b) an explanation of the objective of the method used and of limitations that may result in the information not fully reflecting the fair value of the assets and liabilities involved.

Other market risk disclosures

42. When the sensitivity analyses disclosed in accordance with paragraph 40 or 41 are unrepresentative of a risk inherent in a financial instrument (for example because the year-end exposure does not reflect the exposure during the year), the entity should disclose that fact and the reason it believes the sensitivity analyses are unrepresentative.

Appendix A

Defined terms

This appendix is an integral part of AS 32, Financial Instruments: Disclosures.

credit risk

The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

currency risk

The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

interest rate risk

The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

liquidity risk

The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities.

loans payable

Loans payable are financial liabilities, other than short-term trade payables on normal credit terms.

market risk

The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: **currency risk**, **interest rate risk** and **other price risk**.

other price risk

The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from **interest rate risk** or **currency risk**), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.

past due

A financial asset is past due when a counterparty has failed to make a payment when contractually due.

The following terms are defined in paragraph 8 of AS 30, *Financial Instruments: Recognition and Measurement,* or paragraph 7 of AS 31*, Financial Instruments: Presentation,* and are used in this Standard with the meaning specified in AS 30 and AS 31.

- amortised cost of a financial asset or financial liability
- available-for-sale financial assets
- derecognition
- derivative
- effective interest method
- equity instrument
- fair value
- financial asset
- financial instrument
- financial liability
- financial asset or financial liability at fair value through profit or loss
- financial guarantee contract
- financial asset or financial liability held for trading
- forecast transaction
- hedging instrument
- held-to-maturity investments
- loans and receivables
- regular way purchase or sale

Appendix B

Application guidance

This appendix is an integral part of AS 32, Financial Instruments: Disclosures

Classes of financial instruments and level of disclosure (paragraph 6)

B1 Paragraph 6 requires an entity to group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. The classes described in paragraph 6 are determined by the entity and are, thus, distinct from the categories of financial instruments specified in AS 30 (which determine how financial instruments are measured and where changes in fair value are recognised).

B2 In determining classes of financial instrument, an entity should, at a minimum:

(a) distinguish instruments measured at amortised cost from those measured at fair value.

(b) treat as a separate class or classes those financial instruments outside the scope of this AS.

B3 An entity decides, in the light of its circumstances, how much detail it provides to satisfy the requirements of this AS, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information with different characteristics. It is necessary to strike a balance between overburdening financial statements with excessive detail that may not assist users of financial statements and obscuring important information as a result of too much aggregation. For example, an entity should not obscure important information by including it among a large amount of insignificant detail. Similarly, an entity should not disclose information that is so aggregated that it obscures important differences between individual transactions or associated risks.

Significance of financial instruments for financial position and performance

Financial liabilities at fair value through profit or loss (paragraphs 10 and 11)

B4 If an entity designates a financial liability as at fair value through profit or loss, paragraph 10(a) requires it to disclose the amount of change in the fair value of the financial liability that is attributable to changes in the liability's credit risk. Paragraph

10(a)(i) permits an entity to determine this amount as the amount of change in the liability's fair value that is not attributable to changes in market conditions that give rise to market risk. If the only relevant changes in market conditions for a liability are changes in an observed (benchmark) interest rate, this amount can be estimated as follows:

(a) First, the entity computes the liability's internal rate of return at the start of the period using the observed market price of the liability and the liability's contractual cash flows at the start of the period. It deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return.

(b) Next, the entity calculates the present value of the cash flows associated with the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period and (ii) the instrument-specific component of the internal rate of return as determined in (a).

(c) The difference between the observed market price of the liability at the end of the period and the amount determined in (b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be disclosed.

This example assumes that changes in fair value arising from factors other than changes in the instrument's credit risk or changes in interest rates are not significant. If the instrument in the example contains an embedded derivative, the change in fair value of the embedded derivative is excluded in determining the amount to be disclosed in accordance with paragraph 10(a).

Other disclosure – accounting policies (paragraph 21)

B5 Paragraph 21 requires disclosure of the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements. For financial instruments, such disclosure may include:

(a) for financial assets or financial liabilities designated as at fair value through profit or loss:

(i) the nature of the financial assets or financial liabilities the entity has designated as at fair value through profit or loss;

(ii) the criteria for so designating such financial assets or financial liabilities on initial recognition; and

(iii) how the entity has satisfied the conditions in paragraphs 8, 11 or 12 of AS 30 for such designation. For instruments designated in accordance with paragraph 8.2 (b)(i) of the definition of a financial asset or financial liability at fair value through profit or loss in AS 30, that disclosure includes a narrative description of the circumstances underlying the measurement or recognition inconsistency that would otherwise arise. For instruments designated in accordance with paragraph 8.2 (b)(ii) of the definition of a financial asset or financial liability at fair value through profit or loss in AS 30, that disclosure includes a narrative description of how designation at fair value through profit or loss is consistent with the entity's documented risk management or investment strategy.

