

Exposure Draft
Accounting Standard (AS) 109
Financial Instruments

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Issued by
Accounting Standards Board
The Institute of Chartered Accountants of India

Exposure Draft Accounting Standard (AS) 109 Financial Instruments

The Indian Accounting Standards (Ind AS), as notified by the Ministry of Corporate Affairs in February, 2015, have been applicable to the specified class of companies. For other class of companies, i.e., primarily the unlisted companies having net worth less than Rs. 250 crores, Accounting Standards, as notified under Companies (Accounting Standards) Rules, 2006, have been applicable. However, the Ministry of Corporate Affairs has requested the Accounting Standards Board of the Institute of Chartered Accountants of India (ICAI) to upgrade Accounting Standards, as notified under Companies (Accounting Standards) Rules, 2006, to bring them nearer to Indian Accounting Standards. Accordingly, the Accounting Standards Board of ICAI has initiated the process of upgradation of these standards which will be applicable to all companies having net-worth less than Rs. 250 crores. Further, there are set of Accounting Standards issued by ICAI, which are broadly consistent with ASs notified under Companies (Accounting Standards) Rules, 2006, and these ASs are applicable for non-corporate entities. This set of ASs issued by ICAI are also part of the upgradation process mentioned above.

Brief Synopsis of draft AS 109, *Financial Instruments*

Currently, under existing Accounting Standards (AS) there is no comprehensive robust standard on financial instruments. However, certain guidance with regard to financial instruments exist which is provided under:

- AS 11, *The Effects of Changes in Foreign Exchange Rates*
- AS 13, *Accounting for Investments*
- Guidance Note on Accounting for Derivative Contracts

However, , under Ind ASs, comprehensive standards and guidance is given on the subject under following 3 Ind AS:

- Ind AS 32, *Financial Instruments: Presentation*
- Ind AS 107, *Financial Instruments: Disclosures*
- Ind AS 109, *Financial Instruments*

It may also be noted that a separate standards viz. Ind AS 113, Fair Value Measurement prescribes elaborate principles and requirements regarding fair value measurement for financial instruments and non financial items.

While, this draft standard is primarily based on IFRSs for SMEs, which are simplified versions of IFRS Standards (which form the basis of Ind ASs), the draft also substantially carries forward provisions of existing pronouncement of ICAI, 'Guidance Note on Accounting for Derivative Contracts' applicable for entities not covered by Ind AS roadmap. Efforts are made to keep the standard simple, appropriate balance between fair presentation and prudence is maintained. Following are relevant sections in IFRS for SMEs, corresponding to which this draft standard comprises of 3 sections:

Sections in IFRS for SMEs	Sections in upgraded AS 109
Section 11, <i>Basic Financial Instruments</i>	Section A, <i>Basic Financial Instruments</i>
Section 12, <i>Other Financial Instruments Issues</i>	Section B, <i>Other Financial Instruments</i>
Section 22, <i>Liabilities and Equity</i>	Section C, <i>Liabilities and Equity</i>

Section A applies to basic financial instruments (those that are commonly used and have simple features) and is relevant to all entities. Section B applies to other, more complex financial instruments and transactions. Section C *Liabilities and Equity* establishes principles for classifying financial instruments as either liabilities or equity and addresses accounting for equity instruments issued to individuals or other parties acting in their capacity as investors in equity instruments (ie in their capacity as owners).

Similar to IFRS for SMEs, no separate AS equivalent to Ind AS 113, *Fair Value Measurement* is currently proposed, rather fair value measurement principles are incorporated in individual standards based on ‘entry price’ concept.

Appendix 1 covering major differences between draft AS 109 and existing GAAP is included in the draft Standard. Similarly, major differences between draft AS 109 and Ind AS 109 are given in Appendix 2 of this draft Standard.

Following is the Exposure Draft of the Accounting Standard (AS) 109, Financial Instruments, issued by the Accounting Standards Board of the Institute of Chartered Accountants of India, for comments. The Board invites comments on any aspect of this Exposure Draft. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

How to Comment

Comments *can be submitted using one of the following methods so as to receive not later than June 30, 2018:*

1. Electronically:	Visit the following link http://www.icai.org/comments/asb/
2. Email:	Comments can be sent at commentsasb@icai.in
3. Postal:	Secretary, Accounting Standards Board, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002

Further clarifications on any aspect of this Exposure Draft may be sought by email to asb@icai.in.

Accounting Standard (AS) 109, *Financial Instruments*

Scope

- 1 Section A *Basic Financial Instrument* and Section B *Other Financial Instruments* together deal with recognising, presenting, derecognising, measuring and disclosing financial instruments (financial assets and financial liabilities). Section A applies to basic financial instruments and is relevant to all entities. Section B applies to other, more complex financial instruments and transactions. If an entity enters into only basic financial instrument transactions then Section B is not applicable. However, even entities with only basic financial instruments shall consider the scope of Section B to ensure they are exempt. Section C *Liabilities and Equity* establishes principles for classifying financial instruments as either liabilities or equity and addresses accounting for equity instruments issued to individuals or other parties acting in their capacity as investors in equity instruments (ie in their capacity as owners).

Section A *Basic Financial Instrument*

Introduction

- 2 A financial instrument is a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.
- 3 Section A requires an amortised cost method for all basic financial instruments except for Investments in Equity Instruments, Non-convertible Preference Shares and Units of Mutual Funds. Investments in Equity Instruments, Non-convertible Preference Shares and Units of Mutual Funds held for trading are measured at Fair Value through Profit or Loss and said instruments not held for trading are measured at Cost less Impairment.
- 4 Basic financial instruments within the scope of Section A are those that satisfy the conditions in paragraph 7 of this section. Examples of financial instruments that normally satisfy those conditions include:
- (a) cash;
 - (b) demand and fixed-term deposits when the entity is the depositor, for example bank accounts;
 - (c) commercial paper and commercial bills held;
 - (d) accounts, notes and loans receivable and payable;
 - (e) bonds and similar debt instruments;
 - (f) investments in non-convertible preference shares and non-puttable ordinary and preference shares; and
 - (g) commitment fees paid to receive a loan if the commitment cannot be net settled in cash.
- 5 Examples of financial instruments that do not normally satisfy the conditions in paragraph 7 of this section, and are therefore within the scope of Section B, include:

- (a) asset-backed securities with complex features, such as collateralised mortgage obligations, repurchase agreements and securitised packages of receivables;
- (b) options, rights, warrants, futures contracts, forward contracts and interest rate swaps that can be settled in cash or by exchanging another financial instrument;
- (c) financial instruments that qualify and are designated as hedging instruments in accordance with the requirements in Section B;
- (d) commitments to make a loan to another entity; and
- (e) commitment fees paid to receive a loan if the commitment can be net settled in cash.
- (f) contracts for contingent consideration in a business combination.

Scope of Section A

- 6 Section A applies to all financial instruments meeting the conditions of paragraph 7 of this section except for the following:
- (a) investments in subsidiaries, associates and joint ventures that are accounted for in accordance with AS 110, *Consolidated Financial Statements*, AS 28, *Investments in Associates and Joint Ventures* or AS 111, *Joint Arrangements*.
 - (b) financial instruments that meet the definition of an entity's own equity, including the equity component of compound financial instruments issued by the entity (see Section C *Liabilities and Equity*).
 - (c) leases, to which AS 17, *Leases* or paragraph 1(e) of section B apply. However, the derecognition requirements in paragraphs 40-45 of this section apply to the derecognition of lease receivables recognised by a lessor and lease payables recognised by a lessee, and the impairment requirements in paragraphs 27-33 of this section apply to lease receivables recognised by a lessor.
 - (d) employers' rights and obligations under employee benefit plans, to which AS 19, *Employee Benefits*, applies.
 - (e) financial instruments, contracts and obligations under share-based payment transactions to which AS 102, *Share-based Payment*, applies.
 - (f) reimbursement assets that are accounted for in accordance with AS 37, *Provisions, Contingent liabilities and Contingent Assets*.

Basic financial instruments

- 7 An entity shall account for the following financial instruments as basic financial instruments in accordance with Section A:
- (a) cash;
 - (b) a debt instrument (such as an account, note or loan receivable or payable) that meets the conditions in paragraph 8 of this section;
 - (c) a commitment fees paid to receive a loan that:
 - (i) cannot be settled net in cash; and

- (ii) when the commitment is executed, is expected to meet the conditions in paragraph 8 of this section.
 - (d) Investments in Equity Instruments, Non-convertible Preference Shares and Units of Mutual Funds.
- 8 A debt instrument that satisfies all of the conditions in (a)–(d) shall be accounted for in accordance with Section A:
- (a) returns to the holder (the lender/creditor) assessed in the currency in which the debt instrument is denominated are either:
 - (i) a fixed amount;
 - (ii) a fixed rate of return over the life of the instrument;
 - (iii) a variable return that, throughout the life of the instrument, is equal to a single referenced quoted or observable interest rate (such as London Interbank Offered Rate (LIBOR), Mumbai Interbank Offered Rate (MIBOR) etc); or
 - (iv) some combination of such fixed and variable rates, provided that both the fixed and variable rates are positive.

For fixed and variable rate interest returns, interest is calculated by multiplying the rate for the applicable period by the principal amount outstanding during the period.

- (b) there is no contractual term or condition that could, by its terms, result in the holder (the lender/creditor) losing the principal amount or any interest attributable to the current period or prior periods. The fact that a debt instrument is subordinated to other debt instruments is not an example of such a contractual term or condition.
 - (c) contractual terms and conditions that permit or require the issuer (the borrower) to prepay a debt instrument or permit or require the holder (the lender/creditor) to put it back to the issuer (ie to demand repayment) before maturity are not contingent on future events other than to protect:
 - (i) the holder against a change in the credit risk of the issuer or the instrument (for example, defaults, credit downgrades or loan covenant violations) or a change in control of the issuer; or
 - (ii) the holder or issuer against changes in relevant taxation or law.
 - (d) there are no conditional returns or repayment provisions except for the variable rate return described in (a) and prepayment provisions described in (c).
- 9 Examples of debt instruments that would normally satisfy the conditions in paragraph 8(a)(iv) of this section include:
- (a) a bank loan that has a fixed interest rate for an initial period that then reverts to a quoted or observable variable interest rate after that period; and
 - (b) a bank loan with interest payable at a quoted or observable variable interest rate plus a fixed rate throughout the life of the loan, for example LIBOR plus 200 basis points.
- 10 An example of a debt instrument that would normally satisfy the conditions set out in paragraph 8(c) of this section would be a bank loan that permits the borrower to terminate the

arrangement early, ie making premature payment even though the borrower may be required to pay a penalty to compensate the bank for its costs of the borrower terminating the arrangement early.

- 11 Other examples of financial instruments that would normally satisfy the conditions in paragraph 8 of this section are:
- (a) trade accounts and notes receivable and payable, and loans from banks or other third parties.
 - (b) accounts payable in a foreign currency. However, any change in the account payable because of a change in the exchange rate is recognised in profit or loss as required by AS 21, *The Effects of Changes in Foreign Exchange Rates*.
 - (c) loans to or from subsidiaries or associates that are due on demand.
 - (d) a debt instrument that would become immediately receivable if the issuer defaults on an interest or principal payment (such a provision does not violate the conditions in paragraph 8 of this section).
- 12 Examples of financial instruments that do not satisfy the conditions in paragraph 8 of this section (and are therefore within the scope of Section B) include:
- (a) an interest rate swap that returns a cash flow that is positive or negative, or a forward commitment to purchase a commodity or financial instrument that is capable of being cash-settled and that, on settlement, could have positive or negative cash flow, because such swaps and forwards do not meet the condition in paragraph 8(a) of this section; options and forward contracts, because returns to the holder are not fixed and the condition in paragraph 8(a) of this section is not met; and
 - (b) investments in debt convertible into equity instruments of the debt issuer, because the return to the holder can vary with the price of the issuer's equity shares instead of just with market interest rates.

Initial recognition of financial assets and liabilities

- 13 An entity shall recognise a financial asset or a financial liability only when the entity becomes a party to the contractual terms and conditions of the instrument.

Initial measurement

- 14 When a financial asset or financial liability is recognised initially, an entity shall measure it at the transaction price (including transaction costs except in the initial measurement of financial assets and liabilities that are subsequently measured at Fair Value through Profit or Loss) unless the arrangement constitutes, in effect, a financing transaction for either the entity (for a financial liability) or the counterparty (for a financial asset) to the arrangement. An arrangement constitutes a financing transaction if payment is deferred beyond normal business terms, for example, providing interest-free credit to a buyer for the sale of goods, or is financed at a rate of interest that is not a market rate, for example, an interest-free or below market interest rate loan made to an employee. If the arrangement constitutes a financing

transaction, the entity shall measure the financial asset or financial liability at the present value of the future payments discounted at a market rate of interest for a similar debt instrument as determined at initial recognition.

Examples—financial assets

- 1 For a long-term loan made to another entity, a receivable is recognised at the present value of cash receivable (including interest payments and repayment of principal) from that entity.
- 2 For goods sold to a customer on short-term credit, a receivable is recognised at the undiscounted amount of cash receivable from that entity, which is normally the invoice price.
- 3 For an item sold to a customer on two-year interest-free credit, a receivable is recognised at the current cash sale price for that item. If the current cash sale price is not known, it may be estimated as the present value of the cash receivable discounted using the prevailing market rate(s) of interest for a similar receivable.
- 4 For a cash purchase of another entity's ordinary shares, the investment is recognised at the amount of cash paid to acquire the shares.

