Indian Accounting Standard (Ind AS) 39

Financial Instruments: Recognition and Measurement

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Indian Accounting Standard (Ind AS) *39*

Financial Instruments: Recognition and Measurement

(This Indian Accounting Standard includes paragraphs set in bold type and plain type, which have equal authority. Paragraphs in bold type indicate the main principles.

Objective

1 The objective of this Standard is to establish principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. Requirements for presenting information about financial instruments are in Ind AS 32, *Financial Instruments: Presentation*. Requirements for disclosing information about financial instruments are in Ind AS 107 *Financial Instruments: Disclosures*.

Scope

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

(a) those interests in subsidiaries, associates and joint ventures that are accounted for under Ind AS 27 *Consolidated and Separate Financial Statements,* Ind AS 28 *Investments in Associates* or Ind AS 31 *Interests in Joint Ventures.* However, entities shall apply this Standard to an interest in a subsidiary, associate or joint venture that according to Ind AS 27, Ind AS 28, or Ind AS 31 is accounted for under this Standard. Entities shall also apply this Standard to derivatives on an interest in a subsidiary, associate or joint venture unless the derivative meets the definition of an equity instrument of the entity in Ind AS 32.

(b) rights and obligations under leases to which Ind AS 17 *Leases* applies. However:

(i) lease receivables recognised by a lessor are subject to the derecognition and impairment provisions of this Standard (see paragraphs 15–37, 58, 59, 63–65 and Appendix A paragraphs AG36–AG52 and AG84–AG93);

(ii) finance lease payables recognised by a lessee are subject to the derecognition provisions of this Standard (see paragraphs 39–42 and Appendix A paragraphs AG57–AG63); and

(iii) derivatives that are embedded in leases are subject to the embedded derivatives provisions of this Standard (see paragraphs 10–13 and Appendix A paragraphs AG27–AG33).

(c) employers' rights and obligations under employee benefit plans, to which Ind AS 19 *Employee Benefits* applies.

(d) financial instruments issued by the entity that meet the definition of an equity instrument in Ind AS 32 (including options and warrants) or that are required to be classified as an equity instrument in accordance with paragraphs 16A and 16B or paragraphs 16C and 16D of Ind AS 32. However, the holder of such equity instruments shall apply this Standard to those instruments, unless they meet the exception in (a) above.

(e) rights and obligations arising under (i) an insurance contract as defined in Ind AS 104 *Insurance Contracts*, other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract in paragraph 9, or (ii) a contract that is within the scope of Ind AS 104 because it contains a discretionary participation feature. However, this Standard applies to a derivative that is embedded in a contract within the scope of Ind AS 104 if the derivative is not itself a contract within the scope of Ind AS 104 (see paragraphs 10–13 and Appendix A paragraphs AG27–AG33 of this Standard). Moreover, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either this Standard or Ind AS 104 to such financial guarantee contracts (see paragraphs AG4 and AG4A). The issuer may make that election contract by contract, but the election for each contract is irrevocable.

(f) [Refer to Appendix 1]

(g) any forward contract between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination at a future acquisition date. The term of the forward contract should not exceed a reasonable period normally necessary to obtain any required approvals and to complete the transaction.

(h) loan commitments other than those loan commitments described in paragraph 4. An issuer of loan commitments shall apply Ind AS 37 *Provisions, Contingent Liabilities and Contingent Assets* to loan commitments that are not within the scope of this Standard. However, all loan commitments are subject to the derecognition provisions of this Standard (see paragraphs 15–42 and Appendix A paragraphs AG36–AG63).

(i) financial instruments, contracts and obligations under share-based payment transactions to which Ind AS 104 *Share-based Payment* applies, except for contracts within the scope of paragraphs 5–7 of this Standard, to which this Standard applies.

(j) rights to payments to reimburse the entity for expenditure it is required to make to settle a liability that it recognises as a provision in accordance withInd AS 37, or for which, in an earlier period, it recognised a provision in accordance with Ind AS 37.

3 [Refer to Appendix 1]

4 The following loan commitments are within the scope of this Standard:

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

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

(c) commitments to provide a loan at a below-market interest rate. Paragraph 47(d) specifies the subsequent measurement of liabilities arising from these loan commitments.

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

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

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

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

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

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

A contract to which (b) or (c) applies is not entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements and, accordingly, is within the scope of this Standard. Other contracts to which paragraph 5 applies are evaluated to determine whether they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements and, accordingly, whether they are within the scope of this Standard.

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

Definitions

8 The terms defined in Ind AS 32 are used in this Standard with the meanings specified in paragraph 11 of Ind AS 32. Ind AS 32 defines the following terms:

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

and provides guidance on applying those definitions.

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

Definition of a derivative

A *derivative* is a financial instrument or other contract within the scope of this Standard (see paragraphs 2–7) with all three of the following characteristics:

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

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

(c) it is settled at a future date.

Definitions of four categories of financial instruments

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

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

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

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

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

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

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

(ii) a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel (as defined in Ind AS 24 *Related Party Disclosures*), for example the entity's board of directors and chief executive officer.

In Ind AS 107, paragraphs 9–11 and B4 require the entity to provide disclosures about financial assets and financial liabilities it has designated as at fair value through profit or loss, including how it has satisfied these conditions. For instruments qualifying in accordance with (ii) above, that disclosure includes a narrative description of how designation as at fair value through profit or loss is consistent with the entity's documented risk management or investment strategy.

Investments in equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured (see paragraph 46(c) and Appendix A paragraphs AG80 and AG81), shall not be designated as at fair value through profit or loss.

It should be noted that paragraphs 48, 48A, 49 and Appendix A paragraphs AG69–AG82, which set out requirements for determining a reliable measure of the fair value of a financial asset or financial liability, apply equally to all items that are measured at fair value, whether by designation or otherwise, or whose fair value is disclosed.

Held-to-maturity investments **are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity (see Appendix A paragraphs AG16–AG25) other than:**

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

(b) those that the entity designates as available for sale; and

(c) those that meet the definition of loans and receivables.

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

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

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

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

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

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

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

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

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

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

Definition of a financial guarantee contract

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

Definitions relating to recognition and measurement

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

The *effective interest method* **is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. 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) but shall not consider future credit losses. The calculation includes all fees and points paid or**

received between parties to the contract that are an integral part of the effective interest rate (see Ind AS 18 *Revenue*), transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

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

Fair value **is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.**[1]

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

Transaction costs **are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see Appendix A paragraph AG13). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.**

Definitions relating to hedge accounting

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

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

A *hedging instrument* **is a designated derivative or (for a hedge of the risk of changes in foreign currency exchange rates only) a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item (paragraphs 72–77 and Appendix A paragraphs AG94–AG97 elaborate on the definition of a hedging instrument).**

A *hedged item* **is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged (paragraphs 78–84 and Appendix A paragraphs AG98–AG101 elaborate on the definition of hedged items).**

[1] Paragraphs 48–49 and AG69–AG82 of Appendix A contain requirements for determining the fair value of a financial asset or financial liability.

Hedge effectiveness **is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument (see Appendix A paragraphs AG105–AG113).**

Embedded derivatives

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

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

(a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract (see Appendix A paragraphs AG30 and AG33);

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

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

If an embedded derivative is separated, the host contract shall be accounted for under this Standard if it is a financial instrument, and in accordance with other appropriate Standards if it is not a financial instrument. This Standard does not address whether an embedded derivative shall be presented separately in the balance sheet.

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

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

(b) it is clear with little or no analysis when a similar hybrid (combined) instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in

a loan that permits the holder to prepay the loan for approximately its amortised cost.

12 If an entity is required by this Standard to separate an embedded derivative from its host contract, but is unable to measure the embedded derivative separately either at acquisition or at the end of a subsequent financial reporting period, it shall designate the entire hybrid (combined) contract as at fair value through profit or loss. Similarly, if an entity is unable to measure separately the embedded derivative that would have to be separated on reclassification of a hybrid (combined) contract out of the fair value through profit or loss category, that reclassification is prohibited. In such circumstances the hybrid (combined) contract remains classified as at fair value through profit or loss in its entirety.

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

Recognition and derecognition

Initial recognition

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

Derecognition of a financial asset

15 In consolidated financial statements, paragraphs 16–23 and Appendix A paragraphs AG34–AG52 are applied at a consolidated level. Hence, an entity first consolidates all subsidiaries in accordance with Ind AS 27 and Appendix A *Consolidation—Special Purpose Entities* ofInd AS 27 and then applies paragraphs 16–23 and Appendix A paragraphs AG34–AG52 to the resulting group.

16 Before evaluating whether, and to what extent, derecognition is appropriate under paragraphs 17–23, an entity determines whether those paragraphs should be applied to a part of a financial asset (or a part of a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety, as follows.

(a) Paragraphs 17–23 are applied to a part of a financial asset (or a part of a group of similar financial assets) if, and only if, the part being considered for derecognition meets one of the following three conditions.

(i) The part comprises only specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash flows, but not the principal cash flows from a debt instrument, paragraphs 17–23 are applied to the interest cash flows.

(ii) The part comprises only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of all cash flows of a debt instrument, paragraphs 17–23 are applied to 90 per cent of those cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the cash flows provided that the transferring entity has a fully proportionate share.

(iii) The part comprises only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of interest cash flows from a financial asset, paragraphs 17–23 are applied to 90 per cent of those interest cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the specifically identified cash flows provided that the transferring entity has a fully proportionate share.

(b) In all other cases, paragraphs 17–23 are applied to the financial asset in its entirety (or to the group of similar financial assets in their entirety). For example, when an entity transfers (i) the rights to the first or the last 90 per cent of cash collections from a financial asset (or a group of financial assets), or (ii) the rights to 90 per cent of the cash flows from a group of receivables, but provides a guarantee to compensate the buyer for any credit losses up to 8 per cent of the principal amount of the receivables, paragraphs 17–23 are applied to the financial asset (or a group of similar financial assets) in its entirety.

In paragraphs 17–26, the term 'financial asset' refers to either a part of a financial asset (or a part of a group of similar financial assets) as identified in (a) above or, otherwise, a financial asset (or a group of similar financial assets) in its entirety.

17 An entity shall derecognise a financial asset when, and only when:

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

(b) it transfers the financial asset as set out in paragraphs 18 and 19 and the transfer qualifies for derecognition in accordance with paragraph 20.

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

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

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

(b) retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement that meets the conditions in paragraph 19.

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

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

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

(c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents (as defined in Ind AS 7 *Statement of Cash Flows*) during the short settlement period from the collection date to the date of required remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients.

20 When an entity transfers a financial asset (see paragraph 18), it shall evaluate the extent to which it retains the risks and rewards of ownership of the financial asset. In this case:

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

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

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

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

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

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

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

23 Whether the entity has retained control (see paragraph 20(c)) of the transferred asset depends on the transferee's ability to sell the asset. If the transferee has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer, the entity has not retained control. In all other cases, the entity has retained control.

Transfers that qualify for derecognition (see paragraph 20(a) and (c)(i))

24 If an entity transfers a financial asset in a transfer that qualifies for derecognition in its entirety and retains the right to service the financial asset for a fee, it shall recognise either a servicing asset or a servicing liability for that servicing contract. If the fee to be received is not expected

to compensate the entity adequately for performing the servicing, a servicing liability for the servicing obligation shall be recognised at its fair value. If the fee to be received is expected to be more than adequate compensation for the servicing, a servicing asset shall be recognised for the servicing right at an amount determined on the basis of an allocation of the carrying amount of the larger financial asset in accordance with paragraph 27.

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

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

(a) the carrying amount and

(b) **the sum of (i) the consideration received (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss that had been recognised in other comprehensive income (see paragraph 55(b))**

shall be recognised in profit or loss.

27 If the transferred asset is part of a larger financial asset (eg when an entity transfers interest cash flows that are part of a debt instrument, see paragraph 16(a)) and the part transferred qualifies for derecognition in its entirety, the previous carrying amount of the larger financial asset shall be allocated between the part that continues to be recognised and the part that is derecognised, based on the relative fair values of those parts on the date of the transfer. For this purpose, a retained servicing asset shall be treated as a part that continues to be recognised. The difference between:

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

(b) the sum of (i) the consideration received for the part derecognised (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss allocated to it that had been recognised in other comprehensive income (see paragraph 55(b))

shall be recognised in profit or loss. A cumulative gain or loss that had been recognised in other comprehensive income is allocated between the part that continues to be recognised and the part that is derecognised, based on the relative fair values of those parts.

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

value is the difference between the fair value of the larger financial asset as a whole and the consideration received from the transferee for the part that is derecognised.

Transfers that do not qualify for derecognition (see paragraph 20(b))

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

Continuing involvement in transferred assets (see paragraph 20(c)(ii))

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

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

(b) when the entity's continuing involvement takes the form of a written or purchased option (or both) on the transferred asset, the extent of the entity's continuing involvement is the amount of the transferred asset that the entity may repurchase. However, in case of a written put option on an asset that is measured at fair value, the extent of the entity's continuing involvement is limited to the lower of the fair value of the transferred asset and the option exercise price (see paragraph AG48).

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

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

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

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

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

33 For the purpose of subsequent measurement, recognised changes in the fair value of the transferred asset and the associated liability are accounted for consistently with each other in accordance with paragraph 55, and shall not be offset.

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

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

(b) the sum of (i) the consideration received for the part no longer recognised and (ii) any cumulative gain or loss allocated to it that had been recognised in other comprehensive income (see paragraph 55(b))

shall be recognised in profit or loss. A cumulative gain or loss that had been recognised in other comprehensive income is allocated between the part that continues to be recognised and the part that is no longer recognised on the basis of the relative fair values of those parts.

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

All transfers

36 If a transferred asset continues to be recognised, the asset and the associated liability shall not be offset. Similarly, the entity shall not offset any income arising from the transferred asset with any expense incurred on the associated liability (see Ind AS 32 paragraph 42).

37 If a transferor provides non-cash collateral (such as debt or equity instruments) to the transferee, the accounting for the collateral by the transferor and the transferee depends on whether the transferee has the

right to sell or repledge the collateral and on whether the transferor has defaulted. The transferor and transferee shall account for the collateral as follows:

(a) If the transferee has the right by contract or custom to sell or repledge the collateral, then the transferor shall reclassify that asset in its balance sheet (eg 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.

(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.

Regular way purchase or sale of a financial asset

38 A regular way purchase or sale of financial assets shall be recognised and derecognised, as applicable, using trade date accounting or settlement date accounting (see Appendix A paragraphs AG53–AG56).

Derecognition of a financial liability

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

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

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

42 If an entity repurchases a part of a financial liability, the entity shall allocate the previous carrying amount of the financial liability between the part that continues to be recognised and the part that is derecognised based on the relative fair values of those parts on the date of the repurchase. The difference between (a)

the carrying amount allocated to the part derecognised and (b) the consideration paid, including any non-cash assets transferred or liabilities assumed, for the part derecognised shall be recognised in profit or loss.

Measurement

Initial measurement of financial assets and financial liabilities

43 When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

44 When an entity uses settlement date accounting for an asset that is subsequently measured at cost or amortised cost, the asset is recognised initially at its fair value on the trade date (see Appendix A paragraphs AG53–AG56).

Subsequent measurement of financial assets

45 For the purpose of measuring a financial asset after initial recognition, this Standard classifies financial assets into the following four categories defined in paragraph 9:

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

(b) held-to-maturity investments;

(c) loans and receivables; and

(d) available-for-sale financial assets.

These categories apply to measurement and profit or loss recognition under this Standard. The entity may use other descriptors for these categories or other categorisations when presenting information in the financial statements. The entity shall disclose in the notes the information required by Ind AS 107.

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

(a) loans and receivables as defined in paragraph 9, which shall be measured at amortised cost using the effective interest method;

(b) held-to-maturity investments as defined in paragraph 9, which shall be measured at amortised cost using the effective interest method; and

(c) investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by

delivery of such unquoted equity instruments, which shall be measured at cost (see Appendix A paragraphs AG80 and AG81).

Financial assets that are designated as hedged items are subject to measurement under the hedge accounting requirements in paragraphs 89–102. All financial assets except those measured at fair value through profit or loss are subject to review for impairment in accordance with paragraphs 58–70 and Appendix A paragraphs AG84–AG93.

Subsequent measurement of financial liabilities

47 **After initial recognition, an entity shall measure all financial liabilities at amortised cost using the effective interest method, except for:**

(a) **financial liabilities at fair value through profit or loss. Such liabilities, including derivatives that are liabilities, shall be measured at fair value except for a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured, which shall be measured at cost.**

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

(c) **financial guarantee contracts as defined in paragraph 9. After initial recognition, an issuer of such a contract shall (unless paragraph 47(a) or (b) applies) measure it at the higher of:**

(i) **the amount determined in accordance with Ind AS 37; and**

(ii) **the amount initially recognised (see paragraph 43) less, when appropriate, cumulative amortisation recognised in accordance with Ind AS 18.**

(d) **commitments to provide a loan at a below-market interest rate. After initial recognition, an issuer of such a commitment shall (unless paragraph 47(a) applies) measure it at the higher of:**

(i) **the amount determined in accordance with Ind AS 37; and**

(ii) **the amount initially recognised (see paragraph 43) less, when appropriate, cumulative amortisation recognised in accordance with Ind AS 18.**

Financial liabilities that are designated as hedged items are subject to the hedge accounting requirements in paragraphs 89–102.

Fair value measurement considerations

48 **In determining the fair value of a financial asset or a financial liability for the purpose of applying this Standard, Ind AS 32 or Ind AS 107, an entity shall apply paragraphs AG69–AG82 of Appendix A.**

Provided that in determining the fair value of the financial liabilities which upon initial recognition are designated at fair value through profit or loss, any change in fair value consequent to changes in the entity's own credit risk shall be ignored.

48A The best evidence of fair value is quoted prices in an active market. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique. The chosen valuation technique makes maximum use of market inputs and relies as little as possible on entity-specific inputs. It incorporates all factors that market participants would consider in setting a price and is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (ie without modification or repackaging) or based on any available observable market data.