(b) the criteria for designating financial assets as available for sale.

(c) whether regular way purchases and sales of financial assets are accounted for at trade date or at settlement date (see paragraph 38 of AS 30).

(d) when an allowance account is used to reduce the carrying amount of financial assets impaired by credit losses:

(i) the criteria for determining when the carrying amount of impaired financial assets is reduced directly (or, in the case of a reversal of a write-down, increased directly) and when the allowance account is used; and

(ii) the criteria for writing off amounts charged to the allowance account against the carrying amount of impaired financial assets (see paragraph 16).

(e) how net gains or net losses on each category of financial instrument are determined (see paragraph 20(a)), for example, whether the net gains or net losses on items at fair value through profit or loss include interest or dividend income.

(f) the criteria the entity uses to determine that there is objective evidence that an impairment loss has occurred (see paragraph 20(e)).

(g) when the terms of financial assets that would otherwise be past due or impaired have been renegotiated, the accounting policy for financial assets that are the subject of renegotiated terms (see paragraph 36(d)).

AS 1 (Revised)[10], also requires entities to disclose, in the summary of significant accounting policies or other notes, the judgments, apart from those involving estimations,

[10] See footnote 7.

that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

Nature and extent of risks arising from financial instruments (paragraphs 31–42)

B6 The disclosures required by paragraphs 31–42 should be either given in the financial statements or incorporated by cross-reference from the financial statements to some other statement, such as a management commentary or risk report, that is available to users of the financial statements on the same terms as the financial statements and at the same time. Without the information incorporated by cross-reference, the financial statements are incomplete.

Quantitative disclosures (paragraph 34)

B7 Paragraph 34(a) requires disclosures of summary quantitative data about an entity's exposure to risks based on the information provided internally to key management personnel of the entity. When an entity uses several methods to manage a risk exposure, the entity should disclose information using the method or methods that provide the most relevant and reliable information. AS 5*, Accounting Policies, Changes in Accounting Estimates and Errors,*[11] discusses relevance and reliability.

B8 Paragraph 34(c) requires disclosures about concentrations of risk. Concentrations of risk arise from financial instruments that have similar characteristics and are affected similarly by changes in economic or other conditions. The identification of concentrations of risk requires judgement taking into account the circumstances of the entity. Disclosure of concentrations of risk should include:

(a) a description of how management determines concentrations;

(b) a description of the shared characteristic that identifies each concentration (eg counterparty, geographical area, currency or market); and

(c) the amount of the risk exposure associated with all financial instruments sharing that characteristic.

Maximum credit risk exposure (paragraph 36(a))

B9 Paragraph 36(a) requires disclosure of the amount that best represents the entity's maximum exposure to credit risk. For a financial asset, this is typically the gross carrying amount, net of:

(a) any amounts offset in accordance with AS 31; and

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[11] The revised Standard is under preparation.

PREVIOUS HOME NEXT

(b) any impairment losses recognised in accordance with AS 30.

B10 Activities that give rise to credit risk and the associated maximum exposure to credit risk include, but are not limited to:

(a) granting loans and receivables to customers and placing deposits with other entities. In these cases, the maximum exposure to credit risk is the carrying amount of the related financial assets.

(b) entering into derivative contracts, eg foreign exchange contracts, interest rate swaps and credit derivatives. When the resulting asset is measured at fair value, the maximum exposure to credit risk at the reporting date will equal the carrying amount.

(c) granting financial guarantees. In this case, the maximum exposure to credit risk is the maximum amount the entity could have to pay if the guarantee is called on, which may be significantly greater than the amount recognised as a liability.

(d) making a loan commitment that is irrevocable over the life of the facility or is revocable only in response to a material adverse change. If the issuer cannot settle the loan commitment net in cash or another financial instrument, the maximum credit exposure is the full amount of the commitment. This is because it is uncertain whether the amount of any undrawn portion may be drawn upon in the future. This may be significantly greater than the amount recognised as a liability.

Contractual maturity analysis (paragraph 39(a))

B11 In preparing the contractual maturity analysis for financial liabilities required by paragraph 39(a), an entity uses its judgement to determine an appropriate number of time bands. For example, an entity might determine that the following time bands are appropriate:

(a) not later than one month;

(b) later than one month and not later than three months;

(c) later than three months and not later than one year; and

(d) later than one year and not later than five years.

B12 When a counterparty has a choice of when an amount is paid, the liability is included on the basis of the earliest date on which the entity can be required to pay. For example, financial liabilities that an entity can be required to repay on demand (eg demand deposits) are included in the earliest time band.

B13 When an entity is committed to make amounts available in instalments, each instalment is allocated to the earliest period in which the entity can be required to pay. For example, an undrawn loan commitment is included in the time band containing the earliest date it can be drawn down.