Examples—financial liabilities

- 1 For a loan received from a bank, a payable is recognised initially at the present value of cash payable to the bank (for example, including interest payments and repayment of principal).
- 2 For goods purchased from a supplier on short-term credit, a payable is recognised at the undiscounted amount owed to the supplier, which is normally the invoice price.

Subsequent measurement

- 15 At the end of each reporting period, an entity shall measure basic financial instruments as follows, without any deduction for transaction costs the entity may incur on sale or other disposal:
- (a) Investments in Equity Instruments, Non-convertible Preference Shares and Units of Mutual Funds:
 - (i) Held for trading, are measured at Fair Value through Profit or Loss.
 - (ii) Not held for trading, are measured at Cost less Impairment.
 - (b) debt instruments that meet the conditions in paragraph 7(b) of this section shall be measured at amortised cost using the effective interest method. Paragraphs 16-21 of this section provide guidance on determining amortised cost using the effective interest method. Debt instruments that are classified as current assets or current liabilities shall be measured at the undiscounted amount of the cash or other consideration expected to be paid or received (net of impairment—see paragraphs 27-33 of this section) unless the arrangement constitutes, in effect, a financing transaction (see paragraph 14 of this section).

- (c) Commitment fees paid to receive a loan that meet the conditions in paragraph 7(c) of this section shall be measured at Cost less Impairment, if any.

Impairment must be assessed for financial assets in (a) (ii) and (b). Paragraphs 27-33 of this section provide guidance.

Amortised cost and effective interest method

16 The amortised cost of a financial asset or financial liability at each reporting date is the net of the following amounts:

- (a) the amount at which the financial asset or financial liability is measured at initial recognition;
- (b) minus any repayments of the principal;
- (c) plus or minus the cumulative amortisation using the effective interest method of any difference between the amount at initial recognition and the maturity amount;
- (d) minus, in the case of a financial asset, any reduction (directly or through the use of an allowance account) for impairment.

Financial assets and financial liabilities may have no explicit stated interest rate, such as zero-coupon bonds where interest is receivable/payable via accretion of discount on such bonds.

Example of determining amortised cost and application of effective interest method for investment in zero coupon bonds

Entity A purchases zero coupon bonds for ₹1,000. The instrument has a contractual par amount of ₹1,250. The contractual period of bond is 5 years.

The effective interest rate works out to 4.6 per cent annually. The table below provides information about the carrying amount and cash flows from zero coupon bonds.

Amount in ₹				
Year ending	Carrying amount at the beginning of the year (a)	Interest income accumulated using EIR (b)	Cash flow (c)	Carrying amount at the end of the year (d = a+b-c)
20x1	1,000	46	0	1,046
20x2	1,046	48	0	1,094
20x3	1,094	50	0	1,144
20x4	1,144	52	0	1,196
20x5	1,196	54	1250	0

The investor of the bonds makes the following journal entry at issue on 1 April 20X0:

Dr Investment - Bond	₹1,000	
Cr Cash		₹1,000

At the end of each reporting period, the issuer would make the following journal entry:

		20X1	20x2	20x3	20x4	20x5
Dr	Cash	-	-	-	-	1,250
Dr	Investment -Bond	46	48	50	52	54
Cr	Interest income (opening balance x EIR)	46	48	50	52	54
Cr	Investment -Bond	-	-	-	-	1,250

- 17 The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability (or a group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that discounts estimated future cash payments or receipts through the contractual period of the financial instrument or, when appropriate, a shorter period, to the carrying amount of the financial asset or financial liability. The effective interest rate is determined on the basis of the carrying amount of the financial asset or liability at initial recognition. Under the effective interest method:
- (a) the amortised cost of a financial asset (liability) is the present value of future cash receipts (payments) discounted at the effective interest rate; and
 - (b) the interest expense (income) in a period equals the carrying amount of the financial liability (asset) at the beginning of a period multiplied by the effective interest rate for the period.
- 18 When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example prepayment, call and similar options) and known credit losses that have been incurred, but it shall not consider possible future credit losses not yet incurred.
- 19 When calculating the effective interest rate, an entity shall amortise any related fees, brokerage, finance charges paid or received (such as 'points'), transaction costs and other premiums or discounts over the contractual period of the instrument, except as follows. Transaction costs include fees and commission paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and security exchanges, and transfer taxes and duties. Transaction costs do not include, financing costs or internal administrative or holding costs. The entity shall use a shorter period if that is the period to which the fees, finance charges paid or received, transaction costs, premiums or discounts relate. This will be the case when the variable to which the fees, finance charges 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.

Example of determining amortised cost and application of effective interest method for financial asset – Investment

Entity A purchases a debt instrument for ₹1,000 (including transaction costs of ₹50). The instrument has a contractual par amount of ₹1,250 and carries fixed interest of 4.7 per cent that is paid annually ($₹1,250 \times 4.7\% = ₹59$ per year). The contractual period of debt instrument is 5 years.

It can be shown that in order to allocate interest receipts, the initial discount and transaction costs over the term of the debt instrument entity has to compute effective interest rate which works out to 10 per cent annually. The table below provides information about the carrying amount, interest revenue and cash flows of the debt instrument in each reporting period.

Amount in ₹				
Year ending	Carrying amount at the beginning of the	Interest income calculated	Cash flow (c)	Carrying amount at the end of the year (d = a+b-c)

	year (a)	using EIR (b= a x 10%)		
20x1	1,000	100	59	1,041
20x2	1,041	104	59	1,086
20x3	1,086	109	59	1,136
20x4	1,136	113	59	1,190
20x5	1,190	119	1250+59	0

The investor of the bonds makes the following journal entry at issue on 1 April 20X0:

Dr Investment - Bond	₹1,000
Cr Cash	₹1,000

At the end of each reporting period, the issuer would make the following journal entry:

		20X1	20x2	20x3	20x4	20x5
Dr	Cash	59	59	59	59	1,309
Dr	Investment - Bond	41 (₹1,041- ₹1,000)	45 (₹1,086- ₹1,041)	50 (₹1,136- ₹1,086)	54 (₹1,190- ₹1,136)	60 (₹1,250- ₹1,190)
Cr	Interest income (opening balance x 10% EIR)	100	104	109	113	119
Cr	Investment -Bond	-	-	-	-	1,250

- 20 For variable rate financial assets and variable rate financial liabilities, periodic re-estimation of cash flows to reflect changes in market rates of interest alters the effective interest rate. As a result, operational complexities may arise to apply the effective interest method by including elements such as related fees, transactions costs, premium, discounts. Accordingly, such elements may be amortised on straight-line basis over contractual period of the financial instrument.

Example of determining amortised cost and application of effective interest method for debt investments with variable coupon rate

Entity A purchases a debt instrument for ₹1,000 (including transaction costs of ₹50). The instrument has a contractual par amount of ₹1,200 and carries interest rate based on 12 months MIBOR plus 1%. At the time of issue, MIBOR is 4.5%, and subsequently, has increased by 0.5 percent each year. The contractual period of debt instrument is 5 years. Transaction cost and bond discount amounts to ₹250 (₹1200-₹950) for this variable rate financial instruments.

Effective interest rate (EIR) at the time of issue of debt instrument works out to 10 per cent annually. Subsequently due to change in the MIBOR rate, the EIR will change which entails recomputation of EIR at each reset date and adjustment of carrying amount of the financial asset. In order to avoid this complexity, transactions costs and bond discount may be amortised on straight-line basis over contractual period, ie ₹50 each year (₹250/5 years)

The table below provides information about the carrying amount, transaction cost and discount, EIR, interest revenue and cash flows of the debt instrument in each reporting period.

these elements

Amount in ₹

Year ending	Gross Carrying	Transaction costs/discoun	Variable Coupon	Interest income for the period	Cash inflows	Net Carrying
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	amount at the start of the year	t at start of the year	Rate	Contractual rate	Txn cost/discount amortisation		amount at the end of the year
	(a)	(b= b-e)	(c)	(d=a x c)	(e)	(f)	(g=a+b+d-e-f)
20x1	1200	250	5.50%	66	50	66	1,400
20x2	1200	200	6.00%	72	50	72	1,350
20x3	1200	150	6.50%	78	50	78	1,108
20x4	1200	100	7.00%	84	50	84	1,250
20x5	1200	50	7.50%	90	50	1290	0

The investor of the bonds makes the following journal entry at issue on 1 April 20X0:

Dr Investment - Bond	₹1,200
Cr Cash	₹1,200

At the end of each reporting period, the issuer would make the following journal entries:

		20X1	20x2	20x3	20x4	20x5
Dr	Investment – transaction cost and Bond discount	50	50	50	50	50
Cr	Profit or loss	50	50	50	50	50
Dr	Cash	66	72	78	84	1,290
Dr	Investment -Bond Txn cost/discount amortisation	50	50	50	50	50
Cr	Interest income	116	122	128	134	140
Cr	Investment -Bond					1,200

- 21 If an entity revises its estimates of payments or receipts, the entity shall adjust 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 shall recalculate the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The entity shall recognise the adjustment as income or expense in profit or loss at the date of the revision.

Example of adjustment required in amortised cost when an entity revises its estimates of cash flows:

In continuance of the preceding example, On 1 April 20X2 the entity revises its estimate of cash flows. It now expects that 50 per cent of the contractual par amount will be prepaid on 31 March 20X3 and the remaining 50 per cent on 31 March 20X4. In accordance with paragraph 21 of this section of the standard, the carrying amount of the debt instrument in the beginning of 20X2 is adjusted. The carrying amount is recalculated by discounting the amount the entity expects to receive in 20X2-20X3 and subsequent years using the original effective interest rate (10 per cent). This results in the new carrying amount in 20X2-20X3 of ₹1,138. The adjustment of ₹52 (₹1,138 – ₹1,086) is recorded in profit and loss in 20X2-20X3. The table below provides information about the carrying amount, interest revenue and cash flows as they would be adjusted taking into account the change in estimate.

Year	carrying amount at the beginning of the year (a)	Interest revenue (b = a x 10%)	Cash flow (c)	Carrying amount at the end of the year (d = a+b+c)
20x0	1,000	100	59	1,041
20x1	1,041	104	59	1,086
20x2	1,086+52=1,138	114	625+59	568
20x3	568	57	30	595
20x4	595	60	625+30	0

The investor of the bonds makes the following adjustment journal entry as of on 1 April 20X2:

Dr Investment – Bond Discount/Txn Costs	₹52
Cr Interest income	₹52

At the end of each reporting period starting from 31 March 20x3, the issuer would make the following journal entry:

		20X1	20X2	20X3	20X4	20X5
Dr	Cash	59	59	684	30	655
Dr	Investment – Bond	41	45	55	27	30
Cr	Interest income	100	104	114	57	60
Cr	Investment -Bond	-	-	625	-	625

Reclassification

- 22 If there is a change in the underlying objective and intention to hold the asset held for trading, an entity may reclassify financial assets into and out of the Fair Value through Profit or Loss category. A financial asset no longer held for trading may be reclassified from Fair Value through Profit or Loss category to Cost less Impairment category in accordance with paragraph 24 of this section. Similarly, a financial asset that was not held for trading earlier can be reclassified in accordance with paragraph 25 of this section to Fair Value through Profit or Loss category when subsequently it is held for trading.
- 23 Unlike assets, reclassification is not applicable for financial liabilities.
- 24 A financial asset that is reclassified out of the Fair Value through Profit or Loss category shall be reclassified at its fair value on the date of reclassification. Any gain or loss already recognised in profit or loss shall not be reversed. The fair value of the financial asset on the date of reclassification becomes its new cost. Any gain or loss arising at the time of reclassification, is recognised in profit or loss.
- 25 A financial asset that is reclassified into Fair Value through Profit or Loss category shall be reclassified at its fair value on the date of reclassification. Any previously recognised

amortisation shall not be reversed. The fair value as on the date of reclassification becomes its new carrying amount. Any gain or loss arising from a difference between the carrying amount of the financial asset and fair value at the time of reclassification, is recognised in profit or loss.

- 26 If an entity reclassifies financial assets in accordance with paragraphs 22-25 of this section, it shall apply the reclassification prospectively from the reclassification date. The entity shall not restate any previously recognised gains, losses (including impairment gains or losses) or interest.

Impairment of financial assets measured at cost or amortised cost

Recognition

- 27 At the end of each reporting period, an entity shall assess whether there is any indication of impairment of any financial assets that are measured at cost or amortised cost. If there is indication of impairment, the entity shall recognise an impairment loss in profit or loss immediately.
- 28 Indication that a financial asset or group of assets is impaired includes observable indication that come to the attention of the holder of the asset about the following loss events:
- (a) significant financial difficulty of the issuer;
 - (b) a breach of contract, such as a default or delinquency in interest or principal payments;
 - (c) the creditor, for economic or legal reasons relating to the debtor's financial difficulty, granting to the debtor a concession that the creditor would not otherwise consider;
 - (d) it has become probable that the debtor will enter bankruptcy or other financial reorganisation; or
 - (e) evidence indicating that there has been a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, even though the decrease cannot yet be identified with the individual financial assets in the group, such as adverse national or local economic conditions or adverse changes in industry conditions.
- 29 Other factors may also be indicators of impairment, including significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates.
- 30 An entity shall assess the following financial assets individually for impairment:
- (a) all equity instruments regardless of significance; and
 - (b) other financial assets that are individually significant.
- 31 An entity shall assess other financial assets (refer paragraph 30(a) of this section either individually or grouped on the basis of similar credit risk characteristics.