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

Reclassifications

50 An entity:

(a) shall not reclassify a derivative out of the fair value through profit or loss category while it is held or issued;

(b) shall not reclassify any financial instrument out of the fair value through profit or loss category if upon initial recognition it was designated by the entity as at fair value through profit or loss; and

(c) may, if a financial asset is no longer held for the purpose of selling or repurchasing it in the near term (notwithstanding that the financial asset may have been acquired or incurred principally for the purpose of selling or repurchasing it in the near term), reclassify that financial asset out of the fair value through profit or loss category if the requirements in paragraph 50B or 50D are met.

An entity shall not reclassify any financial instrument into the fair value through profit or loss category after initial recognition.

50A The following changes in circumstances are not reclassifications for the purposes of paragraph 50:

(a) a derivative that was previously a designated and effective hedging instrument in a cash flow hedge or net investment hedge no longer qualifies as such;

(b) a derivative becomes a designated and effective hedging instrument in a cash flow hedge or net investment hedge;

(c) financial assets are reclassified when an insurance company changes its accounting policies in accordance with paragraph 45 of Ind AS 104.

50B A financial asset to which paragraph 50(c) applies (except a financial asset of the type described in paragraph 50D) may be reclassified out of the fair value through profit or loss category only in rare circumstances.

50C If an entity reclassifies a financial asset out of the fair value through profit or loss category in accordance with paragraph 50B, the financial asset 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 or amortised cost, as applicable.

50D A financial asset to which paragraph 50(c) applies that would have met the definition of loans and receivables (if the financial asset had not been required to be classified as held for trading at initial recognition) may be reclassified out of the fair value through profit or loss category if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity.

50E A financial asset classified as available for sale that would have met the definition of loans and receivables (if it had not been designated as available for sale) may be reclassified out of the available-for-sale category to the loans and receivables category if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity.

50F If an entity reclassifies a financial asset out of the fair value through profit or loss category in accordance with paragraph 50D or out of the available-for-sale category in accordance with paragraph 50E, it shall reclassify the financial asset at its fair value on the date of reclassification. For a financial asset reclassified in accordance with paragraph 50D, 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 or amortised cost, as applicable. For a financial asset reclassified out of the available-for-sale category in accordance with paragraph 50E, any previous gain or loss on that asset that has been recognised in other comprehensive income in accordance with paragraph 55(b) shall be accounted for in accordance with paragraph 54.

51 If, as a result of a change in intention or ability, it is no longer appropriate to classify an investment as held to maturity, it shall be reclassified as available for sale and remeasured at fair value, and the difference between its carrying amount and fair value shall be accounted for in accordance with paragraph 55(b).

52 Whenever sales or reclassification of more than an insignificant amount of held-to-maturity investments do not meet any of the conditions in

paragraph 9, any remaining held-to-maturity investments shall be reclassified as available for sale. On such reclassification, the difference between their carrying amount and fair value shall be accounted for in accordance with paragraph 55(b).

53 If a reliable measure becomes available for a financial asset or financial liability for which such a measure was previously not available, and the asset or liability is required to be measured at fair value if a reliable measure is available (see paragraphs 46(c) and 47), the asset or liability shall be remeasured at fair value, and the difference between its carrying amount and fair value shall be accounted for in accordance with paragraph 55.

54 If, as a result of a change in intention or ability or in the rare circumstance that a reliable measure of fair value is no longer available (see paragraphs 46(c) and 47) or because the 'two preceding financial years' referred to in paragraph 9 have passed, it becomes appropriate to carry a financial asset or financial liability at cost or amortised cost rather than at fair value, the fair value carrying amount of the financial asset or the financial liability on that date becomes its new cost or amortised cost, as applicable. Any previous gain or loss on that asset that has been recognised in other comprehensive income in accordance with paragraph 55(b) shall be accounted for as follows:

(a) In the case of a financial asset with a fixed maturity, the gain or loss shall be amortised to profit or loss over the remaining life of the held-to-maturity investment using the effective interest method. Any difference between the new amortised cost and maturity amount shall also be amortised over the remaining life of the financial asset using the effective interest method, similar to the amortisation of a premium and a discount. If the financial asset is subsequently impaired, any gain or loss that has been recognised in other comprehensive income is reclassified from equity to profit or loss in accordance with paragraph 67.

(b) In the case of a financial asset that does not have a fixed maturity, the gain or loss shall be recognised in profit or loss when the financial asset is sold or otherwise disposed of. If the financial asset is subsequently impaired any previous gain or loss that has been recognised in other comprehensive income is reclassified from equity to profit or loss in accordance with paragraph 67.

Gains and losses

55 A gain or loss arising from a change in the fair value of a financial asset or financial liability that is not part of a hedging relationship (see paragraphs 89–102), shall be recognised, as follows.

(a) A gain or loss on a financial asset or financial liability classified as at fair value through profit or loss shall be recognised in profit or loss.

(b) A gain or loss on an available-for-sale financial asset shall be recognised in other comprehensive income, except for impairment

losses (see paragraphs 67–70) and foreign exchange gains and losses (see Appendix A paragraph AG83), until the financial asset is derecognised. At that time the cumulative gain or loss previously recognised in other comprehensive income shall be reclassified from equity to profit or loss as a reclassification adjustment (see Ind AS 1 *Presentation of Financial Statements*). However, interest calculated using the effective interest method (see paragraph 9) is recognised in profit or loss (seeInd AS 18). Dividends on an available-for-sale equity instrument are recognised in profit or loss when the entity's right to receive payment is established (see Ind AS 18).

56 For financial assets and financial liabilities carried at amortised cost (see paragraphs 46 and 47), a gain or loss is recognised in profit or loss when the financial asset or financial liability is derecognised or impaired, and through the amortisation process. However, for financial assets or financial liabilities that are hedged items (see paragraphs 78–84 and Appendix A paragraphs AG98–AG101) the accounting for the gain or loss shall follow paragraphs 89–102.

57 If an entity recognises financial assets using settlement date accounting (see paragraph 38 and Appendix A paragraphs AG53 and AG56), any change in the fair value of the asset to be received during the period between the trade date and the settlement date is not recognised for assets carried at cost or amortised cost (other than impairment losses). For assets carried at fair value, however, the change in fair value shall be recognised in profit or loss or in other comprehensive income, as appropriate under paragraph 55.

Impairment and uncollectibility of financial assets

58 An entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired. If any such evidence exists, the entity shall apply paragraph 63 (for financial assets carried at amortised cost), paragraph 66 (for financial assets carried at cost) or paragraph 67 (for available-for-sale financial assets) to determine the amount of any impairment loss.

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

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

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

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

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

(e) the disappearance of an active market for that financial asset because of financial difficulties; or

(f) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:

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

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

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

61 In addition to the types of events in paragraph 59, objective evidence of impairment for an investment in an equity instrument includes information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates, and indicates that the cost of the investment in the equity instrument may not be recovered. A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment.

62 In some cases the observable data required to estimate the amount of an impairment loss on a financial asset may be limited or no longer fully relevant to current circumstances. For example, this may be the case when a borrower is in financial difficulties and there are few available historical data relating to similar borrowers. In such cases, an entity uses its experienced judgement to estimate the amount of any impairment loss. Similarly an entity uses its experienced judgement to adjust observable data for a group of financial assets to reflect current circumstances (see paragraph AG89). The use of reasonable estimates

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

Financial assets carried at amortised cost

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

64 An entity first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant (see paragraph 59). If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

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

Financial assets carried at cost

66 If there is objective evidence that an impairment loss has been incurred on an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured, or on a derivative asset that is linked to and must be settled by delivery of such an unquoted equity instrument, the amount of the impairment loss is measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset (see paragraph 46(c) and Appendix A paragraphs AG80 and AG81). Such impairment losses shall not be reversed.

Available-for-sale financial assets

67 When a decline in the fair value of an available-for-sale financial asset has been recognised in other comprehensive income and there is objective evidence that the asset is impaired (see paragraph 59), the cumulative loss that had been recognised in other comprehensive income shall be reclassified from equity to profit or loss as a reclassification adjustment even though the financial asset has not been derecognised.

68 The amount of the cumulative loss that is reclassified from equity to profit or loss under paragraph 67 shall be the difference between the acquisition cost (net of any principal repayment and amortisation) and current fair value, less any impairment loss on that financial asset previously recognised in profit or loss.

69 Impairment losses recognised in profit or loss for an investment in an equity instrument classified as available for sale shall not be reversed through profit or loss.

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

Hedging

71 If there is a designated hedging relationship between a hedging instrument and a hedged item as described in paragraphs 85–88 and Appendix A paragraphs AG102–AG104, accounting for the gain or loss on the hedging instrument and the hedged item shall follow paragraphs 89–102.

Hedging instruments

Qualifying instruments

72 This Standard does not restrict the circumstances in which a derivative may be designated as a hedging instrument provided the conditions in paragraph 88 are met, except for some written options (see Appendix A paragraph AG94). However, a non-derivative financial asset or non-derivative financial liability may be designated as a hedging instrument only for a hedge of a foreign currency risk.

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

Designation of hedging instruments

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

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

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

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

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

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

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

Hedged items

Qualifying items

78 A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation. The hedged item can be (a) a single asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation, (b) a group of assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations with similar risk

characteristics or (c) in a portfolio hedge of interest rate risk only, a portion of the portfolio of financial assets or financial liabilities that share the risk being hedged.

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

80 For hedge accounting purposes, only assets, liabilities, firm commitments or highly probable forecast transactions that involve a party external to the entity can be designated as hedged items. It follows that hedge accounting can be applied to transactions between entities in the same group only in the individual or separate financial statements of those entities and not in the consolidated financial statements of the group. As an exception, the foreign currency risk of an intragroup monetary item (eg a payable/receivable between two subsidiaries) may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation in accordance with Ind AS 21, *The Effects of Changes in Foreign Exchange Rates*. In accordance with Ind AS 21, foreign exchange rate gains and losses on intragroup monetary items are not fully eliminated on consolidation when the intragroup monetary item is transacted between two group entities that have different functional currencies. In addition, the foreign currency risk of a highly probable forecast intragroup transaction may qualify as a hedged item in consolidated financial statements provided that the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss.

Designation of financial items as hedged items

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

81A In a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only in such a hedge), the portion hedged may be designated in terms of an amount of a currency (eg an amount of dollars, euro, pounds or rand) rather than as individual assets (or liabilities). Although the portfolio may, for risk management purposes, include assets and liabilities, the amount designated is an amount of assets or an amount of liabilities. Designation of a net amount including assets and liabilities is not permitted . The entity may hedge a portion of the interest rate risk associated with this designated amount. For example, in the case of a hedge of a portfolio containing prepayable assets,

the entity may hedge the change in fair value that is attributable to a change in the hedged interest rate on the basis of expected, rather than contractual, repricing dates. When the portion hedged is based on expected repricing dates, the effect that changes in the hedged interest rate have on those expected repricing dates shall be included when determining the change in the fair value of the hedged item. Consequently, if a portfolio that contains prepayable items is hedged with a non-prepayable derivative, ineffectiveness arises if the dates on which items in the hedged portfolio are expected to prepay are revised, or actual prepayment dates differ from those expected.

Designation of non-financial items as hedged items

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

Designation of groups of items as hedged items

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

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

Hedge accounting

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

86 Hedging relationships are of three types:

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

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

(c) *hedge of a net investment in a foreign operation* **as defined in Ind AS 21.**

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

88 A hedging relationship qualifies for hedge accounting under paragraphs 89–102 if, and only if, all of the following conditions are met.

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

(b) The hedge is expected to be highly effective (see Appendix A paragraphs AG105–AG113) in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.

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

(d) The effectiveness of the hedge can be reliably measured, ie the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured (see paragraphs 46 and 47 and Appendix A paragraphs AG80 and AG81 for guidance on determining fair value).

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

Fair value hedges

89 If a fair value hedge meets the conditions in paragraph 88 during the period, it shall be accounted for as follows:

(a) the gain or loss from remeasuring the hedging instrument at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount measured in accordance with Ind AS 21 (for a non-derivative hedging instrument) shall be recognised in profit or loss; and

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

89A For a fair value hedge of the interest rate exposure of a portion of a portfolio of financial assets or financial liabilities (and only in such a hedge), the requirement in paragraph 89(b) may be met by presenting the gain or loss attributable to the hedged item either:

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

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

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

90 If only particular risks attributable to a hedged item are hedged, recognised changes in the fair value of the hedged item unrelated to the hedged risk are recognised as set out in paragraph 55.

91 An entity shall discontinue prospectively the hedge accounting specified in paragraph 89 if:

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

(b) the hedge no longer meets the criteria for hedge accounting in paragraph 88; or

(c) the entity revokes the designation.

92 Any adjustment arising from paragraph 89(b) to the carrying amount of a hedged financial instrument for which the effective interest method is used (or, in the case of a portfolio hedge of interest rate risk, to the separate line item in the balance sheet described in paragraph 89A) shall be amortised to profit or loss. Amortisation may begin as soon as an adjustment exists and shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged. The adjustment is based on a recalculated effective interest rate at the date amortisation begins. However, if, in the case of a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only in such a hedge), amortising using a recalculated effective interest rate is not practicable, the adjustment shall be amortised using a straight-line method. The adjustment shall be amortised fully by maturity of the financial instrument or, in the case of a portfolio hedge of interest rate risk, by expiry of the relevant repricing time period.

93 When an unrecognised firm commitment is designated as a hedged item, the subsequent cumulative change in the fair value of the firm commitment attributable to the hedged risk is recognised as an asset or liability with a corresponding gain or loss recognised in profit or loss (see paragraph 89(b)). The

changes in the fair value of the hedging instrument are also recognised in profit or loss.

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

Cash flow hedges

95 If a cash flow hedge meets the conditions in paragraph 88 during the period, it shall be accounted for as follows:

(a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (see paragraph 88) shall be recognised in other comprehensive income; and

(b) the ineffective portion of the gain or loss on the hedging instrument shall be recognised in profit or loss.

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

(a) the separate component of equity associated with the hedged item is adjusted to the lesser of the following (in absolute amounts):

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

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

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

(c) if an entity's documented risk management strategy for a particular hedging relationship excludes from the assessment of hedge effectiveness a specific component of the gain or loss or related cash flows on the hedging instrument (see paragraphs 74, 75 and 88(a)), that excluded component of gain or loss is recognised in accordance with paragraph 55.

97 If a hedge of a forecast transaction subsequently results in the recognition of a financial asset or a financial liability, the associated gains or losses that were recognised in other comprehensive income in accordance with paragraph 95 shall be reclassified from equity to profit or loss as a reclassification adjustment (see Ind AS 1) in the same period or periods during which the hedged forecast cash flows affect profit or loss (such as in the periods that interest income or interest expense is recognised). However, if an entity expects that all or a portion of a loss recognised in other comprehensive income will not be recovered in one or more future periods, it shall reclassify into profit or loss as a reclassification adjustment the amount that is not expected to be recovered.

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

(a) It reclassifies the associated gains and losses that were recognised in other comprehensive income in accordance with paragraph 95 to profit or loss as a reclassification adjustment (see Ind AS 1) in the same period or periods during which the asset acquired or liability assumed affects profit or loss (such as in the periods that depreciation expense or cost of sales is recognised). However, if an entity expects that all or a portion of a loss recognised in other comprehensive income will not be recovered in one or more future periods, it shall reclassify from equity to profit or loss as a reclassification adjustment the amount that is not expected to be recovered.

(b) It removes the associated gains and losses that were recognised in other comprehensive income in accordance with paragraph 95, and includes them in the initial cost or other carrying amount of the asset or liability.

99 **An entity shall adopt either (a) or (b) in paragraph 98 as its accounting policy and shall apply it consistently to all hedges to which paragraph 98 relates.**

100 **For cash flow hedges other than those covered by paragraphs 97 and 98, amounts that had been recognised in other comprehensive income shall be reclassified from equity to profit or loss as a reclassification adjustment (see Ind AS 1) in the same period or periods during which the hedged forecast cash flows affect profit or loss (for example, when a forecast sale occurs).**

101 **In any of the following circumstances an entity shall discontinue prospectively the hedge accounting specified in paragraphs 95–100:**

(a) The hedging instrument expires or is sold, terminated or exercised (for this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy). In this case, the cumulative gain or loss on the hedging instrument that has been recognised in other comprehensive income from the period when the hedge was effective (see paragraph 95(a)) shall remain separately in equity until the forecast transaction occurs. When the transaction occurs, paragraph 97, 98 or 100 applies.

(b) The hedge no longer meets the criteria for hedge accounting in paragraph 88. In this case, the cumulative gain or loss on the hedging instrument that has been recognised in other comprehensive income from the period when the hedge was effective (see paragraph 95(a)) shall remain separately in equity until the forecast transaction occurs. When the transaction occurs, paragraph 97, 98 or 100 applies.

(c) The forecast transaction is no longer expected to occur, in which case any related cumulative gain or loss on the hedging instrument that has been recognised in other comprehensive income from the period when the hedge was effective (see paragraph 95(a)) shall be reclassified from equity to profit or loss as a reclassification adjustment. A forecast transaction that is no longer highly probable (see paragraph 88(c)) may still be expected to occur.

(d) The entity revokes the designation. For hedges of a forecast transaction, the cumulative gain or loss on the hedging instrument that has been recognised in other comprehensive income from the period when the hedge was effective (see paragraph 95(a)) shall remain separately in equity until the forecast transaction occurs or is no longer expected to occur. When the transaction occurs, paragraph 97, 98 or 100 applies. If the transaction is no longer expected to occur, the cumulative gain or loss that had been recognised in other comprehensive income shall be reclassified from equity to profit or loss as a reclassification adjustment.

Hedges of a net investment

102 Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment (see Ind AS 21), shall be accounted for similarly to cash flow hedges:

(a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (see paragraph 88) shall be recognised in other comprehensive income; and

(b) the ineffective portion shall be recognised in profit or loss.

The gain or loss on the hedging instrument relating to the effective portion of the hedge that has been recognised in other comprehensive income shall be reclassified from equity to profit or loss as a reclassification adjustment (see Ind AS 1) in accordance with paragraphs 48–49 of Ind AS 21 on the disposal or period disposal of the foreign operation.