B14 The amounts disclosed in the maturity analysis are the contractual undiscounted cash flows, for example:

(a) gross finance lease obligations (before deducting finance charges);

(b) prices specified in forward agreements to purchase financial assets for cash;

(c) net amounts for pay-floating/receive-fixed interest rate swaps for which net cash flows are exchanged;

(d) contractual amounts to be exchanged in a derivative financial instrument (eg a currency swap) for which gross cash flows are exchanged; and

(e) gross loan commitments.

Such undiscounted cash flows differ from the amount included in the balance sheet because the balance sheet amount is based on discounted cash flows.

B15 If appropriate, an entity should disclose the analysis of derivative financial instruments separately from that of non-derivative financial instruments in the contractual maturity analysis for financial liabilities required by paragraph 39(a). For example, it would be appropriate to distinguish cash flows from derivative financial instruments and non-derivative financial instruments if the cash flows arising from the derivative financial instruments are settled gross. This is because the gross cash outflow may be accompanied by a related inflow.

B16 When the amount payable is not fixed, the amount disclosed is determined by reference to the conditions existing at the reporting date. For example, when the amount payable varies with changes in an index, the amount disclosed may be based on the level of the index at the reporting date.

Market risk – sensitivity analysis (paragraphs 40 and 41)

B17 Paragraph 40(a) requires a sensitivity analysis for each type of market risk to which the entity is exposed. In accordance with paragraph B3, an entity decides how it aggregates information to display the overall picture without combining information with different characteristics about exposures to risks from significantly different economic environments. For example:

(a) an entity that trades financial instruments might disclose this information separately for financial instruments held for trading and those not held for trading.

(b) an entity would not aggregate its exposure to market risks from areas of hyperinflation with its exposure to the same market risks from areas of very low inflation.

If an entity has exposure to only one type of market risk in only one economic environment, it would not show disaggregated information.

B18 Paragraph 40(a) requires the sensitivity analysis to show the effect on profit or loss and equity of reasonably possible changes in the relevant risk variable (eg prevailing market interest rates, currency rates, equity prices or commodity prices). For this purpose:

(a) entities are not required to determine what the profit or loss for the period would have been if relevant risk variables had been different. Instead, entities disclose the effect on profit or loss and equity at the balance sheet date assuming that a reasonably possible change in the relevant risk variable had occurred at the balance sheet date and had been applied to the risk exposures in existence at that date. For example, if an entity has a floating rate liability at the end of the year, the entity would disclose the effect on profit or loss (i.e. interest expense) for the current year if interest rates had varied by reasonably possible amounts.

(b) entities are not required to disclose the effect on profit or loss and equity for each change within a range of reasonably possible changes of the relevant risk variable. Disclosure of the effects of the changes at the limits of the reasonably possible range would be sufficient.

B19 In determining what a reasonably possible change in the relevant risk variable is, an entity should consider:

(a) the economic environments in which it operates. A reasonably possible change should not include remote or 'worst case' scenarios or 'stress tests'. Moreover, if the rate of change in the underlying risk variable is stable, the entity need not alter the chosen reasonably possible change in the risk variable. For example, assume that interest rates are 5 per cent and an entity determines that a fluctuation in interest rates of ±50 basis points is reasonably possible. It would disclose the effect on profit or loss and equity if interest rates were to change to 4.5 per cent or 5.5 per cent. In the next period, interest rates have increased to 5.5 per cent. The entity continues to believe that interest rates may fluctuate by ±50 basis points (i.e. that the rate of change in interest rates is stable). The entity would disclose the effect on profit or loss and equity if interest rates were to change to 5 per cent

PREVIOUS HOME NEXT

or 6 per cent. The entity would not be required to revise its assessment that interest rates might reasonably fluctuate by ±50 basis points, unless there is evidence that interest rates have become significantly more volatile.

(b) the time frame over which it is making the assessment. The sensitivity analysis should show the effects of changes that are considered to be reasonably possible over the period until the entity will next present these disclosures, which is usually its next annual reporting period.

B20 Paragraph 41 permits an entity to use a sensitivity analysis that reflects interdependencies between risk variables, such as a value-at-risk methodology, if it uses this analysis to manage its exposure to financial risks. This applies even if such a methodology measures only the potential for loss and does not measure the potential for gain. Such an entity might comply with paragraph 41(a) by disclosing the type of value-at-risk model used (eg whether the model relies on Monte Carlo simulations), an explanation about how the model works and the main assumptions (eg the holding period and confidence level). Entities might also disclose the historical observation period and weightings applied to observations within that period, an explanation of how options are dealt with in the calculations, and which volatilities and correlations (or, alternatively, Monte Carlo probability distribution simulations) are used.

B21 An entity should provide sensitivity analyses for the whole of its business, but may provide different types of sensitivity analysis for different classes of financial instruments.

Interest rate risk

B22 *Interest rate risk* arises on interest-bearing financial instruments recognised in the balance sheet (eg loans and receivables and debt instruments issued) and on some financial instruments not recognised in the balance sheet (eg some loan commitments).