Measurement

- 32 An entity shall measure an impairment loss on the following financial assets measured at cost or amortised cost as follows:
- (a) for a financial asset measured at amortised cost in accordance with paragraph 15(b) of this section, the impairment loss is the difference between the asset's carrying amount and the present value of estimated cash flows discounted at the asset's original effective interest rate. If such a financial asset has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate determined under the contract.
 - (b) for a financial asset measured at cost less impairment in accordance with paragraph 15(c) of this section the impairment loss is the difference between the asset's carrying amount and the best estimate (which will necessarily be an approximation) of the amount (which might be zero) that the entity would receive for the asset if it were to be sold at the reporting date.

Reversal

- 33 If, in a subsequent period, the amount of an 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 entity shall reverse the previously recognised impairment loss either directly or by adjusting an allowance account. The reversal shall not result in a carrying amount of the financial asset (net of any allowance account) that exceeds what the carrying amount would have been had the impairment not previously been recognised. The entity shall recognise the amount of the reversal in profit or loss immediately.

Fair Value

- 34 The fair value of a financial instrument at initial recognition is normally the transaction price (ie the fair value of the consideration given or received).
- 35 An entity shall use the following hierarchy to estimate the fair value of an asset:
- (a) the best evidence of fair value is a quoted price for an identical asset (or similar asset) in an active market. This is usually the current bid price.
 - (b) when quoted prices are unavailable, the price in a binding sale agreement or a recent transaction for an identical asset (or similar asset) in an arm's length transaction between knowledgeable, willing parties provides evidence of fair value. However this price may not be a good estimate of fair value if there has been a significant change in economic circumstances or a significant period of time between the date of the binding sale agreement, or the transaction, and the measurement date. If the entity can demonstrate that the last transaction price is not a good estimate of fair value (for example, because it reflects the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale), then that price is adjusted.
 - (c) if the market for the asset is not active and any binding sale agreements or recent transactions of an identical asset (or similar asset) on their own are not a good estimate of fair value, an entity estimates the fair value by using another valuation technique. The objective of using a valuation technique is to estimate what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations.

Other sections of this Standard make reference to the fair value guidance in paragraphs 34-39 of this section.

Valuation technique

- 36 Valuation techniques include using recent arm's length market transactions for an identical asset between knowledgeable, willing parties, if available, reference to the current fair value of another asset that is substantially the same as the asset being measured, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the asset and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.
- 37 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-determined inputs. A valuation technique would be expected to arrive at a reliable estimate of the fair value if
- (a) it reasonably reflects how the market could be expected to price the asset; and
 - (b) the inputs to the valuation technique reasonably represent market expectations and measures of the risk return factors inherent in the asset.

No active market

- 38 The fair value of investments in assets that do not have a quoted market price in an active market is reliably measurable if
- (a) the variability in the range of reasonable fair value estimates is not significant for that asset; or
 - (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.
- 39 There are many situations in which the variability in the range of reasonable fair value estimates of assets that do not have a quoted market price is likely not to be significant. Normally it is possible to estimate the fair value of an 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 asset at fair value.

Derecognition of a financial asset

- 40 An entity shall derecognise a financial asset only when either:
- (a) the contractual rights to the cash flows from the financial asset expire or are settled;
 - (b) the entity transfers to another party substantially all of the risks and rewards of ownership of the financial asset; or
 - (c) the entity, despite having retained some significant risks and rewards of ownership, has transferred control of the asset to another party and the other party has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer—in this case, the entity shall:

- (i) derecognise the asset; and
- (ii) recognise separately any rights and obligations retained or created in the transfer.

The carrying amount of the transferred asset shall be allocated between the rights or obligations retained and those transferred on the basis of their relative fair values at the transfer date. Newly created rights and obligations shall be measured at their fair values at that date. Any difference between the consideration received and the amounts recognised and derecognised in accordance with this paragraph shall be recognised in profit or loss in the period of the transfer.

- 41 If a transfer does not result in derecognition because the entity has retained significant risks and rewards of ownership of the transferred asset, the entity shall continue to recognise the transferred asset in its entirety and shall recognise a financial liability for the consideration received. The asset and liability shall not be offset. In subsequent periods, the entity shall recognise any income on the transferred asset and any expense incurred on the financial liability.
- 42 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 shall account for the collateral as follows:
- (a) if the transferee has the right by contract or custom to sell or repledge the collateral, the transferor shall reclassify that asset in its Balance Sheet (for example, as a loaned asset, pledged equity instruments or repurchase receivable) separately from other assets;
 - (b) if the transferee sells collateral pledged to it, it shall 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 shall derecognise the collateral and the transferee shall 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; and
 - (d) except as provided in (c), the transferor shall continue to carry the collateral as its asset and the transferee shall not recognise the collateral as an asset.

Example—transfer that qualifies for derecognition

An entity sells a group of its accounts receivable to a bank at less than their face amount. The entity continues to handle collections from the debtors on behalf of the bank, including sending monthly statements, and the bank pays the entity a market-rate fee for servicing the receivables. The entity is obliged to remit promptly to the bank any and all amounts collected, but it has no obligation to the bank for slow payment or non-payment by the debtors. In this case, the entity has transferred to the bank substantially all of the risks and rewards of ownership of the receivables. Accordingly, it removes the receivables from its Balance Sheet (ie derecognises them) and it shows no liability in respect of the proceeds received from the bank. The entity recognises a loss calculated as the difference between the carrying amount of the receivables at the time of sale and the proceeds received from the bank. The entity recognises a liability to the extent that it has collected funds from the debtors but has not yet remitted them to the bank.

Example—transfer that does not qualify for derecognition

The facts are the same as the preceding example except that the entity has agreed to buy back from the bank any receivables for which the debtor is in arrears as to principal or interest for more than 120 days. In this case, the entity has retained the risk of slow payment or non-payment by the debtors—a significant risk with respect to receivables. Accordingly, the entity does not treat the receivables as having been sold to the bank, and it does not derecognise them. Instead, it treats the proceeds from the bank as a loan secured by the receivables. The entity continues to recognise the receivables as an asset until they are collected or written off as uncollectable.

Derecognition of a financial liability

- 43 An entity shall derecognise a financial liability (or a part of a financial liability) only when it is extinguished—ie when the obligation specified in the contract is discharged, is cancelled or expires.
- 44 If an existing borrower and lender exchange financial instruments with substantially different terms, the entities shall account for the transaction as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, an entity shall account for 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) as an extinguishment of the original financial liability and the recognition of a new financial liability.
- 45 The entity shall recognise in profit or loss any difference between the carrying amount of the 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.

Example—transfer that qualifies for derecognition

A financial liability will be extinguished if the entity is released from settling the liability by process of law. Some jurisdictions have a 'statute of limitations' which is a statute that sets out the maximum period of time, after certain events have taken place, that legal proceedings based on those events may be initiated. For example, if such a period was five years, a supplier would no longer be able to legally enforce payment by a customer if the supplier did not claim payment within five years from the date the goods were provided.

Example—transfer that does not qualify for derecognition

Payment to a third party, including a trust, where the payment is to be used solely for satisfying scheduled payments of both interest and principal of the outstanding debt (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.

Also, if an entity pays a third party to assume an obligation and notifies its creditor that the third party has assumed its debt obligation, the entity does not derecognise the debt obligation unless is legally released from primary responsibility for the liability.

Disclosures

- 46 The following disclosures make reference to disclosures for financial liabilities measured at Fair Value through Profit or Loss. Entities that have only basic financial instruments (and therefore do not apply Section B) will not have any financial liabilities measured at Fair Value through Profit or Loss and hence will not need to provide such disclosures.

Disclosure of accounting policies for financial instruments

- 47 In accordance with AS 1, *Presentation of Financial Statements*, an entity shall disclose, in the significant accounting policies, the measurement basis (or bases) used for financial instruments and the other accounting policies used for financial instruments that are relevant to an understanding of the financial statements.

Balance Sheet—categories of financial assets and financial liabilities

- 48 An entity shall disclose the carrying amounts of each of the following categories of financial assets and financial liabilities at the reporting date, in total, either in the Balance Sheet or in the notes:
- (a) financial assets measured at Fair Value through Profit or Loss (paragraph 15(a)(i) of this section and paragraphs 6-7 of Section B);
 - (b) financial assets that are debt instruments measured at amortised cost (paragraph 15(b) of this section);
 - (c) financial assets that are investments in Equity Instruments, Non-convertible Preference Shares and Units of Mutual Funds measured at Cost less Impairment (paragraph 15(a)(ii) of this section and paragraphs 6-7 of Section B);
 - (d) financial liabilities measured at Fair Value through Profit or Loss (paragraphs 6-7 of Section B);
 - (e) financial liabilities measured at Amortised Cost (paragraph 15(b) of this section); and

- (f) loan commitments measured at Cost less Impairment (paragraph 15(c) of this section).

49 An entity shall disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance. For example, for long-term debt such information would normally include the terms and conditions of the debt instrument (such as interest rate, maturity, repayment schedule, and restrictions that the debt instrument imposes on the entity).

Derecognition

- 50 If an entity has transferred financial assets to another party in a transaction that does not qualify for derecognition (see 40-42 of this section), the entity shall disclose the following 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; and
 - (c) the carrying amounts of the assets and of any associated liabilities that the entity continues to recognise.

Collateral

- 51 An entity shall disclose:
- (a) the carrying amount of the financial assets it has pledged as collateral for liabilities or contingent liabilities, and
 - (b) the terms and conditions relating to its pledge.
- 52 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 shall 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.

Defaults and breaches on loans payable

- 53 For loans payable recognised at the reporting date for which there is a breach of terms or a default of principal, interest, sinking fund or redemption terms that have not been remedied by the reporting date, an entity shall disclose the following:
- (a) details of that breach or default;
 - (b) the carrying amount of the related loans payable at the reporting date; and
 - (c) whether the breach or default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue.

Items of income, expense, gains or losses

- 54 An entity shall disclose the following items of income, expense, gains or losses:
- (a) income, expense, gains or losses, including changes in fair value, recognised on:
 - (i) financial assets measured at Fair Value through Profit or Loss;
 - (ii) financial liabilities measured at Fair Value through Profit or Loss;
 - (iii) financial assets measured at Amortised Cost; and
 - (iv) 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 measured at Fair Value through Profit or Loss; and
 - (c) the amount of any impairment loss for each class of financial asset.

Reclassification

- 55 An entity shall disclose if, in the current or previous reporting periods, it has reclassified any financial assets. For each such event, an entity shall disclose:
- (a) the date of reclassification.
 - (b) a qualitative description of its effect on the entity's financial statements.
 - (c) the amount reclassified into and out of each category.
 - (d) for each reporting period until derecognition, the carrying amounts and fair values of all financial assets that have been reclassified in the current and previous reporting periods;

Section B *Other Financial Instruments*

Scope of this Section

- 1 Section B applies to all financial instruments except the following:
 - (a) Basic Financial Instruments covered by Section A.
 - (b) investments in subsidiaries, associates and joint ventures that are accounted for in accordance with AS 110, *Consolidated Financial Statements*, AS 111, *Joint Arrangements* or AS 28 *Investments in Associates and Joint Ventures*.
 - (c) employers' rights and obligations under employee benefit plans (see AS 19, *Employee Benefits*).
 - (d) financial instruments that meet the definition of an entity's own equity, including the equity component of compound financial instruments issued by the entity (see Section C *Liabilities and Equity*).
 - (e) leases within the scope of AS 17, *Leases*. However, Section B applies to leases that could result in a loss to the lessor or the lessee as a result of contractual terms that are unrelated to:
 - (i) changes in the price of the leased asset;
 - (ii) changes in foreign exchange rates;
 - (iii) changes in lease payments based on variable market interest rates; or
 - (iv) a default by one of the counterparties.
 - (f) contracts for contingent consideration in a business combination (see AS 103 *Business Combinations*). This exemption applies only to the acquirer.
 - (g) financial instruments, contracts and obligations under share-based payment transactions to which AS 102, *Share-based Payment* applies.
 - (h) reimbursement assets that are accounted for in accordance with AS 37, *Provisions, Contingent Liabilities and Contingent Assets*.
- 2 Most contracts to buy or sell a non-financial item such as a commodity, inventory or property, plant and equipment are excluded from this section because they are not financial instruments. However, this section applies to all contracts that impose risks on the buyer or seller that are not typical of contracts to buy or sell non-financial items. For example, this section applies to contracts that could result in a loss to the buyer or seller as a result of contractual terms that are unrelated to changes in the price of the non-financial item, changes in foreign exchange rates or a default by one of the counterparties.
- 3 In addition to the contracts described in paragraph 2 of this section, this section applies to contracts to buy or sell non-financial items if the contract 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 are not financial instruments for the purposes of this section.