Appendix A
Application Guidance

This appendix is an integral part of the Standard.

Scope (paragraphs 2–7)

AG1 Some contracts require a payment based on climatic, geological or other physical variables. (Those based on climatic variables are sometimes referred to as 'weather derivatives'.) If those contracts are not within the scope of Ind AS 39, they are within the scope of this Standard.

AG2 This Standard does not relate to employee benefit plans. This Standard does not change the requirements relating to royalty agreements based on the volume of sales or service revenues that are accounted for under Ind AS 18.

AG3 Sometimes, an entity makes what it views as a 'strategic investment' in equity instruments issued by another entity, with the intention of establishing or maintaining a long-term operating relationship with the entity in which the investment is made. The investor entity uses Ind AS 28 to determine whether the equity method of accounting is appropriate for such an investment. Similarly, the investor entity uses Ind AS 31 to determine whether proportionate consolidation or the equity method is appropriate for such an investment. If neither the equity method nor proportionate consolidation is appropriate, the entity applies this Standard to that strategic investment.

AG3A This Standard applies to the financial assets and financial liabilities of insurers, other than rights and obligations that paragraph 2(e) excludes because they arise under contracts within the scope of Ind AS 104.

AG4 Financial guarantee contracts may have various legal forms, such as a guarantee, some types of letter of credit, a credit default contract or an insurance contract. Their accounting treatment does not depend on their legal form. The following are examples of the appropriate treatment (see paragraph 2(e)):

(a) Although a financial guarantee contract meets the definition of an insurance contract in Ind AS 104 if the risk transferred is significant, the issuer applies this Standard. Nevertheless, if the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either this Standard or Ind AS 104 to such financial guarantee contracts. If this Standard applies, paragraph 43 requires the issuer to recognise a financial guarantee contract initially at fair value. If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's length transaction, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary. Subsequently, unless the financial guarantee contract was designated at inception as at fair value through profit or loss or unless paragraphs 29–37 and AG47–AG52 apply

(when a transfer of a financial asset does not qualify for derecognition or the continuing involvement approach applies), the issuer measures it at the higher of:

(i) the amount determined in accordance with Ind AS 37; and

(ii) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with Ind AS 18 (see paragraph 47(c)).

(b) Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a guarantee is one that requires payments in response to changes in a specified credit rating or credit index. Such guarantees are not financial guarantee contracts, as defined in this Standard, and are not insurance contracts, as defined in Ind AS 104. Such guarantees are derivatives and the issuer applies this Standard to them.

(c) If a financial guarantee contract was issued in connection with the sale of goods, the issuer applies Ind AS 18 in determining when it recognises the revenue from the guarantee and from the sale of goods.

AG4A Assertions that an issuer regards contracts as insurance contracts are typically found throughout the issuer's communications with customers and regulators, contracts, business documentation and financial statements. Furthermore, insurance contracts are often subject to accounting requirements that are distinct from the requirements for other types of transaction, such as contracts issued by banks or commercial companies. In such cases, an issuer's financial statements typically include a statement that the issuer has used those accounting requirements.

Definitions (paragraphs 8 and 9)

Designation as at fair value through profit or loss

AG4B Paragraph 9 of this Standard allows an entity to designate a financial asset, a financial liability, or a group of financial instruments (financial assets, financial liabilities or both) as at fair value through profit or loss provided that doing so results in more relevant information.

AG4C The decision of an entity to designate a financial asset or financial liability as at fair value through profit or loss is similar to an accounting policy choice (although, unlike an accounting policy choice, it is not required to be applied consistently to all similar transactions). When an entity has such a choice, paragraph 14(b) of Ind AS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires the chosen policy to result in the financial statements providing reliable and more relevant information about the effects of transactions, other events and conditions on the entity's financial position, financial performance or cash flows. In the case of designation as at fair value through profit or loss, paragraph 9 sets out the two circumstances when the requirement for more relevant information will be met. Accordingly, to choose such designation in accordance with

paragraph 9, the entity needs to demonstrate that it falls within one (or both) of these two circumstances.

Paragraph 9(b)(i): Designation eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise

AG4D Under Ind AS 39, measurement of a financial asset or financial liability and classification of recognised changes in its value are determined by the item's classification and whether the item is part of a designated hedging relationship. Those requirements can create a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') when, for example, in the absence of designation as at fair value through profit or loss, a financial asset would be classified as available for sale (with most changes in fair value recognised in other comprehensive income) and a liability the entity considers related would be measured at amortised cost (with changes in fair value not recognised). In such circumstances, an entity may conclude that its financial statements would provide more relevant information if both the asset and the liability were classified as at fair value through profit or loss.

AG4E The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through profit or loss only if it meets the principle in paragraph 9(b)(i).

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

(b) An entity has liabilities under insurance contracts whose measurement incorporates current information (as permitted by Ind AS 104, paragraph 24), and financial assets it considers related that would otherwise be classified as available for sale or measured at amortised cost.

(c) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other. However, only some of the instruments would be measured at fair value through profit or loss (ie are derivatives, or are classified as held for trading). It may also be the case that the requirements for hedge accounting are not met, for example because the requirements for effectiveness in paragraph 88 are not met.

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

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

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

AG4F In cases such as those described in the preceding paragraph, to designate, at initial recognition, the financial assets and financial liabilities not otherwise so measured as at fair value through profit or loss may eliminate or significantly reduce the measurement or recognition inconsistency and produce more relevant information. For practical purposes, the entity need not enter into all of the assets and liabilities giving rise to the measurement or recognition inconsistency at exactly the same time. A reasonable delay is permitted provided that each transaction is designated as at fair value through profit or loss at its initial recognition and, at that time, any remaining transactions are expected to occur.

AG4G It would not be acceptable to designate only some of the financial assets and financial liabilities giving rise to the inconsistency as at fair value through profit or loss if to do so would not eliminate or significantly reduce the inconsistency and would therefore not result in more relevant information. However, it would be acceptable to designate only some of a number of similar financial assets or similar financial liabilities if doing so achieves a significant reduction (and possibly a greater reduction than other allowable designations) in the inconsistency. For example, assume an entity has a number of similar financial liabilities that sum to Rs.100 and a number of similar financial assets that sum to Rs.50 but are measured on a different basis. The entity may significantly reduce the measurement inconsistency by designating at initial recognition all of the assets but only some of the liabilities (for example, individual liabilities with a combined total of Rs.45) as at fair value through profit or loss. However, because designation as at fair value through profit or loss can be applied only to the whole of a financial instrument, the entity in this example must designate one or more liabilities in their entirety. It could not designate either a component of a liability (eg changes in value attributable to only one risk, such as changes in a benchmark interest rate) or a proportion (ie percentage) of a liability.

Paragraph 9(b)(ii): A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy

AG4H An entity may manage and evaluate the performance of a group of financial assets, financial liabilities or both in such a way that measuring that group at fair

value through profit or loss results in more relevant information. The focus in this instance is on the way the entity manages and evaluates performance, rather than on the nature of its financial instruments.

AG4I The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through profit or loss only if it meets the principle in paragraph 9(b)(ii).

(a) The entity is a venture capital organisation, mutual fund, unit trust or similar entity whose business is investing in financial assets with a view to profiting from their total return in the form of interest or dividends and changes in fair value. Ind AS 28 and Ind AS 31 allow such investments to be excluded from their scope provided they are measured at fair value through profit or loss. An entity may apply the same accounting policy to other investments managed on a total return basis but over which its influence is insufficient for them to be within the scope of Ind AS 28 or Ind AS 31.

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

(c) The entity is an insurer that holds a portfolio of financial assets, manages that portfolio so as to maximise its total return (ie interest or dividends and changes in fair value), and evaluates its performance on that basis. The portfolio may be held to back specific liabilities, equity or both. If the portfolio is held to back specific liabilities, the condition in paragraph 9(b)(ii) may be met for the assets regardless of whether the insurer also manages and evaluates the liabilities on a fair value basis. The condition in paragraph 9(b)(ii) may be met when the insurer's objective is to maximise total return on the assets over the longer term even if amounts paid to holders of participating contracts depend on other factors such as the amount of gains realised in a shorter period (eg a year) or are subject to the insurer's discretion.

AG4J As noted above, this condition relies on the way the entity manages and evaluates performance of the group of financial instruments under consideration. Accordingly, (subject to the requirement of designation at initial recognition) an entity that designates financial instruments as at fair value through profit or loss on the basis of this condition shall so designate all eligible financial instruments that are managed and evaluated together.

AG4K Documentation of the entity's strategy need not be extensive but should be sufficient to demonstrate compliance with paragraph 9(b)(ii). Such documentation is not required for each individual item, but may be on a portfolio basis. For example, if the performance management system for a department—as approved by the entity's key management personnel—clearly demonstrates that

its performance is evaluated on a total return basis, no further documentation is required to demonstrate compliance with paragraph 9(b)(ii).

Effective interest rate

AG5 In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. Entities include such incurred credit losses in the estimated cash flows when computing the effective interest rate.

AG6 When applying the effective interest method, an entity generally amortises any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the instrument. However, a shorter period is used if this is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate. This will be the case when the variable to which the fees, points paid or received, transaction costs, premiums or discounts relate is repriced to market rates before the expected maturity of the instrument. In such a case, the appropriate amortisation period is the period to the next such repricing date. For example, if a premium or discount on a floating rate instrument reflects interest that has accrued on the instrument since interest was last paid, or changes in market rates since the floating interest rate was reset to market rates, it will be amortised to the next date when the floating interest is reset to market rates. This is because the premium or discount relates to the period to the next interest reset date because, at that date, the variable to which the premium or discount relates (ie interest rates) is reset to market rates. If, however, the premium or discount results from a change in the credit spread over the floating rate specified in the instrument, or other variables that are not reset to market rates, it is amortised over the expected life of the instrument.

AG7 For floating rate financial assets and floating rate financial liabilities, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate. If a floating rate financial asset or floating rate financial liability is recognised initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or liability.

AG8 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 recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate or, when applicable, the revised effective interest rate calculated in accordance with paragraph 92. The adjustment is recognised in profit or loss as income or expense. If a financial asset is reclassified in accordance with paragraph 50B, 50D or 50E, and the entity subsequently increases its estimates of future cash receipts as a result of increased recoverability of those cash receipts, the effect of that increase shall be recognised as an adjustment to the effective interest rate from the date of the change in estimate rather than as an adjustment to the carrying amount of the asset at the date of the change in estimate.

Derivatives

AG9 Typical examples of derivatives are futures and forward, swap and option contracts. A derivative usually has a notional amount, which is an amount of currency, a number of shares, a number of units of weight or volume or other units specified in the contract. However, a derivative instrument does not require the holder or writer to invest or receive the notional amount at the inception of the contract. Alternatively, a derivative could require a fixed payment or payment of an amount that can change (but not proportionally with a change in the underlying) as a result of some future event that is unrelated to a notional amount. For example, a contract may require a fixed payment of Rs.1,000 if six-month MIBOR increases by 100 basis points. Such a contract is a derivative even though a notional amount is not specified.

AG10 The definition of a derivative in this Standard includes contracts that are settled gross by delivery of the underlying item (eg a forward contract to purchase a fixed rate debt instrument). An entity may have a contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument or by exchanging financial instruments (eg a contract to buy or sell a commodity at a fixed price at a future date). Such a contract is within the scope of this Standard unless it was entered into and continues to be held for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (see paragraphs 5–7).

AG11 One of the defining characteristics of a derivative is that it has an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. An option contract meets that definition because the premium is less than the investment that would be required to obtain the underlying financial instrument to which the option is linked. A currency swap that requires an initial exchange of different currencies of equal fair values meets the definition because it has a zero initial net investment.

AG12 A regular way purchase or sale gives rise to a fixed price commitment between trade date and settlement date that meets the definition of a derivative. However, because of the short duration of the commitment it is not recognised as a derivative financial instrument. Rather, this Standard provides for special accounting for such regular way contracts (see paragraphs 38 and AG53–AG56).

AG12A The definition of a derivative refers to non-financial variables that are not specific to a party to the contract. These include an index of earthquake losses in a particular region and an index of temperatures in a particular city. Non-financial variables specific to a party to the contract include the occurrence or non-occurrence of a fire that damages or destroys an asset of a party to the contract. A change in the fair value of a non-financial asset is specific to the owner if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific non-financial asset held (a non-financial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car's physical condition, the change in that residual value is specific to the owner of the car.

Transaction costs

AG13 Transaction costs include fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

Financial assets and financial liabilities held for trading

AG14 Trading generally reflects active and frequent buying and selling, and financial instruments held for trading generally are used with the objective of generating a profit from short-term fluctuations in price or dealer's margin.

AG15Financial liabilities held for trading include:

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

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

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

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

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

Held-to-maturity investments

AG16 An entity does not have a positive intention to hold to maturity an investment in a financial asset with a fixed maturity if:

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

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

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

AG17 A debt instrument with a variable interest rate can satisfy the criteria for a held-to-maturity investment. Equity instruments cannot be held-to-maturity investments either because they have an indefinite life (such as ordinary shares) or because the amounts the holder may receive can vary in a manner that is not predetermined (such as for share options, warrants and similar rights). With respect to the definition of held-to-maturity investments, fixed or determinable payments and fixed maturity mean that a contractual arrangement

defines the amounts and dates of payments to the holder, such as interest and principal payments. A significant risk of non-payment does not preclude classification of a financial asset as held to maturity as long as its contractual payments are fixed or determinable and the other criteria for that classification are met. If the terms of a perpetual debt instrument provide for interest payments for an indefinite period, the instrument cannot be classified as held to maturity because there is no maturity date.

AG18 The criteria for classification as a held-to-maturity investment are met for a financial asset that is callable by the issuer if the holder intends and is able to hold it until it is called or until maturity and the holder would recover substantially all of its carrying amount. The call option of the issuer, if exercised, simply accelerates the asset's maturity. However, if the financial asset is callable on a basis that would result in the holder not recovering substantially all of its carrying amount, the financial asset cannot be classified as a held-to-maturity investment. The entity considers any premium paid and capitalised transaction costs in determining whether the carrying amount would be substantially recovered.

AG19 A financial asset that is puttable (ie the holder has the right to require that the issuer repay or redeem the financial asset before maturity) cannot be classified as a held-to-maturity investment because paying for a put feature in a financial asset is inconsistent with expressing an intention to hold the financial asset until maturity.

AG20 For most financial assets, fair value is a more appropriate measure than amortised cost. The held-to-maturity classification is an exception, but only if the entity has a positive intention and the ability to hold the investment to maturity. When an entity's actions cast doubt on its intention and ability to hold such investments to maturity, paragraph 9 precludes the use of the exception for a reasonable period of time.

AG21 A disaster scenario that is only remotely possible, such as a run on a bank or a similar situation affecting an insurer, is not something that is assessed by an entity in deciding whether it has the positive intention and ability to hold an investment to maturity.

AG22 Sales before maturity could satisfy the condition in paragraph 9—and therefore not raise a question about the entity's intention to hold other investments to maturity—if they are attributable to any of the following:

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

that a financial asset is impaired (see paragraphs 58 and 59), the deterioration in creditworthiness is often regarded as significant.

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

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

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

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

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

AG23 An entity does not have a demonstrated ability to hold to maturity an investment in a financial asset with a fixed maturity if:

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

(b) it is subject to an existing legal or other constraint that could frustrate its intention to hold the financial asset to maturity. (However, an issuer's call option does not necessarily frustrate an entity's intention to hold a financial asset to maturity—see paragraph AG18.)

AG24 Circumstances other than those described in paragraphs AG16–AG23 can indicate that an entity does not have a positive intention or the ability to hold an investment to maturity.

AG25 An entity assesses its intention and ability to hold its held-to-maturity investments to maturity not only when those financial assets are initially recognised, but also at the end of each subsequent reporting period.

Loans and receivables

AG26 Any non-derivative financial asset with fixed or determinable payments (including loan assets, trade receivables, investments in debt instruments and deposits held in banks) could potentially meet the definition of loans and receivables. However, a financial asset that is quoted in an active market (such as a quoted debt instrument, see paragraph AG71) does not qualify for classification as a loan or receivable. Financial assets that do not meet the definition of loans and receivables may be classified as held-to-maturity investments if they meet the conditions for that classification (see paragraphs 9 and AG16–AG25). On initial

recognition of a financial asset that would otherwise be classified as a loan or receivable, an entity may designate it as a financial asset at fair value through profit or loss, or available for sale.

Embedded derivatives (paragraphs 10–13)

AG27 If a host contract has no stated or predetermined maturity and represents a residual interest in the net assets of an entity, then its economic characteristics and risks are those of an equity instrument, and an embedded derivative would need to possess equity characteristics related to the same entity to be regarded as closely related. If the host contract is not an equity instrument and meets the definition of a financial instrument, then its economic characteristics and risks are those of a debt instrument.

AG28 An embedded non-option derivative (such as an embedded forward or swap) is separated from its host contract on the basis of its stated or implied substantive terms, so as to result in it having a fair value of zero at initial recognition. An embedded option-based derivative (such as an embedded put, call, cap, floor or swaption) is separated from its host contract on the basis of the stated terms of the option feature. The initial carrying amount of the host instrument is the residual amount after separating the embedded derivative.

AG29 Generally, multiple embedded derivatives in a single instrument are treated as a single compound embedded derivative. However, embedded derivatives that are classified as equity (see Ind AS 32) are accounted for separately from those classified as assets or liabilities. In addition, if an instrument has more than one embedded derivative and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other.

AG30 The economic characteristics and risks of an embedded derivative are not closely related to the host contract (paragraph 11(a)) in the following examples. In these examples, assuming the conditions in paragraph 11(b) and (c) are met, an entity accounts for the embedded derivative separately from the host contract.

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

(b) A call option embedded in an equity instrument that enables the issuer to reacquire that equity instrument at a specified price is not closely related to the host equity instrument from the perspective of the holder (from the issuer's perspective, the call option is an equity instrument provided it meets the conditions for that classification under Ind AS 32, in which case it is excluded from the scope of this Standard).

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

the term to maturity of the debt instrument provided the issuer can be required to participate in or facilitate the remarketing of the debt instrument as a result of the call option being exercised.