Currency risk

B23 *Currency risk* (or foreign exchange risk) arises on financial instruments that are denominated in a foreign currency, i.e. in a currency other than the functional currency[12] in which they are measured. For the purpose of this Standard, currency risk does not arise from financial instruments that are non-monetary items or from financial instruments denominated in the functional currency.

B24 A sensitivity analysis is disclosed for each currency to which an entity has significant exposure.

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[12] See paragraph 8.16 of AS 30 for definition of 'Functional Currency'.

Other price risk

B25 *Other price risk* arises on financial instruments because of changes in, for example, commodity prices or equity prices. To comply with paragraph 40, an entity might disclose the effect of a decrease in a specified stock market index, commodity price, or other risk variable. For example, if an entity gives residual value guarantees that are financial instruments, the entity discloses an increase or decrease in the value of the assets to which the guarantee applies.

B26 Two examples of financial instruments that give rise to equity price risk are a holding of equities in another entity, and an investment in a trust, which in turn holds investments in equity instruments. Other examples include forward contracts and options to buy or sell specified quantities of an equity instrument and swaps that are indexed to equity prices. The fair values of such financial instruments are affected by changes in the market price of the underlying equity instruments.

B27 In accordance with paragraph 40(a), the sensitivity of profit or loss (that arises, for example, from instruments classified as at fair value through profit or loss and impairments of available-for-sale financial assets) is disclosed separately from the sensitivity of equity (that arises, for example, from instruments classified as available for sale).

B28 Financial instruments that an entity classifies as equity instruments are not remeasured. Neither profit or loss nor equity will be affected by the equity price risk of those instruments. Accordingly, no sensitivity analysis is required.

Appendix C

Comparison with IFRS 7, *Financial Instruments: Disclosures*

Note: This Appendix is not a part of the Accounting Standard (AS) 32. The purpose of this appendix is only to bring out the differences between Accounting Standard (AS) 32 and the corresponding International Financial Reporting Standard (IFRS) 7.

This Accounting Standard is based on International Financial Reporting Standard (IFRS) 7, *Financial Instruments: Disclosures* issued by the International Accounting Standards Board (IASB). There is no material difference between AS 32 and IFRS 7.

Appendix D

GUIDANCE ON IMPLEMENTING AS 32, *FINANCIAL INSTRUMENTS: DISCLOSURES*

Guidance on implementing AS 32, *Financial Instruments: Disclosures*

This Appendix is not part of AS 32.

Introduction

IG1 This guidance suggests possible ways to apply some of the disclosure requirements in AS 32. The guidance does not create additional requirements.

IG2 For convenience, each disclosure requirement in the AS is discussed separately. In practice, disclosures would normally be presented as an integrated package and individual disclosures might satisfy more than one requirement. For example, information about concentrations of risk might also convey information about exposure to credit or other risk.

Materiality

IG3 Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

IG4 Assessing whether an omission or misstatement could influence economic decisions of users, and so be material, requires consideration of the characteristics of those users. The *Framework for the Preparation and Presentation of Financial Statements* states in paragraph 26 that 'It is assumed that users have a reasonable knowledge of business and economic activities and accounting and study the information with reasonable diligence.' Therefore, the assessment needs to take into account how users with such attributes could reasonably be expected to be influenced in making economic decisions.

Classes of financial instruments and level of disclosure (paragraphs 6 and B1–B3)

IG5 Paragraph B3 states that 'an entity decides in the light of its circumstances how much detail it provides to satisfy the requirements of AS 32, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information with different characteristics.' To satisfy the requirements, an entity may not need to disclose all the information suggested in this guidance.

IG6 AS 1 (Revised)[13] requires an entity to 'provide additional disclosures when compliance with the specific requirements in ASs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.'

Significance of financial instruments for financial position and performance (paragraphs 7–30, B4 and B5)

Financial liabilities at fair value through profit or loss (paragraphs 10(a)(i) and B4)

IG7 The following example illustrates the calculation that an entity might perform in accordance with paragraph B4 of Appendix B of this AS.

IG8 On 1 January 20X1, an entity issues a 10-year bond with a par value of Rs. 150,000 and an annual fixed coupon rate of 8 per cent, which is consistent with market rates for bonds with similar characteristics.

IG9 The entity uses MIBOR as its observable (benchmark) interest rate. At the date of inception of the bond, MIBOR is 5 per cent. At the end of the first year:

(a) MIBOR has decreased to 4.75 per cent.

(b) the fair value for the bond is Rs. 153,811, consistent with an interest rate of 7.6 per cent.[14]

IG10 The entity assumes a flat yield curve, all changes in interest rates result from a parallel shift in the yield curve, and the changes in MIBOR are the only relevant changes in market conditions.

IG11 The entity estimates the amount of change in the fair value of the bond that is not attributable to changes in market conditions that give rise to market risk as follows:

[paragraph B4(a)]	
First, the entity computes the liability's internal rate of return at the start of the period using the observed market price of the liability and the liability's contractual cash flows at the start of the period. It	At the start of the period of a 10-year bond with a coupon of 8 per cent, the bond's internal rate of return is 8 per cent. Because the observed (benchmark) interest

[13] See footnote 7.