Initial recognition of financial assets and liabilities

- 4 An entity shall recognise a financial asset or a financial liability only when the entity becomes a party to the contractual terms and conditions of the instrument.

Initial measurement

- 5 When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value.

Subsequent measurement

- 6 At the end of each reporting period, an entity shall measure all financial instruments within the scope of this section at fair value and recognise changes in fair value in profit or loss.
- 7 If a reliable measure of fair value is no longer available without undue cost or effort, financial instruments within the scope of this section shall be measured at cost less impairment until it is able to determine a reliable measure of fair value without undue cost or effort. Its carrying amount at the last date the asset was reliably measurable becomes its new cost.

Fair value

[Paragraph 34-39 of Section A provides prescriptions and guidance on Fair Value Measurement]

Impairment of financial assets measured at cost

- 8 An entity shall apply the guidance on impairment in paragraphs 27-33 of Section A to financial assets measured at cost less impairment in accordance with this section. Its carrying amount at the last date the asset was reliably measurable becomes its new cost.

Derecognition of a financial asset or financial liability

- 9 An entity shall apply the derecognition requirements in paragraphs 40-45 of Section A to financial assets and financial liabilities to which this section applies.

Accounting for derivatives

- 10 The accounting for derivatives covered by this Section is based on the following key principles:
- (i) (a) An entity recognises a derivative contract as per Paragraph 4 of this Section.

(b) A derivative contract is always measured at Fair Value through Profit or Loss except a derivative that is financial guarantee contract or a designated and effective hedging instrument.

- (ii) If any entity decides not to use hedge accounting as described in this Section, it should account for its derivatives at fair value with changes in fair value being recognised in the profit or loss.
- (iii) If an entity decides to apply hedge accounting as described in this Section, it should be able to clearly identify its risk management objective, the risk that it is hedging, how it will measure the derivative instrument if its risk management objective is being met and document this adequately at the inception of the hedge relationship and on an ongoing basis.
- (iv) An entity may decide to use hedge accounting for certain derivative contracts and for derivatives not included as part of hedge accounting, it will apply the principles at (i) and (ii) above.
- (v) Adequate disclosures of accounting policies, risk management objectives and hedging activities should be made in its financial statements.

Examples of Derivatives

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

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
Purchased or written stock option (call or put)	Equity prices (equity of another entity)
Interest rate futures linked to government debt (treasury futures)	Interest rates
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)

- 11 This Section does not permit synthetic accounting, i.e. combining a derivative and the underlying together as a single package. For instance, if any entity has a foreign currency borrowing that it has hedged by entering into a cross currency interest rate swap, it would require the entity to recognise the loan liability separately from the cross currency interest rate swap and not treat them as a package (synthetic accounting) as INR loan. Alternatively, if any entity has borrowed in terms of INR which it swaps with foreign currency borrowing it would not treat such a loan as a foreign currency borrowing.

Hedge Accounting

Need for hedge accounting

- 12 Hedge accounting may be required due to accounting mismatches in:
- (i) *Measurement* – some financial instruments (non-derivative) are not measured at fair value with changes being recognised in the profit or loss whereas all derivatives, which commonly are used as hedging instruments, are measured at fair value.
- (ii) *Recognition* – unsettled or forecast transactions that may be hedged are not recognised on the balance sheet or are included in the profit or loss only in a future accounting period, whereas all derivatives are recognised at inception.
- 13 An example of measurement mismatch is the hedge of interest rate risk on fixed rate debt instruments that are not held with the intention of trading. Another example of a measurement mismatch could be a derivative undertaken to hedge the price risk associated with recognised inventory.
- 14 Recognition mismatches include the hedge of a contracted or expected but not yet recognised sale, purchase or financing transaction in a foreign currency and future committed variable interest payments.
- 15 In order that the profit or loss reflects the effect of the hedge properly, it is necessary to match the recognition of gains and losses on the hedging instrument and those on the hedged item. Matching can be achieved in principle by delaying the recording of certain gains or losses on the hedging instrument or by accelerating the recording of certain gains and losses on the hedged item in the profit or loss. Both of these techniques are used while applying hedge accounting, depending on the nature of the hedging relationship.

Designation of a derivative contract as a hedging instrument

- 16 An entity is permitted but not required to designate a derivative contract as a hedging instrument. Where it designates a derivative contract as a hedging instrument, it needs to document the following, as a minimum:
- (i) identify its risk management objective;
 - (ii) demonstrate how the derivative contract helps meet that risk management objective;
 - (iii) specify how it plans to measure the fair value of the derivative instrument if the derivative contract is effective in meeting its risk management objective (including the relevant hedge ratio);
 - (iv) document this assessment (of points (i), (ii), (v) and (vi) of this paragraph) at inception of the hedging relationship and subsequently at every reporting period;
 - (v) demonstrate in cases of hedging a future cash flow that the cash flows are highly probable of occurring; and
 - (vi) conclude that the risk that is being hedged could impact the profit or loss.
- 17 In India, for a large number of derivative contracts that are undertaken in the Over The Counter (OTC) market, authorised dealers (generally banks) are required by the concerned regulator (e.g. the Reserve Bank of India (RBI)) to determine whether all or some of the above criteria are met before permitting an entity to enter into such a contract. The permissibility of a contract under RBI regulations, whilst persuasive, is not a sufficient condition to assert that it qualifies for hedge accounting under this Section. Certain derivative instruments that are traded on stock exchanges such as foreign exchange futures contracts or equity options / equity futures do not have such requirements and in those cases, in particular, it will be important to demonstrate compliance with the above criteria before hedge accounting can be applied.
- 18 In case a derivative contract is not classified as a hedging instrument because it does not meet the required criteria or an entity decides against such designation, it will be measured at fair value and changes in fair value will be recognised immediately in the profit or loss.
- 19 It is clarified that derivatives cannot be designated for a partial term of the derivative instrument. A derivative may be used in a hedging relationship relating to a portion of a non-financial item as long as the hedged portion is clearly identifiable and capable of being measured reliably. Examples of such non-financial components include exchange (for instance London Metal Exchange) traded prices components of metal inventory and crude oil components of aviation turbine fuel (ATF).

Types of hedge accounting

- 20 This Section recognises the following three types of hedging;
- (i) the fair value hedge accounting model is applied when hedging the risk of a fair value change of assets and liabilities already recognised in the balance sheet, or a firm commitment that is not yet recognised.
 - (ii) the cash flow hedge accounting model is applied when hedging the risk of changes in highly probable future cash flows or a firm commitment in a foreign currency.
 - (iii) the hedge of a net investment in a foreign operation.

Fair value hedge accounting model

- 21 A fair value hedge seeks to offset the risk of changes in the fair value of an existing asset or liability or an unrecognised firm commitment that may give rise to a gain or loss being recognised in the profit or loss. A fair value hedge is a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect the profit or loss.
- 22 When applying fair value hedge accounting, the hedging instrument is measured at fair value with changes in fair value recognised in the profit or loss. The hedged item is remeasured to fair value in respect of the hedged risk even if normally it is measured at amortised cost, e.g., a fixed rate borrowing measured at amortised cost needs to be measured at fair value if any risk element say foreign exchange risk is designated as part of qualifying hedge. Any resulting adjustment to the carrying amount of the hedged item related to the hedged risk is recognised in the profit or loss even if normally such a change may not be recognised.
- 23 The fair value changes of the hedged item and the hedging instrument will offset and result in no net impact in the profit or loss except for the impact of ineffectiveness.
- 24 An example of a fair value hedge is the hedge of a fixed rate bond with an interest rate swap, changing the interest rate from fixed to floating. Another example is the hedge of the changes in value of inventory using commodity futures contracts.
- 25 The adjusted carrying amounts of the hedged assets in a fair value hedging relationship are subject to impairment testing under other applicable Accounting Standards such as AS 36, *Impairment of Assets*, AS 2, *Inventories* etc.

Cash flow hedge accounting model

- 26 A cash flow hedge seeks to offset certain risks of the variability of cash flows in respect of an existing asset or liability or a highly probable forecast transaction that may be reflected in the profit or loss in a future period.
- 27 A cash flow hedge is a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction or a firm commitment in respect of foreign currency and (ii) could affect the profit or loss. An example of a cash flow hedge is the hedge of future highly probable sales in a foreign currency using a forward exchange contract. Another example of a cash flow hedge is the use of a swap to change the future floating interest payments on a recognised liability to fixed rate payments.
- 28 Under a cash flow hedge, the hedging instrument is measured at fair value, but any gain or loss that is determined to be an effective hedge is recognised in other comprehensive income as cash flow hedge reserve. This is intended to avoid volatility in the profit or loss in a period when the gains or losses on the hedged item are not recognised therein.
- 29 In order to match the gains and losses of the hedged item and the hedging instrument in the profit or loss, the changes in fair value of the hedging instrument recognised in other comprehensive income must be reclassified from other comprehensive income and recognised in the profit or loss at the same time that the impact from the hedged item is recognised (reclassified) in the profit or loss. The manner in which this is done depends on the nature of the hedged item:

- (a) if the hedged forecast transaction results in a financial asset or a financial liability being recognised, the gains or losses are reclassified from other comprehensive income as and when the asset acquired or liability incurred affects the profit or loss, e.g., when interest income or expense is recognised.
- (b) if the hedged forecast transaction results in a non-financial asset or non-financial liability being recognised, the gains or losses are reclassified from other comprehensive income and included as a separate adjustment that is clubbed for financial statement presentation purposes with carrying amount of the asset acquired or liability incurred (referred to as the “basis adjustment”).

Note that in Paragraph 30(a) and (b) above, any gain or loss (or portions thereof) that is not expected to be recovered in future periods are reclassified from other comprehensive income as soon as an entity becomes aware of the fact that those amounts are not expected to be recovered.

- 30 An example of a forecast transaction that results in the recognition of a financial liability is a forecast issuance of a bond, which is hedged for interest rate risk using a forward-starting interest rate swap. The fair value gains or losses on the swap would be deferred in equity until the bond is issued and the swap starts, after which date they would remain in equity until amortised into the profit or loss over the life of the bond.
- 31 The basis adjustment is relevant for hedges of forecast purchases of non-financial assets such as inventory or property, plant and equipment. Any basis adjustment or accumulated balance in the hedging reserve (referred as cash flow hedge reserve) will require to be tested at least at every reporting date for impairment. For the purposes of this impairment assessment, the basis adjustment / relevant portion of the hedging reserve may be combined with the carrying amount of the hedged item and compared to its current realisable value.

Net investment hedging

- 32 An investor in a non-integral operation is exposed to changes in the carrying amount of the net assets of the foreign operation (the net investment) arising from the translation of those assets into the reporting currency of the investor.
- 33 Principles relating to the hedge of a net investment in a foreign operation are:
- (a) foreign exchange gains or losses on a net investment in a non-integral foreign operation are recognised in other comprehensive income. This occurs through the translation of the non-integral foreign operation’s net assets for purposes of consolidation;
 - (b) gains or losses on foreign currency derivatives used as hedging instruments are recognised in other comprehensive income to the extent that the hedge is considered to be effective;
 - (c) the ineffective portion of the gains or losses on the hedging instruments (and any proportion not designated in the hedging relationship) is recognised in the profit or loss immediately;
 - (d) any net deferred foreign currency gains or losses, i.e., arising from both the net investment and the hedging instruments are recognised in the profit or loss at the time of disposal of the foreign operation.
- 34 When the net investment is disposed off, the cumulative amount in the foreign currency translation reserve in other comprehensive income is transferred to the profit or loss as reclassification adjustment. Therefore, it is necessary for an entity to keep track of the

amount recognised in other comprehensive income separately in respect of each foreign operation, in order to identify the amounts to be transferred to the profit or loss on disposal.

Formal documentation at inception

- 35 At inception of a hedge, formal documentation of the hedge relationship must be established. The hedge documentation prepared at inception of the hedge must include a description of the following:
- (i) the entity's risk management objective and strategy for undertaking the hedge;
 - (ii) the nature of the risk being hedged;
 - (iii) clear identification of the hedged item (asset, liability or cash flows) and the hedging instrument;
 - (iv) demonstrate how the derivative contract helps meet that risk management objective;
 - (v) indentify how it plans to measure the derivative if the derivative contract is effective in meeting its risk management objective;
 - (vi) demonstrate in cases of hedging a future cash flow that the cash flows are highly probable of occurring; and
 - (vii) conclude that the risk that is being hedged could impact the profit or loss.
- 36 A hedging relationship is effective if it meets all of the following requirements:
- (i) There is an economic relationship between the hedged item and the hedging instrument.
 - (ii) The effect of credit risk does not dominate the value changes that result from that economic relationship.
- 37 The hedging relationship is expected to be highly effective in achieving the stated risk management objective and the entity is in a position to reliably measure the achievement of this objective both at inception and on an ongoing basis during the tenure of the hedging relationship.

Hedge effectiveness testing and measurement of ineffectiveness

- 38 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.
- 39 An entity may consider the costs associated with a hedging instrument e.g. forward premium or time value of an option contract as a period cost (for example akin to interest costs when hedging an interest bearing asset or liability) or at a point in time (for example when hedging a forecasted sale or purchase) depending on the manner of designation and how the hedged item impacts the profit or loss.