(d) Equity-indexed interest or principal payments embedded in a host debt instrument or insurance contract—by which the amount of interest or principal is indexed to the value of equity instruments—are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.

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

(f) An equity conversion feature embedded in a convertible debt instrument is not closely related to the host debt instrument from the perspective of the holder of the instrument (from the issuer's perspective, the equity conversion option is an equity instrument and excluded from the scope of this Standard provided it meets the conditions for that classification under Ind AS 32).

(g) A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless:

(i) the option's exercise price is approximately equal on each exercise date to the amortised cost of the host debt instrument or the carrying amount of the host insurance contract; or

(ii) the exercise price of a prepayment option reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract. Lost interest is the product of the principal amount prepaid multiplied by the interest rate differential. The interest rate differential is the excess of the effective interest rate of the host contract over the effective interest rate the entity would receive at the prepayment date if it reinvested the principal amount prepaid in a similar contract for the remaining term of the host contract.

The assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element of a convertible debt instrument in accordance with Ind AS 32.

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

AG31 An example of a hybrid instrument is a financial instrument that gives the holder a right to put the financial instrument back to the issuer in exchange for an

amount of cash or other financial assets that varies on the basis of the change in an equity or commodity index that may increase or decrease (a 'puttable instrument'). Unless the issuer on initial recognition designates the puttable instrument as a financial liability at fair value through profit or loss, it is required to separate an embedded derivative (ie the indexed principal payment) under paragraph 11 because the host contract is a debt instrument under paragraph AG27 and the indexed principal payment is not closely related to a host debt instrument under paragraph AG30(a). Because the principal payment can increase and decrease, the embedded derivative is a non-option derivative whose value is indexed to the underlying variable.

AG32 In the case of a puttable instrument that can be put back at any time for cash equal to a proportionate share of the net asset value of an entity (such as units of an open-ended mutual fund or some unit-linked investment products), the effect of separating an embedded derivative and accounting for each component is to measure the combined instrument at the redemption amount that is payable at the end of the reporting period if the holder exercised its right to put the instrument back to the issuer.

AG33 The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract in the following examples. In these examples, an entity does not account for the embedded derivative separately from the host contract.

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

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

(c) An embedded foreign currency derivative that provides a stream of principal or interest payments that are denominated in a foreign currency and is embedded in a host debt instrument (eg a dual currency bond) is closely related to the host debt instrument. Such a derivative is not separated from the host instrument because Ind AS 21 requires foreign currency gains and losses on monetary items to be recognised in profit or loss.

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

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

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

(iii) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade).

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

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

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

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

Instruments containing embedded derivatives

AG33A When an entity becomes a party to a hybrid (combined) instrument that contains one or more embedded derivatives, paragraph 11 requires the entity to identify any such embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently. These requirements can be more complex, or result in less reliable measures,

than measuring the entire instrument at fair value through profit or loss. For that reason this Standard permits the entire instrument to be designated as at fair value through profit or loss.

AG33B Such designation may be used whether paragraph 11 requires the embedded derivatives to be separated from the host contract or prohibits such separation. However, paragraph 11A would not justify designating the hybrid (combined) instrument as at fair value through profit or loss in the cases set out in paragraph 11A(a) and (b) because doing so would not reduce complexity or increase reliability.

Recognition and derecognition (paragraphs 14–42)

Initial recognition (paragraph 14)

AG34 As a consequence of the principle in paragraph 14, an entity recognises all of its contractual rights and obligations under derivatives in its balance sheet as assets and liabilities, respectively, except for derivatives that prevent a transfer of financial assets from being accounted for as a sale (see paragraph AG49). If a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset (see paragraph AG50).

AG35 The following are examples of applying the principle in paragraph 14:

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

(b) assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognised until at least one of the parties has performed under the agreement. For example, an entity that receives a firm order does not generally recognise an asset (and the entity that places the order does not recognise a liability) at the time of the commitment but, rather, delays recognition until the ordered goods or services have been shipped, delivered or rendered. If a firm commitment to buy or sell non-financial items is within the scope of this Standard under paragraphs 5–7, its net fair value is recognised as an asset or liability on the commitment date (see (c) below). In addition, if a previously unrecognised firm commitment is designated as a hedged item in a fair value hedge, any change in the net fair value attributable to the hedged risk is recognised as an asset or liability after the inception of the hedge (see paragraphs 93 and 94).

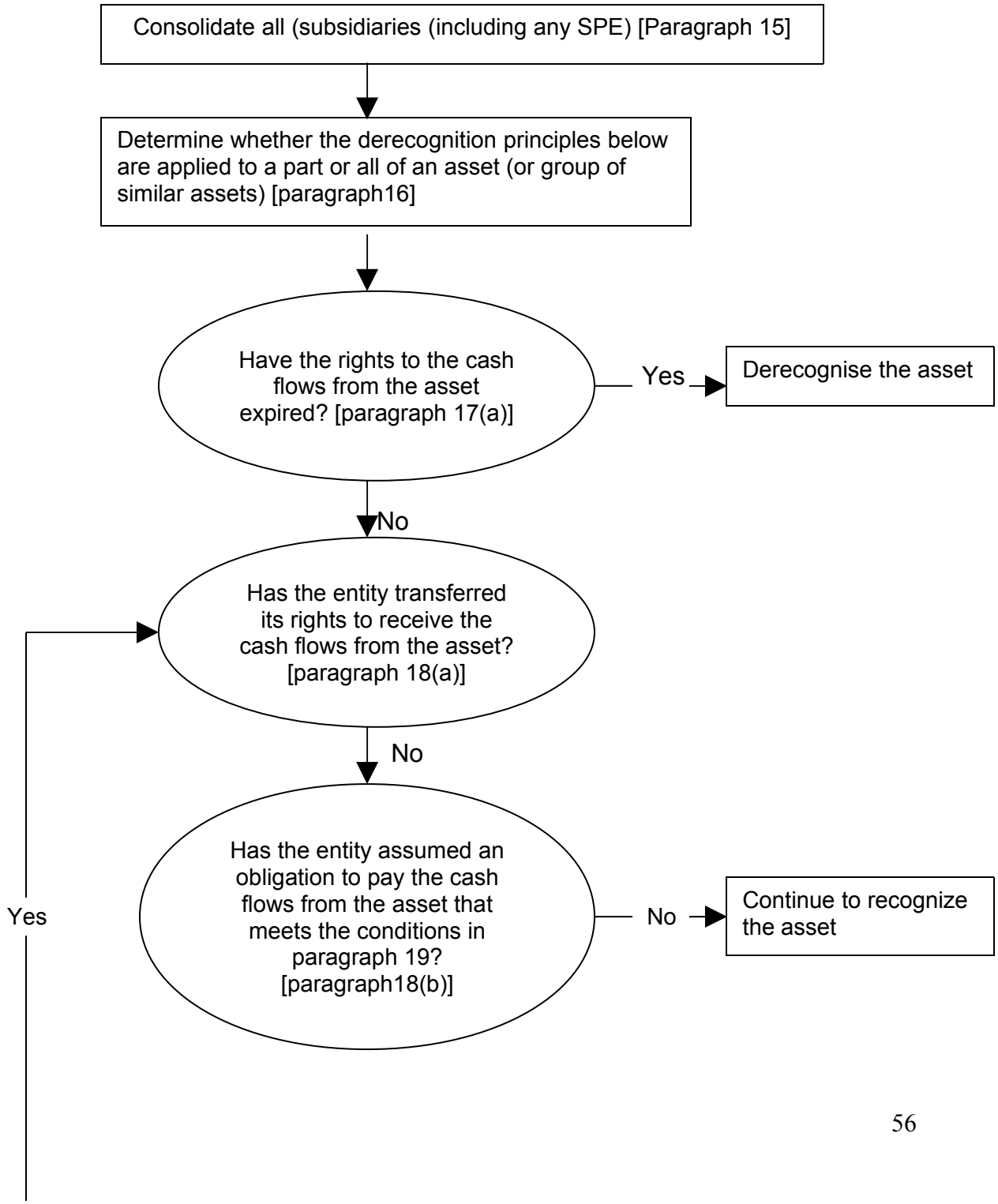
(c) a forward contract that is within the scope of this Standard (see paragraphs 2–7) is recognised as an asset or a liability on the commitment date, rather than on the date on which settlement takes place. When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero. If the net fair value of the right and obligation is not zero, the contract is recognised as an asset or liability.

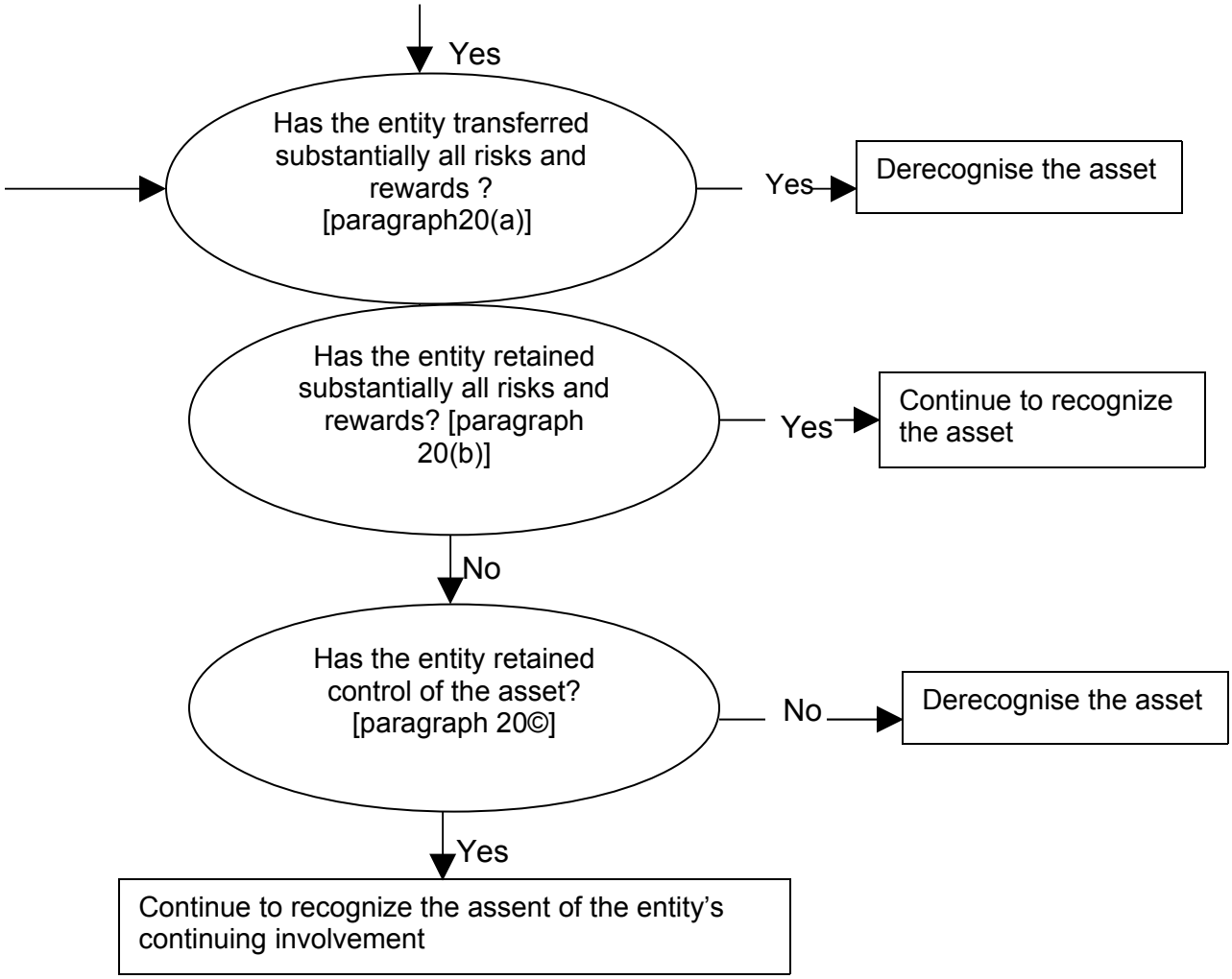
(d) option contracts that are within the scope of this Standard (see paragraphs 2–7) are recognised as assets or liabilities when the holder or writer becomes a party to the contract.

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

Derecognition of a financial asset (paragraphs 15–37)

AG36 The following flow chart illustrates the evaluation of whether and to what extent a financial asset is derecognised.





Arrangements under which an entity retains the contractual rights to receive the cash flows of a financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients (paragraph 18(b))

AG37 The situation described in paragraph 18(b) (when an entity retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients) occurs, for example, if the entity is a special purpose entity or trust, and issues to investors beneficial interests in the underlying financial assets that it owns and provides servicing of those financial assets. In that case, the financial assets qualify for derecognition if the conditions in paragraphs 19 and 20 are met.

AG38 In applying paragraph 19, the entity could be, for example, the originator of the financial asset, or it could be a group that includes a consolidated special purpose entity that has acquired the financial asset and passes on cash flows to unrelated third party investors.

Evaluation of the transfer of risks and rewards of ownership (paragraph 20)

AG39 Examples of when an entity has transferred substantially all the risks and rewards of ownership are:

(a) an unconditional sale of a financial asset;

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

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

AG40 Examples of when an entity has retained substantially all the risks and rewards of ownership are:

(a) a sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return;

(b) a securities lending agreement;

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

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

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

AG41 If an entity determines that as a result of the transfer, it has transferred substantially all the risks and rewards of ownership of the transferred asset, it does not recognise the transferred asset again in a future period, unless it reacquires the transferred asset in a new transaction.

Evaluation of the transfer of control

AG42 An entity has not retained control of a transferred asset if the transferee has the practical ability to sell the transferred asset. An entity has retained control of a transferred asset if the transferee does not have the practical ability to sell the transferred asset. A transferee has the practical ability to sell the transferred asset if it is traded in an active market because the transferee could repurchase the transferred asset in the market if it needs to return the asset to the entity. For example, a transferee may have the practical ability to sell a transferred asset if the transferred asset is subject to an option that allows the entity to repurchase it, but the transferee can readily obtain the transferred asset in the market if the option is exercised. A transferee does not have the practical ability to sell the transferred asset if the entity retains such an option and the transferee cannot readily obtain the transferred asset in the market if the entity exercises its option.

AG43 The transferee has the practical ability to sell the transferred asset only if the transferee can sell the transferred asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without imposing additional restrictions on the transfer. The critical question is what the transferee is able to

do in practice, not what contractual rights the transferee has concerning what it can do with the transferred asset or what contractual prohibitions exist. In particular:

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

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

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

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

AG44 That the transferee is unlikely to sell the transferred asset does not, of itself, mean that the transferor has retained control of the transferred asset. However, if a put option or guarantee constrains the transferee from selling the transferred asset, then the transferor has retained control of the transferred asset. For example, if a put option or guarantee is sufficiently valuable it constrains the transferee from selling the transferred asset because the transferee would, in practice, not sell the transferred asset to a third party without attaching a similar option or other restrictive conditions. Instead, the transferee would hold the transferred asset so as to obtain payments under the guarantee or put option. Under these circumstances the transferor has retained control of the transferred asset.

Transfers that qualify for derecognition

AG45 An entity may retain the right to a part of the interest payments on transferred assets as compensation for servicing those assets. The part of the interest payments that the entity would give up upon termination or transfer of the servicing contract is allocated to the servicing asset or servicing liability. The part of the interest payments that the entity would not give up is an interest-only strip receivable. For example, if the entity would not give up any interest upon termination or transfer of the servicing contract, the entire interest spread is an interest-only strip receivable. For the purposes of applying paragraph 27, the fair values of the servicing asset and interest-only strip receivable are used to allocate the carrying amount of the receivable between the part of the asset that is derecognised and the part that continues to be recognised. If there is no servicing fee specified or the fee to be received is not expected to compensate the entity adequately for performing the servicing, a liability for the servicing obligation is recognised at fair value.

AG46 In estimating the fair values of the part that continues to be recognised and the part that is derecognised for the purposes of applying paragraph 27, an entity applies the fair value measurement requirements in paragraphs 48–49 and AG69–AG82 in addition to paragraph 28.

Transfers that do not qualify for derecognition

AG47 The following is an application of the principle outlined in paragraph 29. If a guarantee provided by the entity for default losses on the transferred asset prevents a transferred asset from being derecognised because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the transferred asset continues to be recognised in its entirety and the consideration received is recognised as a liability.

Continuing involvement in transferred assets

AG48 The following are examples of how an entity measures a transferred asset and the associated liability under paragraph 30.

All assets

(a) If a guarantee provided by an entity to pay for default losses on a transferred asset prevents the transferred asset from being derecognised to the extent of the continuing involvement, the transferred asset at the date of the transfer is measured at the lower of (i) the carrying amount of the asset and (ii) the maximum amount of the consideration received in the transfer that the entity could be required to repay ('the guarantee amount'). The associated liability is initially measured at the guarantee amount plus the fair value of the guarantee (which is normally the consideration received for the guarantee). Subsequently, the initial fair value of the guarantee is recognised in profit or loss on a time proportion basis (see Ind AS 18) and the carrying value of the asset is reduced by any impairment losses.

Assets measured at amortised cost

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

Assets measured at fair value

(c) If a call option right retained by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at fair value, the asset continues to be measured at its fair value. The associated liability is measured at (i) the option exercise price less the time value of the option if the option is in or at the money, or (ii) the fair value of the transferred asset less the time value of the option if the option is out of the money. The adjustment to the measurement of the associated liability

ensures that the net carrying amount of the asset and the associated liability is the fair value of the call option right. For example, if the fair value of the underlying asset is Rs.80, the option exercise price is Rs.95 and the time value of the option is Rs.5, the carrying amount of the associated liability is Rs.75 (Rs.80 – Rs.5) and the carrying amount of the transferred asset is Rs.80 (ie its fair value).