[14] This reflects a shift in MIBOR from 5 per cent to 4.75 per cent and a movement of 0.15 per cent which, in the absence of other relevant changes in market conditions, is assumed to reflect changes in credit risk of the instrument.

deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return.	rate (MIBOR) is 5 per cent, the instrument-specific component of the internal rate of return is 3 per cent.
[paragraph B4(b)] Next, the entity calculates the present value of the cash flows associated with the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period and (ii) the instrument-specific component of the internal rate of return as determined in accordance with paragraph B4(a).	The contractual cash flows of the instrument at the end of the period are: • interest: Rs. 12,000[(a)] per year for each of years 2–10. • principal: Rs. 150,000 in year 10. The discount rate to be used to calculate the present value of the bond is thus 7.75 per cent, which is 4.75 per cent end of period MIBOR rate plus the 3 per cent instrument-specific component. This gives a present value of Rs. 152,367[(b)].
[paragraph B4(c)] The difference between the observed market price of the liability at the end of the period and the amount determined in accordance with paragraph B4(b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be disclosed.	The market price of the liability at the end of the period is Rs. 153,811.[(c)] Thus, the entity discloses Rs. 1,444, which is Rs. 153,811 – Rs. 152,367 as the increase in fair value of the bond that is not attributable to changes in market conditions that give rise to market risk.
(a) Rs. 150,000 × 8% = Rs. 12,000 (b) PV = [Rs. 12,000 × $(1 - (1 + 0.0775)^{-9})/0.0775$] + Rs. 150,000 × $(1 + 0.0775)^{-9}$ (c) market price = [Rs. 12,000 × $(1 - (1 + 0.076)^{-9})/0.076$] + Rs. 150,000 × $(1 + 0.076)^{-9}$	

Defaults and breaches (paragraphs 18 and 19)

IG12 Paragraphs 18 and 19 require disclosures when there are any defaults or breaches of loans payable. Any defaults or breaches may affect the classification of the liability as current or non-current in accordance with AS 1 (Revised)[15].

Total interest expense (paragraph 20(b))

IG13 The total interest expense disclosed in accordance with paragraph 20(b) is a component of the finance costs, which AS 1 (Revised)[16] requires to be presented separately on the face of the statement of profit and loss. The line item for finance costs may also include amounts associated with non-financial liabilities.

Fair value (paragraph 28)

IG14 The fair value at initial recognition of financial instruments that are not traded in active markets is determined in accordance with paragraph A95 of AS 30. However, when, after initial recognition, an entity will use a valuation technique that incorporates data not obtained from observable markets, there may be a difference between the transaction price at initial recognition and the amount determined at initial recognition using that valuation technique. In these circumstances, the difference will be recognised in the statement of profit and loss in subsequent periods in accordance with AS 30 and the entity's accounting policy. Such recognition reflects changes in factors (including time) that market participants would consider in setting a price (see paragraph A96 of AS 30). Paragraph 28 requires disclosures in these circumstances. An entity might disclose the following to comply with paragraph 28:

Background

On 1 January 20X1 an entity purchases for Rs. 15 crore financial assets that are not traded in an active market. The entity has only one class of such financial assets.

The transaction price of Rs. 15 crore is the fair value at initial recognition.

After initial recognition, the entity will apply a valuation technique to establish the financial assets' fair value. This valuation technique includes variables other than data from observable markets.

At initial recognition, the same valuation technique would have resulted in an amount of

[15] See footnote 7.

[16] ibid

Rs. 14 crore, which differs from fair value by Rs. 1 crore.

The entity has existing differences of Rs. 5 crore at 1 January 20X1.

Application of requirements

The entity's 20X2 disclosure would include the following:

Accounting policies

The entity uses the following valuation technique to determine the fair value of financial instruments that are not traded in an active market: [description of technique, not included in this example]. Differences may arise between the fair value at initial recognition (which, in accordance with AS 30, is generally the transaction price) and the amount determined at initial recognition using the valuation technique. Any such differences are [description of the entity's accounting policy].

In the notes to the financial statements

As discussed in note X, the entity uses [name of valuation technique] to measure the fair value of the following financial instruments that are not traded in an active market. However, in accordance with AS 30, the fair value of an instrument at inception is generally the transaction price. If the transaction price differs from the amount determined at inception using the valuation technique, that difference is [description of the entity's accounting policy].

The differences yet to be recognised in the statement of profit and loss are as follows:

	31 Dec X2 Rs. crore	**31 Dec X1** Rs. crore
Balance at beginning of year	5.3	5.0
New transactions	–	1.0
Amounts recognised in the statement of profit and loss during the year	(0.7)	(0.8)
Other increases	–	0.2
Other decreases	(0.1)	(0.1)
Balance at end of year	4.5	5.3

Nature and extent of risks arising from financial instruments (paragraphs 31–42 and B6–B28)

Qualitative disclosures (paragraph 33)

IG15 The type of qualitative information an entity might disclose to meet the requirements in paragraph 33 includes, but is not limited to, a narrative description of:

(a) the entity's exposures to risk and how they arose. Information about risk exposures might describe exposures both gross and net of risk transfer and other risk-mitigating transactions.