- 40 This Section does not prescribe any specific method for how hedge effectiveness testing and ineffectiveness measurement should be conducted. The appropriate method for each entity will depend on the facts and circumstances relevant to each hedging programme and be driven by the risk management objective of the entity. Entities may apply commonly used measures such as critical terms match, dollar offset or regression methods as appropriate to assess hedge effectiveness.
- 41 Hedge effectiveness is the extent to which changes in the fair value or the cash flows of the hedging instrument offset changes in the fair value or the cash flows of the hedged item (for example, when the hedged item is a risk component, the relevant change in fair value or cash flows of an item is the one that is attributable to the hedged risk). Hedge ineffectiveness is the extent to which the changes in the fair value or the cash flows of the hedging instrument are greater or less than those on the hedged item. This Section does not prescribe bright line tests for effectiveness assessments but instead requires disclosure of the entity's risk management objectives and measures for assessing if these objectives are met.
- 42 When designating a hedging relationship, and on an ongoing basis, an entity will analyse the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term. This analysis will serve as the basis for the entity's assessment of meeting the hedge effectiveness requirements.
- 43 A hedging relationship will meet the hedge effectiveness requirements if:
- (i) there is an economic relationship between the hedged item and the hedging instrument.
 - (ii) the effect of credit risk does not dominate the value changes that result from the economic relationship.
 - (iii) the hedge ratio of the hedging relationship is the same as that resulting from the quantities of:
 - the hedged item that the entity actually hedges; and
 - the hedging instrument that the entity actually uses to hedge that quantity of hedged item; and

For example - if an entity hedges less than 100 per cent of the exposure on an item, such as 85 per cent, it shall designate the hedging relationship using a hedge ratio that is the same as that resulting from 85 per cent of the exposure and the quantity of the hedging instrument that the entity actually uses to hedge those 85 per cent. Similarly, if, for example, an entity hedges an exposure using a nominal amount of 40 units of a financial instrument, it shall designate the hedging relationship using a hedge ratio that is the same as that resulting from that quantity of 40 units (ie the entity must not use a hedge ratio based on a higher quantity of units that it might hold in total or a lower quantity of units) and the quantity of the hedged item that it actually hedges with those 40 units.
 - (iv) the hedged item and the hedging instrument are not intentionally weighted to create hedge ineffectiveness - whether or not it is recognised - to achieve an accounting outcome that would be inconsistent with the purpose of hedge accounting.
- 44 An entity will assess at the inception of the hedging relationship, and on an ongoing basis, whether a hedging relationship meets the hedge effectiveness requirements. At a

minimum, an entity should perform the ongoing assessment at each reporting date or upon a significant change in the circumstances affecting the hedge effectiveness requirements, whichever comes first. The assessment relates to expectations about hedge effectiveness and is therefore only forward-looking.

- 45 If the critical terms of the hedging instrument and the hedged item - e.g. the nominal amount, maturity and underlying - match or are closely aligned, then it may be possible to use a qualitative methodology to determine that an economic relationship exists between the hedged item and the hedging instrument.
- 46 If a hedging relationship ceases to meet the hedge effectiveness requirement relating to the hedge ratio but the risk management objective for that designated hedging relationship remains the same, an entity should adjust the hedge ratio of the hedging relationship so that it meets the qualifying criteria again.
- 47 This Section does not also prescribe a single method of how ineffectiveness measurement should be conducted other than to require an entity to consider how ineffectiveness could affect a hedging relationship and require immediate recognition of such ineffectiveness.
- 48 Hedge ineffectiveness is measured based on the actual performance of the hedging instrument and the hedged item, by comparing the changes in their values in currency unit amounts.
- 49 When measuring hedge ineffectiveness, an entity is required to consider the time value of money. Consequently, the entity determines the value of the hedged item on a present value basis and therefore the change in the value of the hedged item also includes the effect of the time value of money.
- 50 In certain situations, ineffectiveness is required to be recognised. These include
- (a) in a cash flow hedge, when the forecasted hedged transaction is no longer probable of occurring;
 - (b) in a fair value hedge, when the hedging instrument is no longer considered to be an effective hedge of the hedging instrument; and
 - (c) in any hedge relationship, if the risk management objective is changed or no longer expected to be met.

The recognition of ineffectiveness does not necessarily require hedge accounting to be discontinued if the risk management objective and criteria set out by the entity for the specific hedge relationship continues to be met.

Termination of hedge accounting / reclassification of hedge reserves

- 51 An entity is not permitted to stop applying hedge accounting voluntarily unless the risk management objective of the entity, as was originally defined by the entity when first applying hedge accounting, is no longer met.
- 52 If an entity terminates a hedging instrument prior to its maturity / contractual term, hedge accounting is discontinued prospectively. Any amount previously recognised in the hedge reserve (in the case of cash flow or net investment hedges) is reclassified into the profit or loss only in the period when the hedged item impacts earnings, e.g., when a forecasted purchase / sale actually impacts earnings or when a net investment is disposed off in the case of a net investment hedge.

- 53 In case of hedges of highly probable forecast transactions or commitments, if the forecasted transaction is no longer highly probable of occurring, (but still probable of occurring) then hedge accounting is discontinued prospectively but the amount recognised previously in the hedge reserve is reclassified into the profit or loss only in the period when the hedged item impacts earnings (as specified in paragraph 30). ‘Probable’ for the purpose of this assessment is based on whether the forecasted transaction is ‘more likely than not’ of occurring.
- 54 In case of hedges of forecast transactions, if the forecasted transaction is no longer probable of occurring, then hedge accounting is discontinued and all amounts recognised in the hedge reserve are recognised immediately in the profit or loss. ‘Probable’ for the purpose of this assessment is based on whether the forecasted transaction is ‘more likely than not’ of occurring. Judgment may need to be exercised in situations where a forecasted transaction is delayed to determine if the delayed transaction is the one that was subject to the original hedging designation or not. This Section does not provide a bright line test in this context but recognises that judgment is required and an entity should disclose the manner in which such determinations are made in its financial statements.

Disclosures

- 55 An entity applying this section shall make all of the disclosures required in Section A incorporating in those disclosures financial instruments that are within the scope of this section as well as those within the scope of Section A.
- 56 An entity should disclose the methodology used to arrive at the fair value of financial instruments measured at fair value in the profit or loss.

Hedge Accounting and Financial Risk Management

- 57 An entity should satisfy the broader disclosure requirements by describing its overall financial risk management objectives, including its approach towards managing financial risks. Disclosures should explain what the financial risks are, how the entity manages the risk and why the entity enters into various derivative contracts to hedge the risks.
- 58 The entity should disclose its risk management policies. This would include the hedging strategies used to mitigate financial risks. This may include a discussion of:
- (a) how specific financial risks are identified, monitored and measured;
 - (b) what specific types of hedging instruments are entered into and how these instruments modify or eliminate risk; and
 - (c) details of the extent of transactions that are hedged.
- 59 An entity is also required to make specific disclosures about its outstanding hedge accounting relationships. The following disclosures are made separately for fair value hedges, cash flow hedges and hedges of net investments in foreign operations:
- (a) a description of the hedge;
 - (b) a description of the financial instruments designated as hedging instruments for the hedge and their fair values at the balance sheet date;

- (c) the nature of the risks being hedged;
- (d) for hedges of forecast transactions, the periods in which the transactions are expected to occur, when they are expected to affect the profit or loss, and a description of any forecast transactions that were originally hedged but now are no longer expected to occur. This Section does not specify the future time bands for which the disclosures should be made. Entities should decide on appropriate groupings based on the characteristics of the forecast transactions;
- (e) if a gain or loss on derivative or non-derivative financial assets and liabilities designated as hedging instruments in cash flow hedges has been directly recognised in the hedge reserve: -
 - (i) the amount recognised in hedge reserve during the period.
 - (ii) the amount reclassified from the hedge reserve and reported in profit or loss.
 - (iii) the amount reclassified from hedge reserve and added to the initial measurement of the acquisition cost or other carrying amount of a non-financial asset or non-financial liability in a hedged forecast transaction.
- (f) a breakup of the balance in the hedge reserve between realised and unrealised components and a reconciliation of the opening balance to the closing balance for each reporting period.

- 60 Insofar as disclosure of derivatives designated for hedging foreign currency risks are concerned, the same should be disclosed in the Format attached as Appendix B to this standard, which also requires disclosure of all foreign exchange assets and liabilities including contingent liabilities, both hedged and unhedged.
- 61 The Appendix C to this Standard contains examples illustrating the principles contained in this Section.

Section C *Liabilities and Equity*

Scope of this section

- 1 This section establishes principles for classifying financial instruments as either liabilities or equity and addresses accounting for equity instruments issued to individuals or other parties acting in their capacity as investors in equity instruments (ie in their capacity as owners).

- 2 This section shall be applied when classifying all types of financial instruments except:
 - (a) those interests in subsidiaries, associates and joint ventures that are accounted for in accordance with AS 110, *Consolidated Financial Statements*, AS 28, *Investments in Associates and Joint Ventures* or AS 111, *Joint Arrangements*.
 - (b) employers' rights and obligations under employee benefit plans, to which AS 19, *Employee Benefits* applies.
 - (c) contracts for contingent consideration in a business combination (see AS 103, *Business Combinations*). This exemption applies only to the acquirer.
 - (d) financial instruments, contracts and obligations under share-based payment transactions to which AS 102 applies, except that paragraphs 6-9 of this section shall be applied to treasury shares purchased, sold, issued or cancelled in connection with employee share option plans, employee share purchase plans and all other share-based payment arrangements.

Classification of a financial instrument as liability or equity

- 3 Equity is the residual interest in the assets of an entity after deducting all its liabilities. A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Equity includes investments by the owners of the entity, plus additions to those investments earned through profitable operations and retained for use in the entity's operations, minus reductions to owners' investments as a result of unprofitable operations and distributions to owners.

- 4 An entity shall classify a financial instrument as a financial liability or as equity in accordance with the substance of the contractual arrangement, not merely its legal form, and in accordance with the definitions of a financial liability and an equity instrument. Unless an entity has 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, and is classified as such, except for those instruments classified as equity instruments in accordance with paragraph 5.

5 Some financial instruments that meet the definition of a liability are classified as equity because they represent the residual interest in the net assets of the entity:

- (a) a puttable instrument is a financial instrument that gives the holder the right to sell that instrument back to the issuer for cash or another financial asset or is automatically redeemed or repurchased by the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder. A puttable instrument that has all of the following features is classified as an equity instrument:
 - (i) it entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation. The entity's net assets are those assets that remain after deducting all other claims on its assets.
 - (ii) the instrument is in the class of instruments that is subordinate to all other classes of instruments.
 - (iii) all financial instruments in the class of instruments that is subordinate to all other classes of instruments have identical features.
 - (iv) apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, the instrument does not include any contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity, and it is not a contract that will or may be settled in the entity's own equity instruments.
 - (v) the total expected cash flows attributable to the instrument over the life of the instrument are based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity over the life of the instrument (excluding any effects of the instrument).
- (b) instruments, or components of instruments, that are subordinate to all other classes of instruments are classified as equity if they impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation.

6 The following are examples of instruments that are classified as liabilities instead of equity:

- (a) an instrument is classified as a liability if the distribution of net assets on liquidation is subject to a maximum amount (a ceiling). For example, if on liquidation the holders of the instrument receive a pro rata share of the net assets, but this amount is limited to a ceiling and the excess net assets are distributed to a charity organisation or the government, the instrument is not classified as equity.
- (b) a puttable instrument is classified as equity if, when the put option is exercised, the holder receives a pro rata share of the net assets of the entity measured in accordance with this Standard. However, if the holder is entitled to an amount measured on some other basis, the instrument is classified as a liability.

- (c) an instrument is classified as a liability if it obliges the entity to make payments to the holder before liquidation, such as a mandatory dividend.
- (d) a puttable instrument that is classified as equity in a subsidiary's financial statements is classified as a liability in its parent entity's consolidated financial statements.
- (e) 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.

7 Interest, dividends and other returns relating to financial instruments classified as financial liabilities are expenses. Distributions to holders of equity instruments are recognised directly in equity.

Members' shares in co-operative entities and similar instruments

- 8 Members' shares in co-operative entities and similar instruments are equity if:
- (a) the entity has an unconditional right to refuse redemption of the members' shares; or
 - (b) redemption is unconditionally prohibited by local law, regulation or the entity's governing charter. However, provisions in local law, regulation or the entity's governing charter that prohibit redemption only if conditions—such as liquidity constraints—are met (or are not met) do not result in members' shares being equity.
- 9 An unconditional prohibition may be partial if redemption would cause the number of members' shares or amount of paid-in 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. In some cases, the number of shares or the amount of paid-in 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.

Original issue of shares or other equity instruments

- 10 An entity shall recognise the issue of shares or other equity instruments as equity when it issues those instruments and another party is obliged to provide cash or other resources to the entity in exchange for the instruments:
- (a) if the equity instruments are issued before the entity receives the cash or other resources, the entity shall present the amount receivable as an offset to equity in its Balance Sheet, not as an asset. Eg, subscriber to Memorandum of Association (MoA);

- (b) if the entity receives the cash or other resources before the equity instruments are issued, and the entity cannot be required to repay the cash or other resources received, the entity shall recognise the corresponding increase in equity to the extent of consideration received; and
 - (c) to the extent that the equity instruments have been subscribed for but not issued, and the entity has not yet received the cash or other resources, the entity shall not recognise an increase in equity.
- 11 An entity shall measure equity instruments, other than those issued as part of a business combination or those accounted for in accordance with paragraphs 15-16 of this section, at the fair value of the cash or other resources received or receivable, net of transaction costs.
- 12 An entity shall account for the transaction costs of an equity transaction as a deduction from equity. Income tax relating to the transaction costs shall be accounted for in accordance with AS 12, *Income Taxes*.