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

(e) If a collar, in the form of a purchased call and written put, prevents a transferred asset from being derecognised and the entity measures the asset at fair value, it continues to measure the asset at fair value. The associated liability is measured at (i) the sum of the call exercise price and fair value of the put option less the time value of the call option, if the call option is in or at the money, or (ii) the sum of the fair value of the asset and the fair value of the put option less the time value of the call option if the call option is out of the money. The adjustment to the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the options held and written by the entity. For example, assume an entity transfers a financial asset that is measured at fair value while simultaneously purchasing a call with an exercise price of Rs.120 and writing a put with an exercise price of Rs.80. Assume also that the fair value of the asset is Rs.100 at the date of the transfer. The time value of the put and call are Rs.1 and Rs.5 respectively. In this case, the entity recognises an asset of Rs.100 (the fair value of the asset) and a liability of Rs.96 [(Rs.100 + Rs.1) – Rs.5]. This gives a net asset value of Rs.4, which is the fair value of the options held and written by the entity.

All transfers

AG49 To the extent that a transfer of a financial asset does not qualify for derecognition, the transferor's contractual rights or obligations related to the transfer are not accounted for separately as derivatives if recognising both the derivative and either the transferred asset or the liability arising from the transfer would result in recognising the same rights or obligations twice. For example, a call option retained by the transferor may prevent a transfer of financial assets from being accounted for as a sale. In that case, the call option is not separately recognised as a derivative asset.

AG50 To the extent that a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset. The transferee derecognises the cash or other consideration paid and recognises a receivable from the transferor. If the transferor has both a right and an obligation to reacquire control of the entire transferred asset for a fixed amount (such as under a repurchase agreement), the transferee may account for its receivable as a loan or receivable.

Examples

AG51 The following examples illustrate the application of the derecognition principles of this Standard.

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

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

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

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

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

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

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

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

(i) *A not readily obtainable asset subject to a put option written by an entity that is neither deeply in the money nor deeply out of the money.* If an entity transfers a financial asset that is not readily obtainable in the market, and writes a put option that is not deeply out of the money, the entity neither retains nor transfers substantially all the risks and rewards of ownership because of the written put option. The entity retains control of the asset if the put option is sufficiently valuable to prevent the transferee from selling the asset, in which case the asset continues to be recognised to the extent of the transferor's continuing involvement (see paragraph AG44). The entity transfers control of the asset if the put option is not sufficiently valuable to prevent the transferee from selling the asset, in which case the asset is derecognised.

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

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

repurchase agreement is settled net in cash does not automatically mean that the entity has transferred control (see paragraphs AG44 and (g), (h) and (i) above).

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

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

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

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

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

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

AG52 This paragraph illustrates the application of the continuing involvement approach when the entity's continuing involvement is in a part of a financial asset.

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

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

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

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

enhancement is Rs.65 (Rs.25 + Rs.40).

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

	Estimated fair value	*Percentage*	*Allocated carrying amount*
Portion transferred	9,090	90%	9,000
Portion retained	1,010	10%	1,000
Total	**10,100**		**10,000**

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

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

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

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

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

(which includes the excess spread of Rs.40).

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

Regular way purchase or sale of a financial asset (paragraph 38)

AG53 A regular way purchase or sale of financial assets is recognised using either trade date accounting or settlement date accounting as described in paragraphs AG55 and AG56. The method used is applied consistently for all purchases and sales of financial assets that belong to the same category of financial assets defined in paragraph 9. For this purpose assets that are held for trading form a separate category from assets designated at fair value through profit or loss.

AG54 A contract that requires or permits net settlement of the change in the value of the contract is not a regular way contract. Instead, such a contract is accounted for as a derivative in the period between the trade date and the settlement date.

AG55 The trade date is the date that an entity commits itself to purchase or sell an asset. Trade date accounting refers to (a) the recognition of an asset to be received and the liability to pay for it on the trade date, and (b) derecognition of an asset that is sold, recognition of any gain or loss on disposal and the recognition of a receivable from the buyer for payment on the trade date. Generally, interest does not start to accrue on the asset and corresponding liability until the settlement date when title passes.

AG56 The settlement date is the date that an asset is delivered to or by an entity. Settlement date accounting refers to (a) the recognition of an asset on the day it is received by the entity, and (b) the derecognition of an asset and recognition of any gain or loss on disposal on the day that it is delivered by the entity. When settlement date accounting is applied an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset. In other words, the change in value is not recognised for assets carried at cost or amortised cost; it is recognised in profit or loss for assets classified as financial assets at fair value through profit or loss; and it is recognised in other comprehensive income for assets classified as available for sale.

Derecognition of a financial liability (paragraphs 39–42)

AG57 A financial liability (or part of it) is extinguished when the debtor either:

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

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

AG58 If an issuer of a debt instrument repurchases that instrument, the debt is extinguished even if the issuer is a market maker in that instrument or intends to resell it in the near term.

AG59 Payment to a third party, including a trust (sometimes called 'in-substance defeasance'), does not, by itself, relieve the debtor of its primary obligation to the creditor, in the absence of legal release.

AG60 If a debtor pays a third party to assume an obligation and notifies its creditor that the third party has assumed its debt obligation, the debtor does not derecognise the debt obligation unless the condition in paragraph AG57(b) is met. If the debtor pays a third party to assume an obligation and obtains a legal release from its creditor, the debtor has extinguished the debt. However, if the debtor agrees to make payments on the debt to the third party or direct to its original creditor, the debtor recognises a new debt obligation to the third party.

AG61 Although legal release, whether judicially or by the creditor, results in derecognition of a liability, the entity may recognise a new liability if the derecognition criteria in paragraphs 15–37 are not met for the financial assets transferred. If those criteria are not met, the transferred assets are not derecognised, and the entity recognises a new liability relating to the transferred assets.

AG62 For the purpose of paragraph 40, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.

AG63 In some cases, a creditor releases a debtor from its present obligation to make payments, but the debtor assumes a guarantee obligation to pay if the party assuming primary responsibility defaults. In this circumstance the debtor:

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

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

Measurement (paragraphs 43–70)

Initial measurement of financial assets and financial liabilities (paragraph 43)

AG64 The fair value of a financial instrument on initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also paragraph AG76). However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated, using a valuation technique (see paragraphs AG74–AG79). For example, the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset.

AG65 If an entity originates a loan that bears an off-market interest rate (eg 5 per cent when the market rate for similar loans is 8 per cent), and receives an upfront fee as compensation, the entity recognises the loan at its fair value, ie net of the fee it receives. The entity accretes the discount to profit or loss using the effective interest rate method.

Subsequent measurement of financial assets (paragraphs 45 and 46)

AG66 If a financial instrument that was previously recognised as a financial asset is measured at fair value and its fair value falls below zero, it is a financial liability measured in accordance with paragraph 47.

AG67 The following example illustrates the accounting for transaction costs on the initial and subsequent measurement of an available-for-sale financial asset. An asset is acquired for Rs.100 plus a purchase commission of Rs.2. Initially, the asset is recognised at Rs.102. The end of the reporting period occurs one day later, when the quoted market price of the asset is Rs.100. If the asset were sold, a commission of Rs.3 would be paid. On that date, the asset is measured at Rs.100 (without regard to the possible commission on sale) and a loss of Rs.2 is recognised in other comprehensive income. If the available-for-sale financial asset has fixed or determinable payments, the transaction costs are amortised to profit or loss using the effective interest method. If the available-for-sale financial asset does not have fixed or determinable payments, the transaction costs are recognised in profit or loss when the asset is derecognised or becomes impaired.

AG68 Instruments that are classified as loans and receivables are measured at amortised cost without regard to the entity's intention to hold them to maturity.

Fair value measurement considerations (paragraphs 48–49)

AG69 Underlying the definition of fair value is a presumption that an entity is a going concern without any intention or need to liquidate, to curtail materially the scale

of its operations or to undertake a transaction on adverse terms. Fair value is not, therefore, the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale. However, fair value reflects the credit quality of the instrument.

AG70 This Standard uses the terms 'bid price' and 'asking price' (sometimes referred to as 'current offer price') in the context of quoted market prices, and the term 'the bid-ask spread' to include only transaction costs. Other adjustments to arrive at fair value (eg for counterparty credit risk) are not included in the term 'bid-ask spread'.

Active market: quoted price

AG71 A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. Fair value is defined in terms of a price agreed by a willing buyer and a willing seller in an arm's length transaction. The objective of determining fair value for a financial instrument that is traded in an active market is to arrive at the price at which a transaction would occur at the end of the reporting period in that instrument (ie without modifying or repackaging the instrument) in the most advantageous active market to which the entity has immediate access. However, the entity adjusts the price in the more advantageous market to reflect any differences in counterparty credit risk between instruments traded in that market and the one being valued. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used to measure the financial asset or financial liability.

AG72 The appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the asking price. When an entity has assets and liabilities with offsetting market risks, it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate. When current bid and asking prices are unavailable, the price of the most recent transaction provides evidence of the current fair value as long as there has not been a significant change in economic circumstances since the time of the transaction. If conditions have changed since the time of the transaction (eg a change in the risk-free interest rate following the most recent price quote for a corporate bond), the fair value reflects the change in conditions by reference to current prices or rates for similar financial instruments, as appropriate. Similarly, if the entity can demonstrate that the last transaction price is not fair value (eg because it reflected the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale), that price is adjusted. The fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price. If a published price quotation in an active market does not exist for a financial instrument in its entirety, but active markets exist for its component parts, fair value is determined on the basis of the relevant market prices for the component parts.

AG73 If a rate (rather than a price) is quoted in an active market, the entity uses that market-quoted rate as an input into a valuation technique to determine fair value.

If the market-quoted rate does not include credit risk or other factors that market participants would include in valuing the instrument, the entity adjusts for those factors.

No active market: valuation technique

AG74 If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.

AG75 The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Fair value is estimated on the basis of the results of a valuation technique that makes maximum use of market inputs, and relies as little as possible on entity-specific inputs. A valuation technique would be expected to arrive at a realistic estimate of the fair value if (a) it reasonably reflects how the market could be expected to price the instrument and (b) the inputs to the valuation technique reasonably represent market expectations and measures of the risk-return factors inherent in the financial instrument.

AG76 Therefore, a valuation technique (a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (ie without modification or repackaging) or based on any available observable market data. An entity obtains market data consistently in the same market where the instrument was originated or purchased. The best evidence of the fair value of a financial instrument at initial recognition is the transaction price (ie the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets.

AG76A The subsequent measurement of the financial asset or financial liability and the subsequent recognition of gains and losses shall be consistent with the requirements of this Standard. The application of paragraph AG76 may result in no gain or loss being recognised on the initial recognition of a financial asset or financial liability. In such a case, Ind AS 39 requires that a gain or loss shall be recognised after initial recognition only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price.

AG77 The initial acquisition or origination of a financial asset or incurrence of a financial liability is a market transaction that provides a foundation for estimating the fair

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

AG78 The same information may not be available at each measurement date. For example, at the date that an entity makes a loan or acquires a debt instrument that is not actively traded, the entity has a transaction price that is also a market price. However, no new transaction information may be available at the next measurement date and, although the entity can determine the general level of market interest rates, it may not know what level of credit or other risk market participants would consider in pricing the instrument on that date. An entity may not have information from recent transactions to determine the appropriate credit spread over the basic interest rate to use in determining a discount rate for a present value computation. It would be reasonable to assume, in the absence of evidence to the contrary, that no changes have taken place in the spread that existed at the date the loan was made. However, the entity would be expected to make reasonable efforts to determine whether there is evidence that there has been a change in such factors. When evidence of a change exists, the entity would consider the effects of the change in determining the fair value of the financial instrument.

AG79 In applying discounted cash flow analysis, an entity uses one or more discount rates equal to the prevailing rates of return for financial instruments having substantially the same terms and characteristics, including the credit quality of the instrument, the remaining term over which the contractual interest rate is fixed, the remaining term to repayment of the principal and the currency in which payments are to be made. Short-term receivables and payables with no stated interest rate may be measured at the original invoice amount if the effect of discounting is immaterial.

No active market: equity instruments

AG80 The fair value of investments in equity instruments that do not have a quoted market price in an active market and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 46(c) and 47) is reliably measurable if (a) the variability in the range of reasonable fair value estimates is not significant for that instrument or (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.

AG81 There are many situations in which the variability in the range of reasonable fair value estimates of investments in equity instruments that do not have a quoted market price and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 46(c) and 47) is likely not to be significant. Normally it is possible to estimate the fair value of a financial asset that an entity has acquired from an outside party. However, if the range of reasonable fair value estimates is significant and the probabilities of the various estimates cannot be reasonably assessed, an entity is precluded from measuring the instrument at fair value.

Inputs to valuation techniques

AG82 An appropriate technique for estimating the fair value of a particular financial instrument would incorporate observable market data about the market conditions and other factors that are likely to affect the instrument's fair value. The fair value of a financial instrument will be based on one or more of the following factors (and perhaps others).

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

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

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

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

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

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

(g) *Prepayment risk and surrender risk.* Expected prepayment patterns for financial assets and expected surrender patterns for financial liabilities can be estimated on the basis of historical data. (The fair value of a financial liability that can be surrendered by the counterparty cannot be less than the present value of the surrender amount—see paragraph 49.)

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

Gains and losses (paragraphs 55–57)

AG83 An entity applies Ind AS 21 to financial assets and financial liabilities that are monetary items in accordance with Ind AS 21 and denominated in a foreign currency. UnderInd AS 21, any foreign exchange gains and losses on monetary assets and monetary liabilities are recognised in profit or loss. An exception is a monetary item that is designated as a hedging instrument in either a cash flow hedge (see paragraphs 95–101) or a hedge of a net investment (see paragraph 102). For the purpose of recognising foreign exchange gains and losses under Ind AS 21, a monetary available-for-sale financial asset is treated as if it were carried at amortised cost in the foreign currency. Accordingly, for such a financial asset, exchange differences resulting from changes in amortised cost are recognised in profit or loss and other changes in carrying amount are recognised in accordance with paragraph 55(b). For available-for-sale financial assets that are not monetary items under Ind AS 21 (for example, equity instruments), the gain or loss that is recognised in other comprehensive income under paragraph 55(b) includes any related foreign exchange component. If there is a hedging relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in the foreign currency component of those financial instruments are recognised in profit or loss.

Impairment and uncollectibility of financial assets (paragraphs 58–70)

Financial assets carried at amortised cost (paragraphs 63–65)

AG84 Impairment of a financial asset carried at amortised cost is measured using the financial instrument's original effective interest rate because discounting at the current market rate of interest would, in effect, impose fair value measurement on financial assets that are otherwise measured at amortised cost. If the terms of a

loan, receivable or held-to-maturity investment are renegotiated or otherwise modified because of financial difficulties of the borrower or issuer, impairment is measured using the original effective interest rate before the modification of terms. Cash flows relating to short-term receivables are not discounted if the effect of discounting is immaterial. If a loan, receivable or held-to-maturity investment has a variable interest rate, the discount rate for measuring any impairment loss under paragraph 63 is the current effective interest rate(s) determined under the contract. As a practical expedient, a creditor may measure impairment of a financial asset carried at amortised cost on the basis of an instrument's fair value using an observable market price. The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

AG85 The process for estimating impairment considers all credit exposures, not only those of low credit quality. For example, if an entity uses an internal credit grading system it considers all credit grades, not only those reflecting a severe credit deterioration.

AG86 The process for estimating the amount of an impairment loss may result either in a single amount or in a range of possible amounts. In the latter case, the entity recognises an impairment loss equal to the best estimate within the range[2] taking into account all relevant information available before the financial statements are issued about conditions existing at the end of the reporting period.

AG87 For the purpose of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics that are indicative of the debtors' ability to pay all amounts due according to the contractual terms (for example, on the basis of a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status and other relevant factors). The characteristics chosen are relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated. However, loss probabilities and other loss statistics differ at a group level between (a) assets that have been individually evaluated for impairment and found not to be impaired and (b) assets that have not been individually evaluated for impairment, with the result that a different amount of impairment may be required. If an entity does not have a group of assets with similar risk characteristics, it does not make the additional assessment.

AG88 Impairment losses recognised on a group basis represent an interim step pending the identification of impairment losses on individual assets in the group of financial assets that are collectively assessed for impairment. As soon as information is available that specifically identifies losses on individually impaired assets in a group, those assets are removed from the group.

AG89 Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of historical loss experience for assets

[2]Ind AS 37, paragraph 39 contains guidance on how to determine the best estimate in a range of possible outcomes.

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

AG90 As an example of applying paragraph AG89, an entity may determine, on the basis of historical experience, that one of the main causes of default on credit card loans is the death of the borrower. The entity may observe that the death rate is unchanged from one year to the next. Nevertheless, some of the borrowers in the entity's group of credit card loans may have died in that year, indicating that an impairment loss has occurred on those loans, even if, at the year-end, the entity is not yet aware which specific borrowers have died. It would be appropriate for an impairment loss to be recognised for these 'incurred but not reported' losses. However, it would not be appropriate to recognise an impairment loss for deaths that are expected to occur in a future period, because the necessary loss event (the death of the borrower) has not yet occurred.

AG91 When using historical loss rates in estimating future cash flows, it is important that information about historical loss rates is applied to groups that are defined in a manner consistent with the groups for which the historical loss rates were observed. Therefore, the method used should enable each group to be associated with information about past loss experience in groups of assets with similar credit risk characteristics and relevant observable data that reflect current conditions.

AG92 Formula-based approaches or statistical methods may be used to determine impairment losses in a group of financial assets (eg for smaller balance loans) as long as they are consistent with the requirements in paragraphs 63–65 and AG87–AG91. Any model used would incorporate the effect of the time value of money, consider the cash flows for all of the remaining life of an asset (not only the next year), consider the age of the loans within the portfolio and not give rise to an impairment loss on initial recognition of a financial asset.

Interest income after impairment recognition

AG93 Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is thereafter recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

Hedging (paragraphs 71–102)

Hedging instruments (paragraphs 72–77)

Qualifying instruments (paragraphs 72 and 73)

AG94 The potential loss on an option that an entity writes could be significantly greater than the potential gain in value of a related hedged item. In other words, a written option is not effective in reducing the profit or loss exposure of a hedged item. Therefore, a written option does not qualify as a hedging instrument unless it is designated as an offset to a purchased option, including one that is embedded in another financial instrument (for example, a written call option used to hedge a callable liability). In contrast, a purchased option has potential gains equal to or greater than losses and therefore has the potential to reduce profit or loss exposure from changes in fair values or cash flows. Accordingly, it can qualify as a hedging instrument.