(b) the entity's policies and processes for accepting, measuring, monitoring and controlling risk, which might include:

(i) the structure and organisation of the entity's risk management function(s), including a discussion of independence and accountability;

(ii) the scope and nature of the entity's risk reporting or measurement systems;

(iii) the entity's policies for hedging or mitigating risk, including its policies and procedures for taking collateral; and

(iv) the entity's processes for monitoring the continuing effectiveness of such hedges or mitigating devices.

(c) the entity's policies and procedures for avoiding excessive concentrations of risk.

IG16 Information about the nature and extent of risks arising from financial instruments is more useful if it highlights any relationship between financial instruments that can affect the amount, timing or uncertainty of an entity's future cash flows. The extent to which a risk exposure is altered by such relationships might be apparent to users from the disclosures required by this Standard, but in some cases further disclosures might be useful.

IG17 In accordance with paragraph 33(c), entities disclose any change in the qualitative information from the previous period and explain the reasons for the change. Such changes may result from changes in exposure to risk or from changes in the way those exposures are managed.

Quantitative disclosures (paragraphs 34–42 and B7–B28)

IG18 Paragraph 34 requires disclosure of quantitative data about concentrations of risk. For example, concentrations of credit risk may arise from:

(a) industry sectors. Thus, if an entity's counterparties are concentrated in one or more industry sectors (such as retail or wholesale), it would disclose separately exposure to risks arising from each concentration of counterparties.

(b) credit rating or other measure of credit quality. Thus, if an entity's counterparties are concentrated in one or more credit qualities (such as secured loans or unsecured loans) or in one or more credit ratings (such as investment grade or speculative grade), it would disclose separately exposure to risks arising from each concentration of counterparties.

(c) geographical distribution. Thus, if an entity's counterparties are concentrated in one or more geographical markets (such as Asia or Europe), it would disclose separately exposure to risks arising from each concentration of counterparties.

(d) a limited number of individual counterparties or groups of closely related counterparties.

Similar principles apply to identifying concentrations of other risks, including liquidity risk and market risk. For example, concentrations of liquidity risk may arise from the repayment terms of financial liabilities, sources of borrowing facilities or reliance on a particular market in which to realise liquid assets. Concentrations of foreign exchange risk may arise if an entity has a significant net open position in a single foreign currency, or aggregate net open positions in several currencies that tend to move together.

IG19 In accordance with paragraph B8, disclosure of concentrations of risk includes a description of the shared characteristic that identifies each concentration. For example, the shared characteristic may refer to geographical distribution of counterparties by groups of countries, individual countries or regions within countries.

IG20 When quantitative information at the reporting date is unrepresentative of the entity's exposure to risk during the period, paragraph 35 requires further disclosure. To meet this requirement, an entity might disclose the highest, lowest and average amount of risk to which it was exposed during the period. For example, if an entity typically has a large exposure to a particular currency, but at year-end unwinds the position, the entity might disclose a graph that shows the exposure at various times during the period, or disclose the highest, lowest and average exposures.

Credit risk (paragraphs 36–38, B9 and B10)

IG21 Paragraph 36 requires an entity to disclose information about its exposure to credit risk by class of financial instrument. Financial instruments in the same class share economic characteristics with respect to the risk being disclosed (in this case, credit risk). For example, an entity might determine that residential mortgages, unsecured consumer loans, and commercial loans each have different economic characteristics.

Collateral and other credit enhancements pledged (paragraph 36(b))

IG22 Paragraph 36(b) requires an entity to describe collateral available as security for assets it holds and other credit enhancements obtained. An entity might meet this requirement by disclosing:

(a) the policies and processes for valuing and managing collateral and other credit enhancements obtained;

(b) a description of the main types of collateral and other credit enhancements (examples of the latter being guarantees, credit derivatives, and netting agreements that do not qualify for offset in accordance with AS 31);

(c) the main types of counterparties to collateral and other credit enhancements and their creditworthiness; and

(d) information about risk concentrations within the collateral or other credit enhancements.

Credit quality (paragraph 36(c))

IG23 Paragraph 36(c) requires an entity to disclose information about the credit quality of financial assets with credit risk that are neither past due nor impaired. In doing so, an entity might disclose the following information:

(a) an analysis of credit exposures using an external or internal credit grading system;

(b) the nature of the counterparty;

(c) historical information about counterparty default rates; and

(d) any other information used to assess credit quality.

IG24 When the entity considers external ratings when managing and monitoring credit quality, the entity might disclose information about:

(a) the amounts of credit exposures for each external credit grade;

(b) the rating agencies used;

(c) the amount of an entity's rated and unrated credit exposures; and

(d) the relationship between internal and external ratings.