Sale of options, rights and warrants

- 13 An entity shall apply the principles in paragraphs 10-12 of this section to equity issued by means of sales of options, rights, warrants and similar equity instruments.

Capitalisation or bonus issues of shares and share splits

- 14 A capitalisation or bonus issue (sometimes referred to as a stock dividend) is the issue of new shares to shareholders in proportion to their existing holdings. For example, an entity may give its shareholders one dividend or bonus share for every five shares held. A share split (sometimes referred to as a stock split) is the dividing of an entity's existing shares into multiple shares. For example, in a share split, each shareholder may receive one additional share for each share held. In some cases, the previously outstanding shares are consolidated or cancelled and replaced by new shares. Share consolidation is combining entity's multiple shares into fewer number of shares. Capitalisation and bonus issues and share splits do not change total equity. An entity shall reclassify amounts within equity as required by applicable laws.

Convertible debt or similar compound financial instruments

- 15 On issuing convertible debt or similar compound financial instruments that contain both a liability and an equity component, an entity shall allocate the proceeds between the liability component and the equity component. To make the allocation, the entity shall first determine the amount of the liability component as the fair value of a similar liability that does not have a conversion feature or similar associated equity component. The entity shall allocate the residual amount as the equity component. Transaction costs shall be allocated between the debt component and the equity component on the basis of their relative proceeds.

- 16 The entity shall not revise the allocation in a subsequent period.
- 17 In periods after the instruments were issued, the entity shall account for the liability component:
- (a) in accordance with Section A *Basic Financial Instrument* if the liability component meets the conditions in paragraph 8 of section A, the entity shall systematically recognise any difference between the liability component and the principal amount payable at maturity as additional interest expense using the effective interest method (see paragraphs 16-21 of section A).
 - (b) in accordance with Section B *Other Financial Instruments* if the liability component does not meet the conditions in paragraph 8 of section A.

Extinguishing financial liabilities with equity instruments

- 18 An entity may renegotiate the terms of a financial liability with a creditor of the entity with the result that the entity extinguishes the liability fully or partially by issuing equity instruments to the creditor. Issuing equity instruments constitutes consideration paid in accordance with paragraph 45 of section A. An entity shall measure the equity instruments issued at their fair value. However, if the fair value of the equity instruments issued cannot be measured reliably without undue cost or effort, the equity instruments shall be measured at the fair value of the financial liability extinguished. An entity shall derecognise the financial liability, or part of the financial liability, in accordance with paragraphs 43-45 of section A.
- 19 If part of the consideration paid relates to a modification of the terms of the remaining part of the liability, the entity shall allocate the consideration paid between the part of the liability extinguished and the part that remains outstanding. This allocation should be made on a reasonable basis. If the remaining liability has been substantially modified, the entity shall account for the modification as the extinguishment of the original liability and the recognition of a new liability as required by paragraph 44 of section A.
- 20 An entity shall not apply paragraphs 18-19 of this section to transactions in situations in which:
- (a) the creditor is also a direct or indirect shareholder and is acting in its capacity as a direct or indirect existing shareholder;
 - (b) the creditor and the entity are controlled by the same party or parties before and after the transaction and the substance of the transaction includes an equity distribution by, or contribution to, the entity; or
 - (c) extinguishing the financial liability by issuing equity instruments is in accordance with the original terms of the financial liability (see paragraphs 15-17 of this section).

Treasury shares

- 21 Treasury shares are the equity instruments of an entity that have been issued and subsequently reacquired by the entity. An entity shall deduct from equity the fair value of the consideration given for the treasury shares. The entity shall not recognise a gain or loss in profit or loss on the purchase, sale, issue or cancellation of treasury shares.

Distributions to owners

- 22 An entity shall reduce equity for the amount of distributions to its owners (holders of its equity instruments). Income tax relating to distributions to owners shall be accounted for in accordance with AS 12.
- 23 Sometimes an entity distributes assets other than cash to its owners ('non-cash distributions'). When an entity declares such a distribution and has an obligation to distribute non-cash assets to its owners, it shall recognise a liability. It shall measure the liability at the fair value of the assets to be distributed unless it meets the conditions in paragraph 24 of this section. At the end of each reporting period and at the date of settlement, the entity shall review and adjust the carrying amount of the dividend payable to reflect changes in the fair value of the assets to be distributed, with any changes recognised in equity as adjustments to the amount of the distribution. When an entity settles the dividend payable, it shall recognise in profit or loss any difference between the carrying amount of the assets distributed and the carrying amount of the dividend payable.
- 24 If the fair value of the assets to be distributed cannot be measured reliably without undue cost or effort, the liability shall be measured at the carrying amount of the assets to be distributed. If prior to settlement the fair value of the assets to be distributed can be measured reliably without undue cost or effort, the liability is remeasured at fair value with a corresponding adjustment made to the amount of the distribution and accounted for in accordance with paragraph 23 of this section.
- 25 Paragraphs 23-24 of this section do not apply to the distribution of a non-cash asset that is ultimately controlled by the same party or parties before and after the distribution. This exclusion applies to the separate, individual and consolidated financial statements of an entity that makes the distribution.

Non-controlling interest and transactions in shares of a consolidated subsidiary

- 26 In consolidated financial statements, a non-controlling interest in the net assets of a subsidiary is included in equity. An entity shall treat changes in a parent's controlling interest in a subsidiary that do not result in a loss of control as transactions with owners in their capacity as owners. Accordingly, the carrying amount of the non-controlling interest shall be adjusted to reflect the change in the parent's interest in the subsidiary's net assets. Any difference between the amount by which the non-controlling interest is so adjusted and the fair value of

the consideration paid or received, if any, shall be recognised directly in equity and attributed to owners of the parent. An entity shall not recognise gain or loss on these changes. Also, an entity shall not recognise any change in the carrying amounts of assets (including goodwill) or liabilities as a result of such transactions.

Disclosures

- 27 If the fair value of the assets to be distributed as described in paragraphs 23-24 of this section cannot be measured reliably without undue cost or effort, the entity shall disclose that fact and the reasons why a reliable fair value measurement would involve undue cost or effort.
- 28 In case of Members' Shares in Co-operative Entities and Similar Instruments, when a change in the redemption prohibition leads to a transfer between financial liabilities and equity, the entity shall disclose separately the amount, timing and reason for the transfer.

Appendix to Section C

Example of the issuer's accounting for convertible debt

The Appendix accompanies, but is not part of, Section C. It provides guidance for applying the requirements of paragraphs 15-17 of section C.

On 1 April 20X5 an entity issues 500 convertible bonds. The bonds are issued at par with a face value of ₹100 per bond and are for a five-year term, with no transaction costs. The total proceeds from the issue are ₹50,000. Interest is payable annually in arrears at an annual interest rate of 4 per cent. Each bond is convertible, at the holder's discretion, into 25 ordinary shares at any time up to maturity. At the time the bonds are issued, the market interest rate for similar debt that does not have the conversion option is 6 per cent.

When the instrument is issued, the liability component must be valued first, and the difference between the total proceeds on issue (which is the fair value of the instrument in its entirety) and the fair value of the liability component is assigned to the equity component. The fair value of the liability component is calculated by determining its present value using the discount rate of 6 per cent. These calculations and journal entries are illustrated:

	₹
Proceeds from the bond issue (A)	50,000
Present value of principal at the end of five years (see calculations)	37,363
Present value of interest payable annually in arrears for five years	8,425
Present value of liability, which is the fair value of liability component (B)	45,788
Residual, which is the fair value of the equity component (A) – (B)	4,212

The issuer of the bonds makes the following journal entry at issue on 1 April 20X5:

Dr Cash	₹50,000	
Cr Financial Liability – Convertible bond		₹45,788
Cr Equity		₹4,212

The ₹4,212 represents a discount on issue of the bonds, so the entry could also be shown 'gross':

Dr Cash	₹50,000	
Dr Bond discount	₹4,212	
Cr Financial Liability – Convertible bond		₹ 50,000
Cr Equity		₹ 4,212

After issue, the issuer will amortise the bond discount according to the following table:

	(a) Interest payment (₹)	(b) Total interest expense (₹) = 6% ×	(c) Amortisation of bond discount (₹) = (b) – (a)	(d) Bond discount (₹) = (d) – (c)	(e) Net liability (₹) = 50,000 – (d)
1/1/20X5				4,212	45,788
31/12/20X5	2,000	2,747	747	3,465	46,535
31/12/20X6	2,000	2,792	792	2,673	47,327
31/12/20X7	2,000	2,840	840	1,833	48,167
31/12/20X8	2,000	2,890	890	943	49,057
31/12/20X9	2,000	2,943	943	0	50,000
Totals	10,000	14,212	4,212		

At the end of 20X5, the issuer would make the following journal entry:

Dr Interest expense	₹ 2,747
Cr Bond discount	₹ 747
Cr Cash	₹ 2,000

Calculations

Present value of principal of ₹ 50,000 at 6 per cent

$$₹ 50,000 / (1.06)^5 = ₹ 37,363$$

Present value of the interest annuity of ₹ 2,000 (= ₹ 50,000 × 4 per cent) payable at the end of each of five years

The ₹ 2,000 annual interest payments are an annuity—a cash flow stream with a limited number (n) of periodic payments (C), receivable at dates 1 to n. To calculate the present value of this annuity, future payments are discounted by the periodic rate of interest (i) using the following formula:

$$PV = \frac{C}{i} \times \left[1 - \frac{1}{(1+i)^n} \right]$$

Therefore, the present value of the ₹ 2,000 interest payments is

$$(2,000 / .06) \times [1 - (1 / 1.06)^5] = ₹ 8,425$$

This is equivalent to the sum of the present values of the five individual ₹ 2,000 payments, as follows:

	₹
Present value of interest payment at 31 March 20X5 = 2,000/1.06	1,887
Present value of interest payment at 31 March 20X6 = 2,000/1.06 ²	1,780
Present value of interest payment at 31 March 20X7 = 2,000/1.06 ³	1,679
Present value of interest payment at 31 March 20X8 = 2,000/1.06 ⁴	1,584
Present value of interest payment at 31 March 20X9 = 2,000/1.06 ⁵	1,495
Total	8,425

Yet another way to calculate this is to use a table of present value of an ordinary annuity in arrears, five periods, interest rate of 6 per cent per period. (Such tables are easily found on the Internet.) The present value factor is 4.2124. Multiplying this by the annuity payment of ₹ 2,000 determines the present value of ₹ 8,425.

Appendix A

Defined terms

This appendix is an integral part of the Standard.

Amortised cost of a financial asset or financial liability	The amortised cost of a financial asset or financial liability is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment.
Compound financial instrument	A financial instrument that, from the issuer's perspective, contains both a liability and an equity element.
Derivative	<p>A derivative is a financial instrument or other contract with all three of the following characteristics:</p> <ul style="list-style-type: none"> • 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”); • it requires no initial net investment or an initial 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.
Effective interest method	A method of calculating the amortised cost of a financial asset or a financial liability (or a group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.
Effective interest rate	The rate that 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.
Equity instrument	An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.
Fair Value	The amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction.
Financial Asset	<p>A financial asset is any asset that is:</p> <ul style="list-style-type: none"> (a) cash; (b) an equity instrument of another entity; (c) a contractual right: <ul style="list-style-type: none"> (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 puttable financial instruments classified as equity instruments in accordance with paragraphs 5-6 of section C, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 5-6 of section C, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

Financial Instrument

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.

Financial Liability

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, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Apart from the aforesaid, the equity conversion option embedded in a convertible bond denominated in foreign currency to acquire a fixed number of the entity's own equity instruments is an equity instrument if the exercise price is fixed in any currency. Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 5-6 of section C, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 5-6 of section C, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 5-6 of section C.

Firm Commitment	A firm commitment is a binding agreement for the exchange of a specified quantity of resources at a specified future date or dates.
Forecast transaction	A forecast transaction is an uncommitted but anticipated future transaction.
Hedge Effectiveness	Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.
Hedging Instrument	A hedging instrument is a designated derivative whose fair value or cash flows are expected to offset changes in the fair value or cash flows, of a designated hedged item. For the purposes of applying hedging in consolidated financial statements, the counterparty of a derivative instrument needs to be outside the consolidated group.
Hedged Item	A hedged item is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged. A hedged item could also be a portfolio or group of identified assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations.
Hedge Ratio	The ratio between the hedging instrument(s) and the hedged item(s) that is maintained during the course of a hedging relationship.
Held for trading	a financial asset or financial liability that: <ul style="list-style-type: none"> (a) is acquired or incurred principally for the purpose of selling or repurchasing it in the near term; (b) on initial recognition 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; or (c) is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).
Puttable instrument	A puttable instrument is a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.