AG95 A held-to-maturity investment carried at amortised cost may be designated as a hedging instrument in a hedge of foreign currency risk.

AG96 An investment in an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured or a derivative that is linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 46(c) and 47) cannot be designated as a hedging instrument.

AG97 An entity's own equity instruments are not financial assets or financial liabilities of the entity and therefore cannot be designated as hedging instruments.

Hedged items (paragraphs 78–84)

Qualifying items (paragraphs 78–80)

AG98 A firm commitment to acquire a business in a business combination cannot be a hedged item, except for foreign exchange risk, because the other risks being hedged cannot be specifically identified and measured. These other risks are general business risks.

AG99 An equity method investment cannot be a hedged item in a fair value hedge because the equity method recognises in profit or loss the investor's share of the associate's profit or loss, rather than changes in the investment's fair value. For a similar reason, an investment in a consolidated subsidiary cannot be a hedged item in a fair value hedge because consolidation recognises in profit or loss the subsidiary's profit or loss, rather than changes in the investment's fair value. A hedge of a net investment in a foreign operation is different because it is a hedge of the foreign currency exposure, not a fair value hedge of the change in the value of the investment.

AG99A Paragraph 80 states that in consolidated financial statements the foreign currency risk of a highly probable forecast intragroup transaction may qualify as a hedged item in a cash flow hedge, provided the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss. For this purpose an entity can be a parent, subsidiary, associate, joint venture or branch. If the foreign currency risk of a forecast intragroup transaction does not affect consolidated profit or loss, the intragroup transaction cannot qualify as a hedged item. This is usually the case for royalty payments, interest payments or

management charges between members of the same group unless there is a related external transaction. However, when the foreign currency risk of a forecast intragroup transaction will affect consolidated profit or loss, the intragroup transaction can qualify as a hedged item. An example is forecast sales or purchases of inventories between members of the same group if there is an onward sale of the inventory to a party external to the group. Similarly, a forecast intragroup sale of plant and equipment from the group entity that manufactured it to a group entity that will use the plant and equipment in its operations may affect consolidated profit or loss. This could occur, for example, because the plant and equipment will be depreciated by the purchasing entity and the amount initially recognised for the plant and equipment may change if the forecast intragroup transaction is denominated in a currency other than the functional currency of the purchasing entity.

AG99B If a hedge of a forecast intragroup transaction qualifies for hedge accounting, any gain or loss that is recognised in other comprehensive income in accordance with paragraph 95(a) shall be reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which the foreign currency risk of the hedged transaction affects consolidated profit or loss.

AG99BA An entity can designate all changes in the cash flows or fair value of a hedged item in a hedging relationship. An entity can also designate only changes in the cash flows or fair value of a hedged item above or below a specified price or other variable (a one-sided risk). The intrinsic value of a purchased option hedging instrument (assuming that it has the same principal terms as the designated risk), but not its time value, reflects a one-sided risk in a hedged item. For example, an entity can designate the variability of future cash flow outcomes resulting from a price increase of a forecast commodity purchase. In such a situation, only cash flow losses that result from an increase in the price above the specified level are designated. The hedged risk does not include the time value of a purchased option because the time value is not a component of the forecast transaction that affects profit or loss (paragraph 86(b)).

Designation of financial items as hedged items (paragraphs 81 and 81A)

AG99C If a portion of the cash flows of a financial asset or financial liability is designated as the hedged item, that designated portion must be less than the total cash flows of the asset or liability. For example, in the case of a liability whose effective interest rate is below MIBOR, an entity cannot designate (a) a portion of the liability equal to the principal amount plus interest at MIBOR and (b) a negative residual portion. However, the entity may designate all of the cash flows of the entire financial asset or financial liability as the hedged item and hedge them for only one particular risk (eg only for changes that are attributable to changes in MIBOR). For example, in the case of a financial liability whose effective interest rate is 100 basis points below MIBOR, an entity can designate as the hedged item the entire liability (ie principal plus interest at MIBOR minus 100 basis points) and hedge the change in the fair value or cash flows of that entire liability that is attributable to changes in MIBOR. The entity may also choose a hedge ratio of other than one to one in order to improve the

effectiveness of the hedge as described in paragraph AG100.

AG99D In addition, if a fixed rate financial instrument is hedged some time after its origination and interest rates have changed in the meantime, the entity can designate a portion equal to a benchmark rate that is higher than the contractual rate paid on the item. The entity can do so provided that the benchmark rate is less than the effective interest rate calculated on the assumption that the entity had purchased the instrument on the day it first designates the hedged item. For example, assume an entity originates a fixed rate financial asset of Rs.100 that has an effective interest rate of 6 per cent at a time when MIBOR is 4 per cent. It begins to hedge that asset some time later when MIBOR has increased to 8 per cent and the fair value of the asset has decreased to Rs.90. The entity calculates that if it had purchased the asset on the date it first designates it as the hedged item for its then fair value of Rs.90, the effective yield would have been 9.5 per cent. Because MIBOR is less than this effective yield, the entity can designate a MIBOR portion of 8 per cent that consists partly of the contractual interest cash flows and partly of the difference between the current fair value (ie Rs.90) and the amount repayable on maturity (ie Rs.100).

AG99EParagraph 81 permits an entity to designate something other than the entire fair value change or cash flow variability of a financial instrument. For example:

(a) all of the cash flows of a financial instrument may be designated for cash flow or fair value changes attributable to some (but not all) risks; or

(b) some (but not all) of the cash flows of a financial instrument may be designated for cash flow or fair value changes attributable to all or only some risks (ie a 'portion' of the cash flows of the financial instrument may be designated for changes attributable to all or only some risks).

AG99F To be eligible for hedge accounting, the designated risks and portions must be separately identifiable components of the financial instrument, and changes in the cash flows or fair value of the entire financial instrument arising from changes in the designated risks and portions must be reliably measurable. For example:

(a) for a fixed rate financial instrument hedged for changes in fair value attributable to changes in a risk-free or benchmark interest rate, the risk-free or benchmark rate is normally regarded as both a separately identifiable component of the financial instrument and reliably measurable.

(b) inflation is not separately identifiable and reliably measurable and cannot be designated as a risk or a portion of a financial instrument unless the requirements in (c) are met.

(c) a contractually specified inflation portion of the cash flows of a recognised inflation-linked bond (assuming there is no requirement to account for an embedded derivative separately) is separately identifiable and reliably measurable as long as other cash flows of the instrument are not affected by the inflation portion.

Designation of non-financial items as hedged items (paragraph 82)

AG100 Changes in the price of an ingredient or component of a non-financial asset or non-financial liability generally do not have a predictable, separately measurable effect on the price of the item that is comparable to the effect of, say, a change in market interest rates on the price of a bond. Thus, a non-financial asset or non-financial liability is a hedged item only in its entirety or for foreign exchange risk. If there is a difference between the terms of the hedging instrument and the hedged item (such as for a hedge of the forecast purchase of Brazilian coffee using a forward contract to purchase Colombian coffee on otherwise similar terms), the hedging relationship nonetheless can qualify as a hedge relationship provided all the conditions in paragraph 88 are met, including that the hedge is expected to be highly effective. For this purpose, the amount of the hedging instrument may be greater or less than that of the hedged item if this improves the effectiveness of the hedging relationship. For example, a regression analysis could be performed to establish a statistical relationship between the hedged item (eg a transaction in Brazilian coffee) and the hedging instrument (eg a transaction in Colombian coffee). If there is a valid statistical relationship between the two variables (ie between the unit prices of Brazilian coffee and Colombian coffee), the slope of the regression line can be used to establish the hedge ratio that will maximise expected effectiveness. For example, if the slope of the regression line is 1.02, a hedge ratio based on 0.98 quantities of hedged items to 1.00 quantities of the hedging instrument maximises expected effectiveness. However, the hedging relationship may result in ineffectiveness that is recognised in profit or loss during the term of the hedging relationship.

Designation of groups of items as hedged items (paragraphs 83 and 84)

AG101 A hedge of an overall net position (eg the net of all fixed rate assets and fixed rate liabilities with similar maturities), rather than of a specific hedged item, does not qualify for hedge accounting. However, almost the same effect on profit or loss of hedge accounting for this type of hedging relationship can be achieved by designating as the hedged item part of the underlying items. For example, if a bank has Rs.100 of assets and Rs.90 of liabilities with risks and terms of a similar nature and hedges the net Rs.10 exposure, it can designate as the hedged item Rs.10 of those assets. This designation can be used if such assets and liabilities are fixed rate instruments, in which case it is a fair value hedge, or if they are variable rate instruments, in which case it is a cash flow hedge. Similarly, if an entity has a firm commitment to make a purchase in a foreign currency of Rs.100 and a firm commitment to make a sale in the foreign currency of Rs.90, it can hedge the net amount of Rs.10 by acquiring a derivative and designating it as a hedging instrument associated with Rs.10 of the firm purchase commitment of Rs.100.

Hedge accounting (paragraphs 85–102)

AG102 An example of a fair value hedge is a hedge of exposure to changes in the fair value of a fixed rate debt instrument as a result of changes in interest rates. Such a hedge could be entered into by the issuer or by the holder.

AG103 An example of a cash flow hedge is the use of a swap to change floating rate debt to fixed rate debt (ie a hedge of a future transaction where the future cash flows being hedged are the future interest payments).

AG104 A hedge of a firm commitment (eg a hedge of the change in fuel price relating to an unrecognised contractual commitment by an electric utility to purchase fuel at a fixed price) is a hedge of an exposure to a change in fair value. Accordingly, such a hedge is a fair value hedge. However, under paragraph 87 a hedge of the foreign currency risk of a firm commitment could alternatively be accounted for as a cash flow hedge.

Assessing hedge effectiveness

AG105 A hedge is regarded as highly effective only if both of the following conditions are met:

(a) At the inception of the hedge and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. Such an expectation can be demonstrated in various ways, including a comparison of past changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk with past changes in the fair value or cash flows of the hedging instrument, or by demonstrating a high statistical correlation between the fair value or cash flows of the hedged item and those of the hedging instrument. The entity may choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph AG100.

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

AG106 Effectiveness is assessed, at a minimum, at the time an entity prepares its annual or interim financial statements.

AG107 This Standard does not specify a single method for assessing hedge effectiveness. The method an entity adopts for assessing hedge effectiveness depends on its risk management strategy. For example, if the entity's risk management strategy is to adjust the amount of the hedging instrument periodically to reflect changes in the hedged position, the entity needs to demonstrate that the hedge is expected to be highly effective only for the period until the amount of the hedging instrument is next adjusted. In some cases, an entity adopts different methods for different types of hedges. An entity's documentation of its hedging strategy includes its procedures for assessing effectiveness. Those procedures state whether the assessment includes all of the gain or loss on a hedging instrument or whether the instrument's time value is excluded.

AG107A If an entity hedges less than 100 per cent of the exposure on an item, such as 85 per cent, it shall designate the hedged item as being 85 per cent of the

exposure and shall measure ineffectiveness based on the change in that designated 85 per cent exposure. However, when hedging the designated 85 per cent exposure, the entity may use a hedge ratio of other than one to one if that improves the expected effectiveness of the hedge, as explained in paragraph AG100.

AG108 If the principal terms of the hedging instrument and of the hedged asset, liability, firm commitment or highly probable forecast transaction are the same, the changes in fair value and cash flows attributable to the risk being hedged may be likely to offset each other fully, both when the hedge is entered into and afterwards. For example, an interest rate swap is likely to be an effective hedge if the notional and principal amounts, term, repricing dates, dates of interest and principal receipts and payments, and basis for measuring interest rates are the same for the hedging instrument and the hedged item. In addition, a hedge of a highly probable forecast purchase of a commodity with a forward contract is likely to be highly effective if:

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

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

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

AG109Sometimes the hedging instrument offsets only part of the hedged risk. For example, a hedge would not be fully effective if the hedging instrument and hedged item are denominated in different currencies that do not move in tandem. Also, a hedge of interest rate risk using a derivative would not be fully effective if part of the change in the fair value of the derivative is attributable to the counterparty's credit risk.

AG110 To qualify for hedge accounting, the hedge must relate to a specific identified and designated risk, and not merely to the entity's general business risks, and must ultimately affect the entity's profit or loss. A hedge of the risk of obsolescence of a physical asset or the risk of expropriation of property by a government is not eligible for hedge accounting; effectiveness cannot be measured because those risks are not measurable reliably.

AG110AParagraph 74(a) permits an entity to separate the intrinsic value and time value of an option contract and designate as the hedging instrument only the change in the intrinsic value of the option contract. Such a designation may result in a hedging relationship that is perfectly effective in achieving offsetting changes in cash flows attributable to a hedged one-sided risk of a forecast transaction, if the principal terms of the forecast transaction and hedging instrument are the same.

AG110B If an entity designates a purchased option in its entirety as the hedging instrument of a one-sided risk arising from a forecast transaction, the hedging relationship will not be perfectly effective. This is because the premium paid for the option includes time value and, as stated in paragraph AG99BA, a designated one-sided risk does not include the time value of an option.

Therefore, in this situation, there will be no offset between the cash flows relating to the time value of the option premium paid and the designated hedged risk.

AG111 In the case of interest rate risk, hedge effectiveness may be assessed by preparing a maturity schedule for financial assets and financial liabilities that shows the net interest rate exposure for each time period, provided that the net exposure is associated with a specific asset or liability (or a specific group of assets or liabilities or a specific portion of them) giving rise to the net exposure, and hedge effectiveness is assessed against that asset or liability.

AG112 In assessing the effectiveness of a hedge, an entity generally considers the time value of money. The fixed interest rate on a hedged item need not exactly match the fixed interest rate on a swap designated as a fair value hedge. Nor does the variable interest rate on an interest-bearing asset or liability need to be the same as the variable interest rate on a swap designated as a cash flow hedge. A swap's fair value derives from its net settlements. The fixed and variable rates on a swap can be changed without affecting the net settlement if both are changed by the same amount.

AG113 If an entity does not meet hedge effectiveness criteria, the entity discontinues hedge accounting from the last date on which compliance with hedge effectiveness was demonstrated. However, if the entity identifies the event or change in circumstances that caused the hedging relationship to fail the effectiveness criteria, and demonstrates that the hedge was effective before the event or change in circumstances occurred, the entity discontinues hedge accounting from the date of the event or change in circumstances.

Fair value hedge accounting for a portfolio hedge of interest rate risk

AG114 For a fair value hedge of interest rate risk associated with a portfolio of financial assets or financial liabilities, an entity would meet the requirements of this Standard if it complies with the procedures set out in (a)–(i) and paragraphs AG115–AG132 below.

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

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

(c) On the basis of this analysis, the entity decides the amount it wishes to hedge. The entity designates as the hedged item an amount of assets or liabilities (but not a net amount) from the identified portfolio equal to the

amount it wishes to designate as being hedged. This amount also determines the percentage measure that is used for testing effectiveness in accordance with paragraph AG126(b).

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

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

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

(g) Periodically, the entity measures the change in the fair value of the hedged item (as designated in (c)) that is attributable to the hedged risk (as designated in (d)), on the basis of the expected repricing dates determined in (b). Provided that the hedge is determined actually to have been highly effective when assessed using the entity's documented method of assessing effectiveness, the entity recognises the change in fair value of the hedged item as a gain or loss in profit or loss and in one of two line items in the balance sheet as described in paragraph 89A. The change in fair value need not be allocated to individual assets or liabilities.

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

(i) Any ineffectiveness[3] will be recognised in profit or loss as the difference between the change in fair value referred to in (g) and that referred to in (h).

AG115 This approach is described in more detail below. The approach shall be applied only to a fair value hedge of the interest rate risk associated with a portfolio of financial assets or financial liabilities.

AG116 The portfolio identified in paragraph AG114(a) could contain assets and liabilities. Alternatively, it could be a portfolio containing only assets, or only liabilities. The portfolio is used to determine the amount of the assets or liabilities the entity wishes to hedge. However, the portfolio is not itself designated as the hedged item.

AG117 In applying paragraph AG114(b), the entity determines the expected repricing date of an item as the earlier of the dates when that item is expected to mature or to reprice to market rates. The expected repricing dates are estimated at the inception of the hedge and throughout the term of the hedge, based on historical experience and other available information, including information and expectations regarding prepayment rates, interest rates and the interaction between them. Entities that have no entity-specific experience or insufficient

[3] The same materiality considerations apply in this context as apply throughout the Indian Accounting Standards.

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

AG118 As an example of the designation set out in paragraph AG114(c), if in a particular repricing time period an entity estimates that it has fixed rate assets of Rs.100 and fixed rate liabilities of Rs.80 and decides to hedge all of the net position of Rs.20, it designates as the hedged item assets in the amount of Rs.20 (a portion of the assets).[4] The designation is expressed as an 'amount of a currency' (eg an amount of dollars, euro, pounds or rand) rather than as individual assets. It follows that all of the assets (or liabilities) from which the hedged amount is drawn—ie all of the Rs.100 of assets in the above example—must be:

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

(b) items that could have qualified for fair value hedge accounting if they had been designated as hedged individually. In particular, because the Standard[5] specifies that the fair value of a financial liability with a demand feature (such as demand deposits and some types of time deposits) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid, such an item cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the holder can demand payment. In the above example, the hedged position is an amount of assets. Hence, such liabilities are not a part of the designated hedged item, but are used by the entity to determine the amount of the asset that is designated as being hedged. If the position the entity wished to hedge was an amount of liabilities, the amount representing the designated hedged item must be drawn from fixed rate liabilities other than liabilities that the entity can be required to repay in an earlier time period, and the percentage measure used for assessing hedge effectiveness in accordance with paragraph AG126(b) would be calculated as a percentage of these other liabilities. For example, assume that an entity estimates that in a particular repricing time period it has fixed rate liabilities of Rs.100, comprising Rs.40 of demand deposits and Rs.60 of liabilities with no demand feature, and Rs.70 of fixed rate assets. If the entity decides to hedge all of the net position of Rs.30, it designates as the

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

[5] see paragraph 49

hedged item liabilities of Rs.30 or 50 per cent[6] of the liabilities with no demand feature.