IG25 When the entity considers internal credit ratings when managing and monitoring credit quality, the entity might disclose information about:

(a) the internal credit ratings process;

(b) the amounts of credit exposures for each internal credit grade; and

(c) the relationship between internal and external ratings.

Financial assets that are either past due or impaired (paragraph 37)

IG26 A financial asset is past due when the counterparty has failed to make a payment when contractually due. As an example, an entity enters into a lending agreement that requires interest to be paid every month. On the first day of the next month, if interest has not been paid, the loan is past due. Past due does not mean that a counterparty will never pay, but it can trigger various actions such as renegotiation, enforcement of covenants, or legal proceedings.

IG27 When the terms and conditions of financial assets that have been classified as past due are renegotiated, the terms and conditions of the new contractual arrangement apply in determining whether the financial asset remains past due.

IG28 Paragraph 37(a) requires an analysis by class of the age of financial assets that are past due but not impaired. An entity uses its judgement to determine an appropriate number of time bands. For example, an entity might determine that the following time bands are appropriate:

(a) not more than three months;

(b) more than three months and not more than six months;

(c) more than six months and not more than one year; and

(d) more than one year.

IG29 Paragraph 37(b) requires an analysis of impaired financial assets by class. This analysis might include:

(a) the carrying amount, before deducting any impairment loss;

(b) the amount of any related impairment loss; and

(c) the nature and fair value of collateral available and other credit enhancements obtained.

Liquidity risk (paragraphs 39 and B11)

Liquidity management (paragraph 39(b))

IG30 If an entity manages liquidity risk on the basis of expected maturity dates, it might disclose a maturity analysis of the expected maturity dates of both financial liabilities and financial assets. If an entity discloses such an expected maturity analysis, it might clarify that expected dates are based on estimates made by management, and explain how the estimates are determined and the principal reasons for differences from the contractual maturity analysis that is required by paragraph 39(a).

IG31 Paragraph 39(b) requires the entity to describe how it manages the liquidity risk inherent in the maturity analysis of financial liabilities required in paragraph 39(a). The factors that the entity might consider in providing this disclosure include, but are not limited to, whether the entity:

(a) expects some of its liabilities to be paid later than the earliest date on which the entity can be required to pay (as may be the case for customer deposits placed with a bank);

(b) expects some of its undrawn loan commitments not to be drawn;

(c) holds financial assets for which there is a liquid market and that are readily saleable to meet liquidity needs;

(d) has committed borrowing facilities (eg commercial paper facilities) or other lines of credit (eg stand-by credit facilities) that it can access to meet liquidity needs;

(e) holds financial assets for which there is not a liquid market, but which are expected to generate cash inflows (principal or interest) that will be available to meet cash outflows on liabilities;

(f) holds deposits at central banks to meet liquidity needs;

(g) has very diverse funding sources; or

(h) has significant concentrations of liquidity risk in either its assets or its funding sources.

Market risk (paragraphs 40–42 and B17–B28)

IG32 Paragraph 40(a) requires a sensitivity analysis for each type of market risk to which the entity is exposed. There are three types of market risk: interest rate risk, currency risk and other price risk. Other price risk may include risks such as equity price risk, commodity price risk, prepayment risk (ie the risk that one party to a financial asset will incur a financial loss because the other party repays earlier or later than expected), and residual value risk (eg a lessor of motor cars that writes residual value guarantees is exposed to residual value risk). Risk variables that are relevant to disclosing market risk include, but are not limited to:

(a) the yield curve of market interest rates. It may be necessary to consider both parallel and non-parallel shifts in the yield curve.

(b) foreign exchange rates.

(c) prices of equity instruments.

(d) market prices of commodities.

IG33 Paragraph 40(a) requires the sensitivity analysis to show the effect on profit or loss and equity of reasonably possible changes in the relevant risk variable. For example, relevant risk variables might include:

(a) prevailing market interest rates, for interest-sensitive financial instruments such as a variable-rate loan; or

(b) currency rates and interest rates, for foreign currency financial instruments such as foreign currency bonds.

IG34 For interest rate risk, the sensitivity analysis might show separately the effect of a change in market interest rates on:

(a) interest income and expense;

(b) other line items of the statement of profit and loss (such as trading gains and losses); and

(c) when applicable, equity.

An entity might disclose a sensitivity analysis for interest rate risk for each currency in which the entity has material exposures to interest rate risk.

IG35 Because the factors affecting market risk vary depending on the specific circumstances of each entity, the appropriate range to be considered in providing a sensitivity analysis of market risk varies for each entity and for each type of market risk.