Appendix B

Format for Disclosure of Foreign Currency Exposures

Exposures in Foreign Currency:

I. Assets	Foreign Currency	Current Year			Previous Year		
		Exchange Rate	Amount in Foreign currency	Amount in `	Exchange Rate	Amount in Foreign currency	Amount in `
Receivables (trade & other)							
Other Monetary assets (e.g. ICDs/Loans given in FC)							
Total Receivables (A)							
Hedges by derivative contracts (B)							
Unhedged receivables (C=A-B)							
II. Liabilities	Foreign Currency	Current Year			Previous Year		
		Exchange Rate	Amount in Foreign currency	Amount in `	Exchange Rate	Amount in Foreign currency	Amount in `
Payables (trade & other)							
Borrowings (ECB and Others)							
Total Payables (D)							
Hedges by derivative contracts (E)							
Unhedged Payables (F=D-E)							

III. Contingent Liabilities and Commitments	Foreign Currency	Current Year			Previous Year		
		Exchange Rate	Amount in Foreign currency	Amount in `	Exchange Rate	Amount in Foreign currency	Amount in `
Contingent Liabilities							
Commitments							
Total (G)							
Hedges by derivative contracts (H)							
Unhedged Payables (I=G-H)							
Total unhedged FC Exposures (J=C+F+I)							

Explanatory notes:

Note 1: Exposures in Assets and Liabilities to be presented currency wise.

Note 2: Exposure in any foreign currency(s) which are not material may be aggregated. However, any currency in which exposure is more than 10% of the total exposure should be reported separately; at least 75% of total exposure should be reported currency wise.

Note 3: Additional disclosures of any foreign currency exposure in an asset not hedged by an entity on the ground that the same is covered by a corresponding foreign currency exposure in a liability and vice versa, to the extent having same maturity date and the amount (known as ‘natural hedge’) may be made in the notes.

Appendix C

Illustrative examples of application of AS 109

1. Application of cash flow hedge

ABC Ltd. is an exporter of goods. In the month of July 2013, it receives the order for supply of goods to US customers in the month of January 2014 and as per the payment cycle with the customers, it expects to realise USD 100,000 in April 2014.

ABC Ltd has decided to fully hedge the sales from foreign currency risk. Immediately after getting the order, to hedge the firm commitment in foreign currency it enters into a derivative transaction with XYZ Bank, for future sale of USD 100,000 in the month of April 2014 @ ₹ 65 per USD (Spot Rate was ₹ 64.50 per USD).

For this purpose, it is assumed that the company has entered into a cash flow hedge, which is generally the case for hedging foreign currency risk.

Further, it is assumed that:

- At the time of booking of sale in January 2014, the USD rate was ₹ 61, and forward rate for delivery on April 30, 2014 was ₹ 61.20.
- On the reporting date on March 31, 2014, the USD rate was ₹ 60.50, and forward rate for delivery on April 30, 2014 was ₹ 60.60.
- At the time of realisation USD rate was ₹ 60 on April 30, 2014.

The above transaction should be accounted in the following manner (impact of discounting of MTM of the hedging instrument has been ignored in this simplified illustration).

	ABC Limited entered to sell a forward exchange contract for USD 100,000 having ten months maturity on April 30, 2014		
	Forward Exchange Rate	65.00	
	Spot Rate as at July 01, 2013	64.50	
	No entry in the books		
Upto January 31, 2014	ABC Limited accounts the MTM effect in the books		
	Forward Contract Rate Entered	65.00	
	Forward Contract Available in the market with similar maturity	61.20	
	Forward Contract Receivable	3,80,000	
	To Cash Flow Hedge Reserve- OCI		3,80,000

January 31, 2014	ABC Limited recognises the revenue by booking an invoice for USD 100,000, having credited period of 90 days (i.e. due date – April 30, 2014) Spot rate as at January 31, 2014 Forward Contract Available in the Market with similar maturity	61.00 61.20	
	Recognition of Revenue Accounts Receivable To Revenue	61,00,000	61,00,000
	Recognition of Hedge gain Cash Flow hedge reserve-OCI To Profit or Loss	3,80,000	3,80,000
March 31, 2014	Spot Rate Forward Contract Available in the Market with similar maturity	60.50 60.60	
	Restatement of Accounts Receivable Forex Gain/Loss (P&L) To Accounts Receivable	50,000	50,000
	MTM Effect of Forward Cover Forward Contract Receivable To Forex Gain/Loss (P&L)	60,000	60,000
April 30, 2014	Spot rate Realisation of Accounts Receivable Bank Forex Gain/Loss (P&L) To Accounts Receivable	60.00 60,00,000 50,000	60,50,000
	Maturity of Forward Contract Bank To Forward Contract Receivable To Forex Gain/Loss (P&L)	5,00,000	4,40,000 60,000

2. Cash flow hedge of the repayment of a loan

Company X is an Indian company with annual reporting period ending on March 31 each year. On January 1, 2014, Company X borrows from a bank USD 1 million six month debt carrying a floating interest rate of three month LIBOR plus 50 basis points. As per the Company's risk management policies, it enters into a Cross Currency Interest Rate Swap (CCIRS) with a bank to swap the above floating interest bearing USD debt into a fixed interest bearing INR debt.

According to AS 109, Company X will record the following on March 31, 2014:

- (i) Translate the USD loan at closing rate and record the foreign exchange gain/ loss in the profit or loss.
- (ii) Record a derivative asset/ liability based on the fair value (Mark To Market 'MTM' value) of the CCIRS with a corresponding credit/debit in Cash Flow Hedge Reserve.
- (iii) Record the net interest expense in profit or loss, i.e., the USD floating interest expense adjusted for the settlement of the interest rate swap for the period.
- (iv) Reclassify from the Cash Flow Hedeg Reserve to profit or loss the amount by which the hedged item, i.e., the debt has impacted the profit or loss. (In this case, the amount of translation foreign exchange gain/ loss that has been recorded for the loan).

As at March 31, 2014, the Balance Sheet of Company X will carry the following items:

- Loan – Translated at the closing USD – INR conversion rate.
- Derivative asset/ liability – MTM of the CCIRS.
- Cash Flow Hedge Reserve - MTM of the CCIRS less amount reclassified to the profit or loss.

3a. Commodity contract – cash flow hedge of a forecasted sale with an exchange traded future

Company Z is a producer and wholesaler of copper with annual reporting period ending on March 31 each year. On January 1, 2014, Company Z forecasts sales of 100 tonnes of copper expected to occur in September 2014. It is highly probable that the sales will occur based on historical and expected sales. In order to hedge its exposure on the variability of copper prices, Company Z enters into a 'sell' futures contract on the Commodity Exchange to sell 100 tonnes of copper (same grade) with maturity of September 30, 2014. As per its risk management policies, Company Z designates this futures contract as a cash flow hedge of highly probable forecasted sales of 100 tonnes of copper inventory in September 2014.

According to AS 109, Company Z will record the following on March 31, 2014

Record a derivative asset/ liability based on the fair value (MTM) of the commodity future contract with a corresponding credit/ debit to Cash Flow Hedge Reserve.

As at March 31, 2014, the Balance Sheet of Company Z will carry the following items:

- Derivative asset/ liability – MTM of the commodity future contract.
- Cash Flow Hedge Reserve - MTM of the commodity future contract.

Assuming that the sales in future occur as expected, the MTM carried in the Cash Flow Hedge Reserve will be reclassified to the profit or loss when the sales are booked in the profit or loss. In this case, this will happen in September 2014, along with the maturity of the commodity futures contract. Such reclassification can be made in the sales line item in the statement of profit and loss, which potentially records the sales at the hedged price.

3b. Commodity contract – fair value hedge of forecasted sales with an exchange traded future

Continuing the above example, consider that Company Z designates the commodity futures contract as a fair value hedge of a portion of its inventory, i.e., 100 tonnes of copper. The Company documents it as a hedge of the exposure to changes in fair value of the inventory due to commodity price risk. As at March 31, 2014, the price of copper increases thereby resulting in an increase in the fair value of inventory and MTM loss on the derivative.

According to AS 109, Company Z will record the following on March 31, 2014:

- (i) Record a derivative liability based on the fair value (MTM) of the commodity future contract with a corresponding debit to the profit or loss.
- (ii) Record an increase in inventories for the change in fair value as a hedge accounting adjustment through profit or loss. Accounting Standard (AS) 2, *Inventories*, requires inventories to be carried at the lower of cost and net realisable value. Hence, this will be recorded as a separate hedge accounting adjustment distinguished from the valuation of inventories under AS 2.

As at March 31, 2014, the Balance Sheet of Company Z will carry the following items:

- Derivative asset/liability – MTM of the commodity future contract.
- Inventory – valued as per AS 2 at cost.
- Inventory hedge accounting adjustment – basis adjustment to record change in fair value.

When sales of the hedged inventory occur in the future, the hedging related fair value adjustment to inventory will be released to the profit or loss and can be classified as part of 'cost of goods sold'.

4. Hedging a portion of a non-financial item – Commodity future

Company X is a producer and wholesaler of steel with annual reporting period ending on March 31 each year. On January 1, 2014, Company X forecasts sales of 200 tonnes of

steel expected to occur in September 2014. It is highly probable that the sales will occur based on historical and expected sales. In order to hedge its exposure on the variability of expected cash flows from forecasted sales of steel, as per its risk management policies, Company X enters into a 'sell' futures contract on the commodity exchange for 200 tonnes of iron ore which is one of the significant components of the steel making process and significantly impacts the price of steel.

This will not result into a perfect hedge since the hedged commodity, i.e., steel and the hedging instrument used, i.e., iron ore futures, are not perfectly correlated. The AS permits such designation if it is as per the company's risk management policies and strategy.

According to AS 109, Company X will record the following on March 31, 2014:

Record a derivative asset/ liability based on the fair value (MTM) of the iron ore future contract with a corresponding credit/ debit to Cash Flow Hedge Reserve.

As at March 31, 2014, the Balance Sheet of Company X will carry the following items:

- Derivative asset/liability – MTM of the iron ore future contract.
- Cash Flow Hedge Reserve - MTM of the iron ore future contract.

Assuming that the sales in future occur as expected, the MTM carried in the Cash Flow Hedge Reserve will be reclassified to the profit or loss when the sales are booked in the profit or loss. In this case, this will happen in September 2014 along with the maturity of the commodity futures contract. Such reclassification can be made in the sales line item in the statement of profit and loss .

5. Exchange traded contract – Fair value hedge of investment portfolio

Company Z holds a closed portfolio of equity shares classified as long term investments. As per its risk management policies, Company Z hedges its exposure to variability of expected fair value of the investments by entering into equity futures contract on a recognised stock exchange.

Under AS 109, Company Z will record the following on March 31, 2014:

- (i) Record a derivative liability/derivative asset based on the fair value (MTM) of the equity futures contract with a corresponding debit to the profit or loss.
- (ii) Record an increase/decrease in long term investments for the change in fair value as a hedge accounting adjustment through profit or loss.

As at March 31, 2014, the Balance Sheet of Company Z will carry the following items:

- Derivative asset/ liability – MTM of the equity futures contract.
- Long term investments – valued as per AS 109.

- Investment hedge accounting adjustment – adjustment to record change in fair value.

6. Cash flow hedge accounting – forecasted sale with a forward contract

Company X is an Indian Company with annual reporting period ending on March 31 each year. On January 1, 2014, Company X forecasts sales of USD 1 million on September 30, 2014. It is highly probable that the sales will occur based on historical and expected sales. As per its risk management policies, in order to hedge the variability in cash flows arising from future sales in foreign currency, on January 1, 2014, Company X enters into a sell USD – buy INR forward contract which matures on September 30, 2014.

According to AS 109, Company X will record the following on March 31, 2014:

Record a derivative asset/liability based on the fair value (MTM) of the foreign currency forward contract with a corresponding credit/debit to Cash Flow Hedge Reserve.

As at March 31, 2014, the Balance Sheet of Company X will carry the following items:

- Derivative asset/liability – MTM of the foreign currency forward contract.
- Cash Flow Hedge Reserve – MTM of the foreign currency forward contract.

Assuming that the sales in future occur as expected, the MTM carried in the Cash Flow Hedge Reserve will be reclassified to the profit or loss when the sales are booked in the profit or loss. In this case, this will happen in September 30, 2014 along with the maturity of the foreign currency forward contract. Such reclassification can be made in the sales line item in the statement of profit and loss, which records the sales at the hedged rate.

7. Cash flow hedge accounting - forecasted sale with an option contract

Company X is an Indian Company with annual reporting period ending on March 31 each year. On January 1, 2014, Company X forecasts sales of USD 1 million on September 30, 2014. It is highly probable that the sales will occur based on historical and expected sales. As per its risk management policies, in order to hedge the variability in cash flows arising from future sales in foreign currency, on January 1, 2014 Company X enters into a sell USD – buy INR option contract which matures on September 30, 2014. The Company pays a premium to purchase this option which has a strike rate equal the then available forward exchange rate at the date when the option was purchased (often referred to as an ‘At the Money’ strike price option). As a result, the entire amount of the premium paid for the option is attributable to time value of the option. The Company assesses the time value of the option to be the ‘cost of hedging’.

According to AS 109, Company X will record the following:

On January 1, 2014 - Record an option asset on payment of option premium.