AG119 The entity also complies with the other designation and documentation requirements set out in paragraph 88(a). For a portfolio hedge of interest rate risk, this designation and documentation specifies the entity's policy for all of the variables that are used to identify the amount that is hedged and how effectiveness is measured, including the following:

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

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

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

(d) how often the entity will test effectiveness and which of the two methods in paragraph AG126 it will use.

(e) the methodology used by the entity to determine the amount of assets or liabilities that are designated as the hedged item and, accordingly, the percentage measure used when the entity tests effectiveness using the method described in paragraph AG126(b).

(f) when the entity tests effectiveness using the method described in paragraph AG126(b), whether the entity will test effectiveness for each repricing time period individually, for all time periods in aggregate, or by using some combination of the two.

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

AG120 The hedging instrument referred to in paragraph AG114(e) may be a single derivative or a portfolio of derivatives all of which contain exposure to the hedged interest rate risk designated in paragraph AG114(d) (eg a portfolio of interest rate swaps all of which contain exposure to MIBOR). Such a portfolio of derivatives may contain offsetting risk positions. However, it may not include written options or net written options, because the Standard[7] does not permit such options to be designated as hedging instruments (except when a written option is designated as an offset to a purchased option). If the hedging instrument hedges the amount designated in paragraph AG114(c) for more than one repricing time period, it is

[6] Rs.30 ÷ (Rs.100 – Rs.40) = 50 per cent

[7] see paragraphs 77 and AG94

allocated to all of the time periods that it hedges. However, the whole of the hedging instrument must be allocated to those repricing time periods because the Standard[8] does not permit a hedging relationship to be designated for only a portion of the time period during which a hedging instrument remains outstanding.

AG121 When the entity measures the change in the fair value of a prepayable item in accordance with paragraph AG114(g), a change in interest rates affects the fair value of the prepayable item in two ways: it affects the fair value of the contractual cash flows and the fair value of the prepayment option that is contained in a prepayable item. Paragraph 81 of the Standard permits an entity to designate a portion of a financial asset or financial liability, sharing a common risk exposure, as the hedged item, provided effectiveness can be measured. For prepayable items, paragraph 81A permits this to be achieved by designating the hedged item in terms of the change in the fair value that is attributable to changes in the designated interest rate on the basis of *expected*, rather than *contractual*, repricing dates. However, the effect that changes in the hedged interest rate have on those expected repricing dates shall be included when determining the change in the fair value of the hedged item. Consequently, if the expected repricing dates are revised (eg to reflect a change in expected prepayments), or if actual repricing dates differ from those expected, ineffectiveness will arise as described in paragraph AG126. Conversely, changes in expected repricing dates that (a) clearly arise from factors other than changes in the hedged interest rate, (b) are uncorrelated with changes in the hedged interest rate and (c) can be reliably separated from changes that are attributable to the hedged interest rate (eg changes in prepayment rates clearly arising from a change in demographic factors or tax regulations rather than changes in interest rate) are excluded when determining the change in the fair value of the hedged item, because they are not attributable to the hedged risk. If there is uncertainty about the factor that gave rise to the change in expected repricing dates or the entity is not able to separate reliably the changes that arise from the hedged interest rate from those that arise from other factors, the change is assumed to arise from changes in the hedged interest rate.

AG122 The Standard does not specify the techniques used to determine the amount referred to in paragraph AG114(g), namely the change in the fair value of the hedged item that is attributable to the hedged risk. If statistical or other estimation techniques are used for such measurement, management must expect the result to approximate closely that which would have been obtained from measurement of all the individual assets or liabilities that constitute the hedged item. It is not appropriate to assume that changes in the fair value of the hedged item equal changes in the value of the hedging instrument.

AG123Paragraph 89A requires that if the hedged item for a particular repricing time period is an asset, the change in its value is presented in a separate line item within assets. Conversely, if the hedged item for a particular repricing time period is a liability, the change in its value is presented in a separate line item within liabilities. These are the separate line items referred to in paragraph AG114(g). Specific allocation to individual assets (or liabilities) is not required.

[8] see paragraph 75

AG124 Paragraph AG114(i) notes that ineffectiveness arises to the extent that the change in the fair value of the hedged item that is attributable to the hedged risk differs from the change in the fair value of the hedging derivative. Such a difference may arise for a number of reasons, including:

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

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

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

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

Such ineffectiveness[9] shall be identified and recognised in profit or loss.

AG125 Generally, the effectiveness of the hedge will be improved:

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

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

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

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

AG126 An entity tests effectiveness periodically. If estimates of repricing dates change between one date on which an entity assesses effectiveness and the next, it shall calculate the amount of effectiveness either:

(a) as the difference between the change in the fair value of the hedging instrument (see paragraph AG114(h)) and the change in the value of the entire hedged item that is attributable to changes in the hedged interest rate (including the effect that changes in the hedged interest rate have on the fair value of any embedded prepayment option); or

[9] The same materiality considerations apply in this context as apply throughout the Indian Accounting Standards.

(b) using the following approximation. The entity:

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

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

(iii) calculates the change in the fair value of its revised estimate of the hedged item that is attributable to the hedged risk and presents it as set out in paragraph AG114(g).

(iv) recognises ineffectiveness equal to the difference between the amount determined in (iii) and the change in the fair value of the hedging instrument (see paragraph AG114(h)).

AG127 When measuring effectiveness, the entity distinguishes revisions to the estimated repricing dates of existing assets (or liabilities) from the origination of new assets (or liabilities), with only the former giving rise to ineffectiveness. All revisions to estimated repricing dates (other than those excluded in accordance with paragraph AG121), including any reallocation of existing items between time periods, are included when revising the estimated amount in a time period in accordance with paragraph AG126(b)(ii) and hence when measuring effectiveness. Once ineffectiveness has been recognised as set out above, the entity establishes a new estimate of the total assets (or liabilities) in each repricing time period, including new assets (or liabilities) that have been originated since it last tested effectiveness, and designates a new amount as the hedged item and a new percentage as the hedged percentage. The procedures set out in paragraph AG126(b) are then repeated at the next date it tests effectiveness.

AG128 Items that were originally scheduled into a repricing time period may be derecognised because of earlier than expected prepayment or write-offs caused by impairment or sale. When this occurs, the amount of change in fair value included in the separate line item referred to in paragraph AG114(g) that relates to the derecognised item shall be removed from the balance sheet, and included in the gain or loss that arises on derecognition of the item. For this purpose, it is necessary to know the repricing time period(s) into which the derecognised item was scheduled, because this determines the repricing time period(s) from which to remove it and hence the amount to remove from the separate line item referred to in paragraph AG114(g). When an item is derecognised, if it can be determined in which time period it was included, it is removed from that time period. If not, it is removed from the earliest time period if the derecognition resulted from higher than expected prepayments, or allocated to all time periods containing the derecognised item on a systematic and rational basis if the item was sold or became impaired.

AG129 In addition, any amount relating to a particular time period that has not been derecognised when the time period expires is recognised in profit or loss at that time (see paragraph 89A). For example, assume an entity schedules items into three repricing time periods. At the previous redesignation, the change in fair

value reported in the single line item in the balance sheet was an asset of Rs.25. That amount represents amounts attributable to periods 1, 2 and 3 of Rs.7, Rs.8 and Rs.10, respectively. At the next redesignation, the assets attributable to period 1 have been either realised or rescheduled into other periods. Therefore, Rs.7 is derecognised from the balance sheet and recognised in profit or loss. Rs.8 and Rs.10 are now attributable to periods 1 and 2, respectively. These remaining periods are then adjusted, as necessary, for changes in fair value as described in paragraph AG114(g).

AG130 As an illustration of the requirements of the previous two paragraphs, assume that an entity scheduled assets by allocating a percentage of the portfolio into each repricing time period. Assume also that it scheduled Rs.100 into each of the first two time periods. When the first repricing time period expires, Rs.110 of assets are derecognised because of expected and unexpected repayments. In this case, all of the amount contained in the separate line item referred to in paragraph AG114(g) that relates to the first time period is removed from the balance sheet, plus 10 per cent of the amount that relates to the second time period.

AG131 If the hedged amount for a repricing time period is reduced without the related assets (or liabilities) being derecognised, the amount included in the separate line item referred to in paragraph AG114(g) that relates to the reduction shall be amortised in accordance with paragraph 92.

AG132 An entity may wish to apply the approach set out in paragraphs AG114–AG131 to a portfolio hedge that had previously been accounted for as a cash flow hedge in accordance with Ind AS 39. Such an entity would revoke the previous designation of a cash flow hedge in accordance with paragraph 101(d), and apply the requirements set out in that paragraph. It would also redesignate the hedge as a fair value hedge and apply the approach set out in paragraphs AG114–AG131 prospectively to subsequent accounting periods.

Appendix B

References to matters contained in other Indian Accounting Standards

This Appendix is an integral part of Indian Accounting Standard (Ind AS) 39.

This appendix lists the appendices which are part of other Indian Accounting Standards and makes reference to Ind AS 39, *Financial Instruments: Recognition and Measurement*

1. Appendix A *Service Concession Arrangements* contained in Ind AS 11*Construction Contracts*

2. Appendix B *Evaluating the Substance of Transactions Involving the Legal Form of a Lease* contained in Ind AS 17, *Leases.*

Appendix C

Reassessment of Embedded Derivatives

(This appendix is an integral part of Ind AS 39)

Background

1 Ind AS 39 paragraph 10 describes an embedded derivative as 'a component of a hybrid (combined) instrument that also includes a non-derivative host contract—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.'

2 Ind AS 39 paragraph 11 requires an embedded derivative to be separated from the host contract and accounted for as a derivative if, and only if:

(a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;

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

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

Scope

3 Subject to paragraphs 4 and 5 below, this Appendix applies to all embedded derivatives within the scope of Ind AS 39.

4 This Appendix does not address remeasurement issues arising from a reassessment of embedded derivatives.

5 This Appendix does not apply to embedded derivatives in contracts acquired in:

(a) a business combination (as defined in Ind AS 103

(b) a combination of entities or businesses under common control as described in paragraphs B1–B4 of Ind AS 103; or

(c) the formation of a joint venture as defined in Ind AS 31 *Interests in Joint Ventures* or their possible reassessment at the date of acquisition.[10]

Issues

6 Ind AS 39 requires an entity, when it first becomes a party to a contract, to assess whether any embedded derivatives contained in the contract are required to be separated from the host contract and accounted for as derivatives under the Standard. This Appendix addresses the following issues:

(a) Ind AS 39 require such an assessment to be made only when the entity first becomes a party to the contract, or should the assessment be reconsidered throughout the life of the contract?

(b) Should a first-time adopter make its assessment on the basis of the conditions that existed when the entity first became a party to the contract, or those prevailing when the entity adopts Indian Accounting Standards for the first time?

Accounting Principle

7 An entity shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity first becomes a party to the contract. Subsequent reassessment is prohibited unless there is either (a) a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract or (b) a reclassification of a financial asset out of the fair value through profit or loss category, in which cases an reassessment is required. An entity determines whether a modification to cash flows is significant by considering the extent to which the expected future cash flows associated with the embedded derivative, the host contract or both have changed and whether the change is significant relative to the previously expected cash flows on the contract.

7A The assessment whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on reclassification of a financial asset out of the fair value through profit or loss category in accordance with paragraph 7 shall be made on the basis of the circumstances that existed on the later date of:

(a) when the entity first became a party to the contract; and

(b) a change in the terms of the contract that significantly modified the cash flows that otherwise would have been required under the contract.

For the purpose of this assessment paragraph 11(c) of Ind AS 39 shall not be applied (ie the hybrid (combined) contract shall be treated as if it had not been measured at fair value with changes in fair value recognised in profit or loss). If

[10] Ind AS 103 addresses the acquisition of contracts with embedded derivatives in a business combination.

an entity is unable to make this assessment the hybrid (combined) contract shall remain classified as at fair value through profit or loss in its entirety.

8 A first-time adopter shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of the conditions that existed at the later of the date it first became a party to the contract and the date a reassessment is required by paragraph 7.

Appendix D

Hedges of a Net Investment in a Foreign Operation

(This appendix is an integral part of Ind AS 39)

Background

1 Many reporting entities have investments in foreign operations (as defined in Ind AS 21 paragraph 8). Such foreign operations may be subsidiaries, associates, joint ventures or branches. Ind AS 21 requires an entity to determine the functional currency of each of its foreign operations as the currency of the primary economic environment of that operation. When translating the results and financial position of a foreign operation into a presentation currency, the entity is required to recognise foreign exchange differences in other comprehensive income until it disposes of the foreign operation.

2 Hedge accounting of the foreign currency risk arising from a net investment in a foreign operation will apply only when the net assets of that foreign operation are included in the financial statements.[11] The item being hedged with respect to the foreign currency risk arising from the net investment in a foreign operation may be an amount of net assets equal to or less than the carrying amount of the net assets of the foreign operation.

3 Ind AS 39 requires the designation of an eligible hedged item and eligible hedging instruments in a hedge accounting relationship. If there is a designated hedging relationship, in the case of a net investment hedge, the gain or loss on the hedging instrument that is determined to be an effective hedge of the net investment is recognised in other comprehensive income and is included with the foreign exchange differences arising on translation of the results and financial position of the foreign operation.

4 An entity with many foreign operations may be exposed to a number of foreign currency risks. This Appendix provides guidance on identifying the foreign currency risks that qualify as a hedged risk in the hedge of a net investment in a foreign operation.

5 Ind AS 39 allows an entity to designate either a derivative or a non-derivative financial instrument (or a combination of derivative and non-derivative financial instruments) as hedging instruments for foreign currency risk. This Appendix provides guidance on where, within a group, hedging instruments that are

[11] This will be the case for consolidated financial statements, financial statements in which investments are accounted for using the equity method, financial statements in which venturers' interests in joint ventures are proportionately consolidated and financial statements that include a branch.

hedges of a net investment in a foreign operation can be held to qualify for hedge accounting.

6 Ind AS 21 and Ind AS 39 require cumulative amounts recognised in other comprehensive income relating to both the foreign exchange differences arising on translation of the results and financial position of the foreign operation and the gain or loss on the hedging instrument that is determined to be an effective hedge of the net investment to be reclassified from equity to profit or loss as a reclassification adjustment when the parent disposes of the foreign operation. This Appendix provides guidance on how an entity should determine the amounts to be reclassified from equity to profit or loss for both the hedging instrument and the hedged item.

Scope

7 This Appendix applies to an entity that hedges the foreign currency risk arising from its net investments in foreign operations and wishes to qualify for hedge accounting in accordance with Ind AS 39. For convenience this Appendix refers to such an entity as a parent entity and to the financial statements in which the net assets of foreign operations are included as consolidated financial statements. All references to a parent entity apply equally to an entity that has a net investment in a foreign operation that is a joint venture, an associate or a branch.

8 This Appendix applies only to hedges of net investments in foreign operations; it should not be applied by analogy to other types of hedge accounting.

Issues

9 Investments in foreign operations may be held directly by a parent entity or indirectly by its subsidiary or subsidiaries. The issues addressed in this Appendix are:

(a) *the nature of the hedged risk and the amount of the hedged item for which a hedging relationship may be designated:*

(i) whether the parent entity may designate as a hedged risk only the foreign exchange differences arising from a difference between the functional currencies of the parent entity and its foreign operation, or whether it may also designate as the hedged risk the foreign exchange differences arising from the difference between the presentation currency of the parent entity's consolidated financial statements and the functional currency of the foreign operation;

(ii) if the parent entity holds the foreign operation indirectly, whether the hedged risk may include only the foreign exchange differences arising from differences in functional currencies between the foreign operation and its immediate parent entity, or whether the hedged risk may also include any foreign exchange differences between the functional currency of the foreign operation and any intermediate or ultimate parent entity (ie whether the fact that the net investment in

the foreign operation is held through an intermediate parent affects the economic risk to the ultimate parent).

(b) *where in a group the hedging instrument can be held:*

(i) whether a qualifying hedge accounting relationship can be established only if the entity hedging its net investment is a party to the hedging instrument or whether any entity in the group, regardless of its functional currency, can hold the hedging instrument;

(ii) whether the nature of the hedging instrument (derivative or non-derivative) or the method of consolidation affects the assessment of hedge effectiveness.

(c) *what amounts should be reclassified from equity to profit or loss as reclassification adjustments on disposal of the foreign operation:*

(i) when a foreign operation that was hedged is disposed of, what amounts from the parent entity's foreign currency translation reserve in respect of the hedging instrument and in respect of that foreign operation should be reclassified from equity to profit or loss in the parent entity's consolidated financial statements;

(ii) whether the method of consolidation affects the determination of the amounts to be reclassified from equity to profit or loss.

Accounting Principle

Nature of the hedged risk and amount of the hedged item for which a hedging relationship may be designated

10 Hedge accounting may be applied only to the foreign exchange differences arising between the functional currency of the foreign operation and the parent entity's functional currency.

11 In a hedge of the foreign currency risks arising from a net investment in a foreign operation, the hedged item can be an amount of net assets equal to or less than the carrying amount of the net assets of the foreign operation in the consolidated financial statements of the parent entity. The carrying amount of the net assets of a foreign operation that may be designated as the hedged item in the consolidated financial statements of a parent depends on whether any lower level parent of the foreign operation has applied hedge accounting for all or part of the net assets of that foreign operation and that accounting has been maintained in the parent's consolidated financial statements.

12 The hedged risk may be designated as the foreign currency exposure arising between the functional currency of the foreign operation and the functional currency of any parent entity (the immediate, intermediate or ultimate parent entity) of that foreign operation. The fact that the net investment is held through an intermediate parent does not affect the nature of the economic risk arising from the foreign currency exposure to the ultimate parent entity.

13 An exposure to foreign currency risk arising from a net investment in a foreign operation may qualify for hedge accounting only once in the consolidated financial statements. Therefore, if the same net assets of a foreign operation are hedged by more than one parent entity within the group (for example, both a direct and an indirect parent entity) for the same risk, only one hedging relationship will qualify for hedge accounting in the consolidated financial statements of the ultimate parent. A hedging relationship designated by one parent entity in its consolidated financial statements need not be maintained by another higher level parent entity. However, if it is not maintained by the higher level parent entity, the hedge accounting applied by the lower level parent must be reversed before the higher level parent's hedge accounting is recognised.