IG36 The following example illustrates the application of the disclosure requirement in paragraph 40(a):

Interest rate risk

At 31 December 20X2, if interest rates at that date had been 10 basis points lower with all other variables held constant, post-tax profit for the year would have been Rs. 1.7 crore (20X1—Rs. 2.4 crore) higher, arising mainly as a result of lower interest expense on variable borrowings, and other components of equity would have been Rs. 2.8 crore (20X1—Rs. 3.2 crore) higher, arising mainly as a result of an increase in the fair value of fixed rate financial assets classified as available for sale. If interest rates had been 10 basis points higher, with all other variables held constant, post-tax profit would have been Rs. 1.5 crore (20X1—Rs. 2.1 crore) lower, arising mainly as a result of higher interest expense on variable borrowings, and other components of equity would have been Rs. 3.0 crore (20X1—Rs. 3.4 crore) lower, arising mainly as a result of a decrease in the fair value of fixed rate financial assets classified as available for sale. Profit is more sensitive to interest rate decreases than increases because of borrowings with capped interest rates. The sensitivity is lower in 20X2 than in 20X1 because of a reduction in outstanding borrowings that has occurred as the entity's debt has matured (see note X)[a]

Foreign currency exchange rate risk

At 31 December 20X2, if the Rupee had weakened 10 per cent against the US dollar with all other variables held constant, post-tax profit for the year would have been Rs. 2.8 crore (20X1—Rs. 6.4 crore) lower, and other components of equity would have been Rs. 1.2 crore (20X1—Rs. 1.1 crore) higher. Conversely, if the Rupee had strengthened 10 per cent against the US dollar with all other variables held constant, post-tax profit would have been Rs. 2.8 crore (20X1—Rs. 6.4 crore) higher, and other components of equity would have been Rs. 1.2 crore (20X1—Rs. 1.1 crore) lower. The lower foreign currency exchange rate sensitivity in profit in 20X2 compared with 20X1 is attributable to a reduction in foreign currency denominated debt. Equity is more sensitive in 20X2 than in 20X1 because of the increased use of hedges of foreign currency purchases, offset by the reduction in foreign currency debt.

(a) Paragraph 39(a) requires disclosure of a maturity analysis of liabilities.

Other market risk disclosures (paragraph 42)

IG37 Paragraph 42 requires the disclosure of additional information when the sensitivity analysis disclosed is unrepresentative of a risk inherent in a financial instrument. For example, this can occur when:

(a) a financial instrument contains terms and conditions whose effects are not apparent from the sensitivity analysis, eg options that remain out of (or in) the money for the chosen change in the risk variable;

(b) financial assets are illiquid, eg when there is a low volume of transactions in similar assets and an entity finds it difficult to find a counterparty; or

(c) an entity has a large holding of a financial asset that, if sold in its entirety, would be sold at a discount or premium to the quoted market price for a smaller holding.

IG38 In the situation in paragraph IG37(a), additional disclosure might include:

(a) the terms and conditions of the financial instrument (eg the options);

(b) the effect on profit or loss if the term or condition were met (i.e. if the options were exercised); and

(c) a description of how the risk is hedged.

For example, an entity may acquire a zero-cost interest rate collar that includes an out-of-the-money leveraged written option (eg the entity pays ten times the amount of the difference between a specified interest rate floor and the current market interest rate). The entity may regard the collar as an inexpensive economic hedge against a reasonably possible increase in interest rates. However, an unexpectedly large decrease in interest rates might trigger payments under the written option that, because of the leverage, might be significantly larger than the benefit of lower interest rates. Neither the fair value of the collar nor a sensitivity analysis based on reasonably possible changes in market variables would indicate this exposure. In this case, the entity might provide the additional information described above.

IG39 In the situation described in paragraph IG37(b), additional disclosure might include the reasons for the lack of liquidity and how the entity hedges the risk.

IG40 In the situation described in paragraph IG37(c), additional disclosure might include:

(a) the nature of the security (eg entity name);

(b) the extent of holding (eg 15 per cent of the issued shares);

(c) the effect on profit or loss; and

(d) how the entity hedges the risk.

Appendix E

Limited Revision to Accounting Standard (AS) 19
Leases

The following is the text of the limited revision to AS 19, Leases, issued by the Institute of Chartered Accountants of India.

In view of Accounting Standard (AS) 32, *Financial Instruments: Disclosures*, AS 19 is modified as under (modifications are shown as underline/ strike-through):

1. Paragraph 22 is modified as below:

"22. The lessee should, in addition to the requirements of AS 10, Accounting for Fixed Assets, AS 6, Depreciation Accounting, <u>AS 32, Financial Instruments: Disclosures,</u> and the governing statute, make the following disclosures for finance leases:
……."

2. Paragraph 46 is modified as below:

"46. The lessor should, in addition to the requirements of AS 6, Depreciation Accounting and AS 10, Accounting for Fixed Assets, <u>AS 32, Financial Instruments: Disclosures,</u> and the governing statute, make the following disclosures for operating leases:
……."

The limited revision comes into effect in respect of accounting periods commencing on or after the date on which Accounting Standard (AS) 32, *Financial Instruments: Disclosures*, comes into effect.

Source- Accounting Standards Board