On March 31, 2014 - Record changes in fair value of the option asset based on the MTM of the foreign currency option contract with a corresponding credit/ debit to Cash Flow Hedge Reserve. This amount includes both the time value and the intrinsic value, if any, of the option contract on that date.

As at March 31, 2014, the Balance Sheet of Company X will carry the following items:

- Derivative asset/liability – MTM of the foreign currency option contract.
- Cash Flow Hedge Reserve - MTM of the foreign currency option contract.

Assuming that the sales in future occur as expected, the MTM carried in the Cash Flow Hedge Reserve will be reclassified to the profit or loss when the sales are booked in the profit or loss. In this case, this will happen on September 30, 2014, along with the maturity of the foreign currency option contract. Such reclassification can be made in the sales line item in the statement of profit and loss, which records the sales at the hedged rate.

8. Cash flow hedge accounting – hedging the repayment of foreign currency debt with an option contract

Company X is an Indian Company with annual reporting period ending on March 31 each year. On January 1, 2014, Company X has USD 1 million of foreign currency debt that it needs to repay on September 30, 2014. As per its risk management policies, in order to hedge the variability in cash flows arising from the repayment of this debt in foreign currency, on January 1, 2014 Company X enters into a buy USD – sell INR option contract which matures on September 30, 2014. The Company pays a premium to purchase this option which has a strike rate equal the then available forward exchange rate at the date when the option was purchased (often referred to as an ‘At the Money’ strike price option). As a result the entire amount of the premium paid for the option is attributable to time value of the option. The Company assesses the time value of the option to be the ‘cost of hedging’.

According to AS 109, Company X will record the following:

On January 1, 2014 - Record an option asset on payment of option premium.

On March 31, 2014 - Record changes in fair value of the option asset based on the MTM of the foreign currency option contract with a corresponding credit/debit to Cash Flow Hedge Reserve. This amount includes both the time value and the intrinsic value, if any, of the option contract on that date. In addition,

- Company X will also reclassify from the Cash Flow Hedge Reserve, a proportionate amount of the option premium paid as a ‘cost of hedging’ type adjustment into the profit or loss; and
- To the extent that there is intrinsic value in the option contract that offsets the translation gain/loss on the foreign currency debt, Company will additionally reclassify such amounts to the profit or loss.

As at March 31, 2014, the Balance Sheet of Company X will carry the following items:

- Derivative asset/ liability – MTM of the foreign currency option contract.
- Cash Flow Hedge Reserve - MTM of the foreign currency option contract adjusted for the ‘cost of hedging’ reclassification and the intrinsic value reclassification, if any.

On September 30, 2014, in addition to the above treatment, the debt will be repaid at the spot rate, the option settled or expires worthless (as the case may be) and any balance in the cash flow hedge reserve will be reclassified to the profit or loss for the period ended on that date.

Appendix 1

Note: This Appendix is not a part of the Accounting Standard. The purpose of this Appendix is only to bring out the major differences, if any, between relevant provisions of existing accounting requirements i.e. Accounting Standard (AS) 11, *The Effects of Changes in Foreign Exchange Rates*, Accounting Standard (AS) 13, *Accounting for Investments*, and Guidance Note on Accounting for Derivative Contracts with upgraded Accounting Standard (AS) 109, *Financial Instruments*

Comparison with AS 11, *The Effects of Changes in Foreign Exchange Rates*, AS 13, *Accounting for Investments*, and Guidance Note on Accounting for Derivative Contracts

1. There is no comprehensive Accounting Standard that provides guidance on Financial Instruments. AS 30, 31 and 32, based on prevailing IFRS Standards, which were earlier issued by the ICAI on recommendatory basis, were withdrawn in November, 2016 pursuant to commencement of Ind AS implementation. Presently, accounting requirements in respect of certain financial instruments are covered by the following:
 - a) AS 11, *The Effects of Changes in Foreign Exchange Rates*
 - b) AS 13, *Accounting for Investments*
 - c) Guidance Note on Accounting for Derivative Contracts

As part of the Upgraded ASs for entities that are not covered by Ind AS implementation, a new comprehensive standard viz. AS 109 prescribes accounting of all financial instruments and it is divided into following 3 sections:

- a) Section A, *Basic Financial Instruments*
- b) Section B, *Other Financial Instrument* (includes provisions of Guidance Note on Accounting for Derivative Contracts)
- c) Section C, *Liabilities and Equity*

AS 109 is a comprehensive robust standard that addresses accounting and disclosures aspects of all types of financial instruments, with limited exceptions, over the entire life cycle of a financial instrument. The standards prescriptions are broadly categorised into main areas i.e. Scope, Definitions, Recognition, Classification, Initial and Subsequent Measurement (i.e. Fair Value, Amortised Cost, Cost, Impairment etc), Hedge Accounting, Derecognition and Disclosures.

2. Scope: Compared to AS 109, the scope of existing ASs is very limited i.e. it deals only with limited specific type of financial instruments e.g. AS 13 primarily deals with typical financial investments such as Shares and Debentures, AS 11 deals with certain foreign currency transactions in the nature of forward exchange contracts and Guidance Note on Accounting for Derivative Contracts deals with accounting aspects of derivatives and hedge accounting.
3. Classification: Under existing AS, investment are classified into two categories viz. current and long term investments, based on the entity's intention to hold such investments for more than a year or less and the investment's ready realisability. However, under AS 109, financial instruments are divided into :
 - a) Basic Financial Instruments - commonly used instruments such as cash, loans receivable/payable, equity instruments, fixed return bonds etc.

- b) Other Financial Instruments - instruments complex in nature such as convertible debt, financial instruments with embedded derivatives, stand-alone derivative instruments.

4. Measurement:

4.1 Initial Measurement: In AS 109 All financial instruments are initially, at the time of recognition, are measured at fair value. Under AS 13, investments are initially measured at cost with a few exceptions.

4.2 Subsequent Measurement: In AS 109, subsequent measurement of Basic Financial Instruments, except equity instruments etc, depends upon the nature of return (cash flow features) on the financial instruments i.e. if the return is fixed in terms of amount or rate of return, then such instruments are measured at Amortised Cost using the Effective Interest Method. Equity instruments etc. held for trading are measured at Fair Value through Profit or Loss with both gains and losses recognised in profit or loss and those not held for trading are measured at cost less impairment.

5. Complex financial instruments are measured at Fair Value through Profit or Loss except derivative instruments that are designated as part of effective hedging relationship which are accounted as per separate and specific hedge accounting model. There are no differences between hedge accounting model as per existing Guidance Note on Derivative Contracts except introduction of 'Other Comprehensive Income (OCI)' in AS 109. As per Guidance Note on Accounting for Derivative Contracts, gain or loss on effective cash flow hedge is recognized directly in equity. Under AS 109, it is included other comprehensive income concept, therefore such gains or losses are recognized in other comprehensive income. Also, under hedge accounting model of AS 109, option to release gains/losses held in cash flow hedge reserve to profit or loss in the same period in which the hedged non-financial asset or liability affects profit or loss has been eliminated for simplicity.

In contrast, as per AS 13, current investments are carried at lower of cost and fair value.

6. Impairment: Financial assets subsequently measured at Amortised Cost are subject to impairment (commonly referred as provision for bad and doubtful debts or non-performing assets in the existing framework) at each reporting date. Impairment loss recognition is based on 'Incurred Loss Approach' i.e. it is recognised when there is objective evidence of impairment of financial asset and the loss measurement takes into account time value of money where required. AS 13 prescribed impairment loss recognition in re case of long term investment when there is decline, other than temporary' in the value of a long term investment.
7. Derecognition: AS 109 prescribes specific clearly articulated principles for derecognition of financial assets and financial liabilities and also for recognition and measurement of gain/loss on derecognition.

8. Disclosures: AS 109 has more and relevant disclosures regarding various key transactions/events and the determination of fair value and carrying values of different classification/category of financial instruments.

Appendix 2

Note: This Appendix is not a part of the Accounting Standard (AS) 109. The purpose of this Appendix is only to bring out the major differences, if any, between Ind AS 32, *Financial Instruments: Presentation* Ind AS 107, *Financial Instruments: Disclosures* and Ind AS 109, *Financial Instruments* and draft of upgraded AS 109.

Comparison with Ind AS 32, *Financial Instruments: Presentation* Ind AS 107, *Financial Instruments: Disclosures* and Ind AS 109, *Financial Instruments*

1. Under Ind AS, 3 different standards are prescribed for accounting of financial instruments. AS 109 comprehensively deals with all the aspects relating to recognition, presentation, derecognition, measurement and disclosure of financial instruments in a single standard. AS 109 is primarily structured and modelled on the basis of IFRS for SMEs which though based on Full IFRS Standards, is formulated keeping in view the type/nature of transactions undertaken by SMEs and in the style and language familiar to such entities.
2. Scope: Financial Guarantee Contracts are excluded from AS 109 (hence, covered by AS 37, *Provisions, Contingent Liabilities and Contingent Assets*) whereas Ind AS 109 provides an option to account for such contracts under AS 109 or as Insurance Contract.
3. Recognition: Ind AS 109 as an exception to normal accounting principles, provides option to follow either trade date accounting or settlement date accounting for regular way purchase/sale transactions. Under draft AS 109, only trade date accounting is permitted.
4. Classification:
 - 4.1 Under Ind AS 109, financial assets are classified based on Contractual Cash Flow Characteristics Test and Business Model Test, which determine the subsequent measurement of financial assets. In AS 109, financial assets classification is not based on such complex tests, instead they are divided into two broad categories namely, basic financial instruments and Other financial instruments. While the former category has certain similarities with Contractual Cash Flow Characteristics Test of Ind AS 109, it is not same.
 - 4.2 In AS 109, Equity Instruments are classified into two categories i.e. those held for trading and those not held for trading. The former category is subsequently measured at Fair Value through Profit or Loss and latter is carried at cost less impairment. In case of Ind AS 109, Equity Instruments are also classified into two categories but the criteria and subsequent measurement differs. All equity instruments are mandatorily classified as subsequently measured at Fair Value through Profit or Loss except certain equity instruments, at entity's option, are designated as subsequently measured at Fair Value through Other Comprehensive Income.
5. Measurement:
 - 5.1 Fair Value Measurement: Similar to Ind AS 109, the initial measurement of all financial instruments and subsequent measurement of certain financial

instruments is at fair value. However, the fair value measurement principles and concepts are different in AS 109 vis-a-vis Ind AS 109 and these are highlighted below.

- Fair Value Measurement in Ind AS 109 based on definition and principles laid down in a separate standard viz. Ind AS 113. Similar to IFRS for SMEs, the AS 109 provides definition, principles and other accounting requirements of fair value. The main difference is in the approach to fair value measurement i.e. Ind AS 113 is based on 'Exit Price' concept which may be difficult to understand and apply by SMEs such as identification and quantification of 'Day 1 Gains/Losses' and its subsequent accounting. Therefore, AS 109 is based on currently understood and followed approach of 'Entry Price' i.e. fair value is normally the transaction price in an arm's length transaction.
- Ind AS 109 requires classification of fair value into different levels and prescribes a 'three level hierarchy'. AS 109 does not prescribe such a detailed classifications.

5.2 Amortised Cost: Under Ind AS 109, application of computation of effective interest rate and application of effective interest method is operationally challenging in case of floating (variable) rate instruments which also have transactions costs, discount/premiums etc. There is no explicit guidance in this regard. AS 109, provides explicit simple guidance for amortisation of such elements of effective interest rate for floating (variable) rate instruments on straight-line basis.

5.3 Impairment: Under Ind AS 109, Impairment loss recognition and measurement is based on Expected Credit Loss (ECL) approach with '3 Bucket' segregation model and there is explicit requirement for consideration of time value of money. ECL model requires consideration of historical loss data as well as future forecast information which would be conceptually and operationally challenging to apply. Under AS 109, impairment loss is recognised and measured using Incurred Loss Approach.

6. Under Ind AS 109, derecognition is based on complex principles of significant risk and reward, continuing involvement, pass through arrangement etc. Under AS 109, derecognition is based on principles of significant risk and reward and transfer of control over financial instruments.

7. Hedge accounting provisions of AS 109 are quite similar to that of Ind AS 109 except in the following areas:

- When an entity separates intrinsic value and time value of an option contract. As per AS 109, time value of an option contract is treated as a period cost or at a point in time depending on the manner of designation and impact of hedged item on profit or loss. As per Ind AS 109, time value of an option is recognised in Other Comprehensive Income to the extent it relates to hedge item. Further, its treatment differs depending on whether it is a transaction related hedged item (included in carrying amount of asset/liability, or

reclassified to profit or loss) or a time-period related hedged item (amortised on systematic basis).

- Ind AS 109 provides an additional option to designate a credit exposure as measured at fair value through profit or loss if an entity uses a credit derivative (that is measured at fair value through profit or loss) to manage that credit risk.
8. Under Ind AS, Hedge Accounting is based on classification into 3 categories with extensive and stringent prescriptions on hedged item (risk), hedging instruments, effectiveness tests, documentation, hedge ratio etc. Under draft upgraded AS 109, for derivatives and hedge accounting, provisions of Guidance Note on Accounting for Derivatives Contracts is substantially carried forward.
 9. Under Ind AS, a separate standard viz. Ind AS 107, *Financial Instruments: Disclosures* prescribes extensive disclosures. However, upgraded AS 109 contains optimal disclosures.