Where the hedging instrument can be held

14 A derivative or a non-derivative instrument (or a combination of derivative and non-derivative instruments) may be designated as a hedging instrument in a hedge of a net investment in a foreign operation. The hedging instrument(s) may be held by any entity or entities within the group, as long as the designation, documentation and effectiveness requirements of Ind AS 39 paragraph 88 that relate to a net investment hedge are satisfied. In particular, the hedging strategy of the group should be clearly documented because of the possibility of different designations at different levels of the group.

15 For the purpose of assessing effectiveness, the change in value of the hedging instrument in respect of foreign exchange risk is computed by reference to the functional currency of the parent entity against whose functional currency the hedged risk is measured, in accordance with the hedge accounting documentation. Depending on where the hedging instrument is held, in the absence of hedge accounting the total change in value might be recognised in profit or loss, in other comprehensive income, or both. However, the assessment of effectiveness is not affected by whether the change in value of the hedging instrument is recognised in profit or loss or in other comprehensive income. As part of the application of hedge accounting, the total effective portion of the change is included in other comprehensive income. The assessment of effectiveness is not affected by whether the hedging instrument is a derivative or a non-derivative instrument or by the method of consolidation.

Disposal of a hedged foreign operation

16 When a foreign operation that was hedged is disposed of, the amount reclassified to profit or loss as a reclassification adjustment from the foreign currency translation reserve in the consolidated financial statements of the parent in respect of the hedging instrument is the amount that Ind AS 39 paragraph 102 requires to be identified. That amount is the cumulative gain or loss on the hedging instrument that was determined to be an effective hedge.

17 The amount reclassified to profit or loss from the foreign currency translation reserve in the consolidated financial statements of a parent in respect of the net investment in that foreign operation in accordance with Ind AS 21 paragraph 48 is the amount included in that parent's foreign currency translation reserve in

respect of that foreign operation. In the ultimate parent's consolidated financial statements, the aggregate net amount recognised in the foreign currency translation reserve in respect of all foreign operations is not affected by the consolidation method. However, whether the ultimate parent uses the direct or the step-by-step method of consolidation[12] may affect the amount included in its foreign currency translation reserve in respect of an individual foreign operation. The use of the step-by-step method of consolidation may result in the reclassification to profit or loss of an amount different from that used to determine hedge effectiveness. This difference may be eliminated by determining the amount relating to that foreign operation that would have arisen if the direct method of consolidation had been used. Making this adjustment is not required by Ind AS 21. However, it is an accounting policy choice that should be followed consistently for all net investments.

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[12] The direct method is the method of consolidation in which the financial statements of the foreign operation are translated directly into the functional currency of the ultimate parent. The step-by-step method is the method of consolidation in which the financial statements of the foreign operation are first translated into the functional currency of any intermediate parent(s) and then translated into the functional currency of the ultimate parent (or the presentation currency if different).

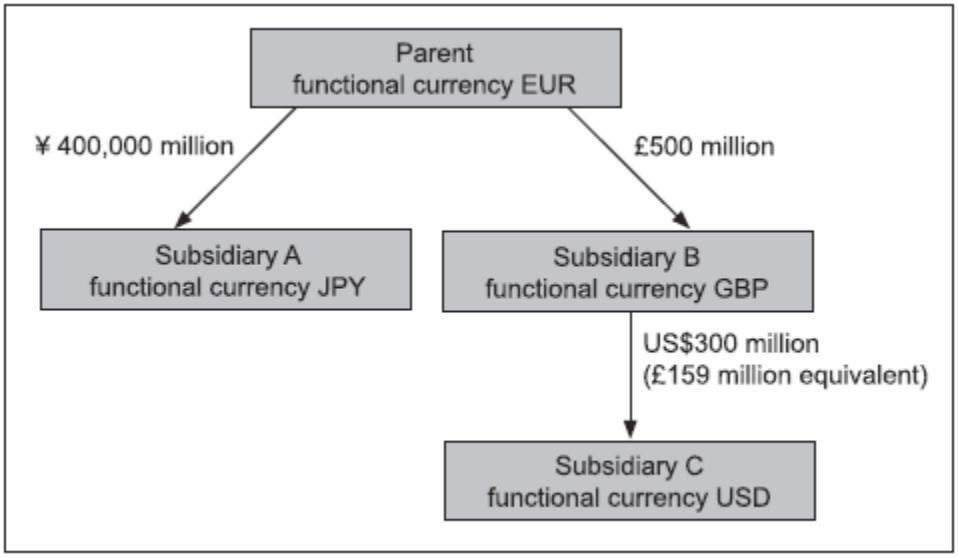
Application guidance to Appendix D

This application guidance is an integral part of the Appendix D.

AG1 This application guidance illustrates the application of the Appendix D using the corporate structure illustrated below. In all cases the hedging relationships described would be tested for effectiveness in accordance with Ind AS 39, although this testing is not discussed in this appendix. Parent, being the ultimate parent entity, presents its consolidated financial statements in its functional currency of euro (EUR). Each of the subsidiaries is wholly owned. Parent's £500 million net investment in Subsidiary B (functional currency pounds sterling (GBP)) includes the £159 million equivalent of Subsidiary B's US$300 million net investment in Subsidiary C (functional currency US dollars (USD)). In other words, Subsidiary B's net assets other than its investment in Subsidiary C are £341 million.

Nature of hedged risk for which a hedging relationship may be designated (paragraphs 10–13)

AG2 Parent can hedge its net investment in each of Subsidiaries A, B and C for the foreign exchange risk between their respective functional currencies (Japanese yen (JPY), pounds sterling and US dollars) and euro. In addition, Parent can hedge the USD/GBP foreign exchange risk between the functional currencies of Subsidiary B and Subsidiary C. In its consolidated financial statements, Subsidiary B can hedge its net investment in Subsidiary C for the foreign exchange risk between their functional currencies of US dollars and pounds sterling. In the following examples the designated risk is the spot foreign exchange risk because the hedging instruments are not derivatives. If the hedging instruments were forward contracts, Parent could designate the forward foreign exchange risk.



Amount of hedged item for which a hedging relationship may be designated (paragraphs 10–13)

AG3 Parent wishes to hedge the foreign exchange risk from its net investment in Subsidiary C. Assume that Subsidiary A has an external borrowing of US$300 million. The net assets of Subsidiary A at the start of the reporting period are ¥400,000 million including the proceeds of the external borrowing of US$300 million.

AG4 The hedged item can be an amount of net assets equal to or less than the carrying amount of Parent's net investment in Subsidiary C (US$300 million) in its consolidated financial statements. In its consolidated financial statements Parent can designate the US$300 million external borrowing in Subsidiary A as a hedge of the EUR/USD spot foreign exchange risk associated with its net investment in the US$300 million net assets of Subsidiary C. In this case, both the EUR/USD foreign exchange difference on the US$300 million external borrowing in Subsidiary A and the EUR/USD foreign exchange difference on the US$300 million net investment in Subsidiary C are included in the foreign currency translation reserve in Parent's consolidated financial statements after the application of hedge accounting.

AG5 In the absence of hedge accounting, the total USD/EUR foreign exchange difference on the US$300 million external borrowing in Subsidiary A would be recognised in Parent's consolidated financial statements as follows:

- USD/JPY spot foreign exchange rate change, translated to euro, in profit or loss, and
- JPY/EUR spot foreign exchange rate change in other comprehensive income.

Instead of the designation in paragraph AG4, in its consolidated financial statements Parent can designate the US$300 million external borrowing in Subsidiary A as a hedge of the GBP/USD spot foreign exchange risk between Subsidiary C and Subsidiary B. In this case, the total USD/EUR foreign exchange difference on the US$300 million external borrowing in Subsidiary A would instead be recognised in Parent's consolidated financial statements as follows:

- the GBP/USD spot foreign exchange rate change in the foreign currency translation reserve relating to Subsidiary C,
- GBP/JPY spot foreign exchange rate change, translated to euro, in profit or loss, and
- JPY/EUR spot foreign exchange rate change in other comprehensive income.

AG6 Parent cannot designate the US$300 million external borrowing in Subsidiary A as a hedge of both the EUR/USD spot foreign exchange risk and the GBP/USD spot foreign exchange risk in its consolidated financial statements. A single hedging instrument can hedge the same designated risk only once. Subsidiary B cannot apply hedge accounting in its consolidated financial statements because the hedging instrument is held outside the group comprising Subsidiary B and Subsidiary C.

Where in a group can the hedging instrument be held (paragraphs 14 and 15)?

AG7 As noted in paragraph AG5, the total change in value in respect of foreign exchange risk of the US$300 million external borrowing in Subsidiary A would be recorded in both profit or loss (USD/JPY spot risk) and other comprehensive income (EUR/JPY spot risk) in Parent's consolidated financial statements in the absence of hedge accounting. Both amounts are included for the purpose of assessing the effectiveness of the hedge designated in paragraph AG4 because the change in value of both the hedging instrument and the hedged item are computed by reference to the euro functional currency of Parent against the US dollar functional currency of Subsidiary C, in accordance with the hedge documentation. The method of consolidation (ie direct method or step-by-step method) does not affect the assessment of the effectiveness of the hedge.

Amounts reclassified to profit or loss on disposal of a foreign operation (paragraphs 16 and 17)

AG8 When Subsidiary C is disposed of, the amounts reclassified to profit or loss in Parent's consolidated financial statements from its foreign currency translation reserve (FCTR) are:

(a) in respect of the US$300 million external borrowing of Subsidiary A, the amount that Ind AS 39 requires to be identified, ie the total change in value in respect of foreign exchange risk that was recognised in other comprehensive income as the effective portion of the hedge; and

(b) in respect of the US$300 million net investment in Subsidiary C, the amount determined by the entity's consolidation method. If Parent uses the direct

method, its FCTR in respect of Subsidiary C will be determined directly by the EUR/USD foreign exchange rate. If Parent uses the step-by-step method, its FCTR in respect of Subsidiary C will be determined by the FCTR recognised by Subsidiary B reflecting the GBP/USD foreign exchange rate, translated to Parent's functional currency using the EUR/GBP foreign exchange rate. Parent's use of the step-by-step method of consolidation in prior periods does not require it to or preclude it from determining the amount of FCTR to be reclassified when it disposes of Subsidiary C to be the amount that it would have recognised if it had always used the direct method, depending on its accounting policy.

Hedging more than one foreign operation (paragraphs 11, 13 and 15)

AG9 The following examples illustrate that in the consolidated financial statements of Parent, the risk that can be hedged is always the risk between its functional currency (euro) and the functional currencies of Subsidiaries B and C. No matter how the hedges are designated, the maximum amounts that can be effective hedges to be included in the foreign currency translation reserve in Parent's consolidated financial statements when both foreign operations are hedged are US$300 million for EUR/USD risk and £341 million for EUR/GBP risk. Other changes in value due to changes in foreign exchange rates are included in Parent's consolidated profit or loss. Of course, it would be possible for Parent to designate US$300 million only for changes in the USD/GBP spot foreign exchange rate or £500 million only for changes in the GBP/EUR spot foreign exchange rate.

Parent holds both USD and GBP hedging instruments

AG10 Parent may wish to hedge the foreign exchange risk in relation to its net investment in Subsidiary B as well as that in relation to Subsidiary C. Assume that Parent holds suitable hedging instruments denominated in US dollars and pounds sterling that it could designate as hedges of its net investments in Subsidiary B and Subsidiary C. The designations Parent can make in its consolidated financial statements include, but are not limited to, the following:

(a) US$300 million hedging instrument designated as a hedge of the US$300 million of net investment in Subsidiary C with the risk being the spot foreign exchange exposure (EUR/USD) between Parent and Subsidiary C and up to £341 million hedging instrument designated as a hedge of £341 million of the net investment in Subsidiary B with the risk being the spot foreign exchange exposure (EUR/GBP) between Parent and Subsidiary B.

(b) US$300 million hedging instrument designated as a hedge of the US$300 million of net investment in Subsidiary C with the risk being the spot foreign exchange exposure (GBP/USD) between Subsidiary B and Subsidiary C and up to £500 million hedging instrument designated as a hedge of £500 million of the net investment in Subsidiary B with the risk being the spot foreign exchange exposure (EUR/GBP) between Parent and Subsidiary B.

AG11 The EUR/USD risk from Parent's net investment in Subsidiary C is a different risk from the EUR/GBP risk from Parent's net investment in Subsidiary B. However, in the case described in paragraph AG10(a), by its designation of the USD hedging instrument it holds, Parent has already fully hedged the EUR/USD risk from its net investment in Subsidiary C. If Parent also designated a GBP instrument it holds as a hedge of its £500 million net investment in Subsidiary B, £159 million of that net investment, representing the GBP equivalent of its USD net investment in Subsidiary C, would be hedged twice for GBP/EUR risk in Parent's consolidated financial statements.

AG12 In the case described in paragraph AG10(b), if Parent designates the hedged risk as the spot foreign exchange exposure (GBP/USD) between Subsidiary B and Subsidiary C, only the GBP/USD part of the change in the value of its US$300 million hedging instrument is included in Parent's foreign currency translation reserve relating to Subsidiary C. The remainder of the change (equivalent to the GBP/EUR change on £159 million) is included in Parent's consolidated profit or loss, as in paragraph AG5. Because the designation of the USD/GBP risk between Subsidiaries B and C does not include the GBP/EUR risk, Parent is also able to designate up to £500 million of its net investment in Subsidiary B with the risk being the spot foreign exchange exposure (GBP/EUR) between Parent and Subsidiary B.

Subsidiary B holds the USD hedging instrument

AG13 Assume that Subsidiary B holds US$300 million of external debt the proceeds of which were transferred to Parent by an inter-company loan denominated in pounds sterling. Because both its assets and liabilities increased by £159 million, Subsidiary B's net assets are unchanged. Subsidiary B could designate the external debt as a hedge of the GBP/USD risk of its net investment in Subsidiary C in its consolidated financial statements. Parent could maintain Subsidiary B's designation of that hedging instrument as a hedge of its US$300 million net investment in Subsidiary C for the GBP/USD risk (see paragraph 13) and Parent could designate the GBP hedging instrument it holds as a hedge of its entire £500 million net investment in Subsidiary B. The first hedge, designated by Subsidiary B, would be assessed by reference to Subsidiary B's functional currency (pounds sterling) and the second hedge, designated by Parent, would be assessed by reference to Parent's functional currency (euro). In this case, only the GBP/USD risk from Parent's net investment in Subsidiary C has been hedged in Parent's consolidated financial statements by the USD hedging instrument, not the entire EUR/USD risk. Therefore, the entire EUR/GBP risk from Parent's £500 million net investment in Subsidiary B may be hedged in the consolidated financial statements of Parent.

AG14 However, the accounting for Parent's £159 million loan payable to Subsidiary B must also be considered. If Parent's loan payable is not considered part of its net investment in Subsidiary B because it does not satisfy the conditions in Ind AS 21 paragraph 15, the GBP/EUR foreign exchange difference arising on translating it would be included in Parent's consolidated profit or loss. If the £159 million loan payable to Subsidiary B is considered part of Parent's net investment, that net investment would be only £341 million and the amount

Parent could designate as the hedged item for GBP/EUR risk would be reduced from £500 million to £341 million accordingly.

AG15 If Parent reversed the hedging relationship designated by Subsidiary B, Parent could designate the US$300 million external borrowing held by Subsidiary B as a hedge of its US$300 million net investment in Subsidiary C for the EUR/USD risk and designate the GBP hedging instrument it holds itself as a hedge of only up to £341 million of the net investment in Subsidiary B. In this case the effectiveness of both hedges would be computed by reference to Parent's functional currency (euro). Consequently, both the USD/GBP change in value of the external borrowing held by Subsidiary B and the GBP/EUR change in value of Parent's loan payable to Subsidiary B (equivalent to USD/EUR in total) would be included in the foreign currency translation reserve in Parent's consolidated financial statements. Because Parent has already fully hedged the EUR/USD risk from its net investment in Subsidiary C, it can hedge only up to £341 million for the EUR/GBP risk of its net investment in Subsidiary B.

Ilustrative example

This example accompanies, but is not part of, Appendix D.

Disposal of a foreign operation (paragraphs 16 and 17)

IE1 This example illustrates the application of paragraphs 16 and 17 in connection with the reclassification adjustment on the disposal of a foreign operation.

Background

IE2 This example assumes the group structure set out in the application guidance and that Parent used a USD borrowing in Subsidiary A to hedge the EUR/USD risk of the net investment in Subsidiary C in Parent's consolidated financial statements. Parent uses the step-by-step method of consolidation. Assume the hedge was fully effective and the full USD/EUR accumulated change in the value of the hedging instrument before disposal of Subsidiary C is €24 million (gain). This is matched exactly by the fall in value of the net investment in Subsidiary C, when measured against the functional currency of Parent (euro).

IE3 If the direct method of consolidation is used, the fall in the value of Parent's net investment in Subsidiary C of €24 million would be reflected totally in the foreign currency translation reserve relating to Subsidiary C in Parent's consolidated financial statements. However, because Parent uses the step-by-step method, this fall in the net investment value in Subsidiary C of €24 million would be reflected both in Subsidiary B's foreign currency translation reserve relating to Subsidiary C and in Parent's foreign currency translation reserve relating to Subsidiary B.

IE4 The aggregate amount recognised in the foreign currency translation reserve in respect of Subsidiaries B and C is not affected by the consolidation method. Assume that using the direct method of consolidation, the foreign currency translation reserves for Subsidiaries B and C in Parent's consolidated financial statements are €62 million gain and €24 million loss respectively; using the step-by-step method of consolidation those amounts are €49 million gain and €11 million loss respectively.

Reclassification

IE5 When the investment in Subsidiary C is disposed of, Ind AS 39 requires the full €24 million gain on the hedging instrument to be reclassified to profit or loss. Using the step-by-step method, the amount to be reclassified to profit or loss in respect of the net investment in Subsidiary C would be only €11 million loss. Parent could adjust the foreign currency translation reserves of both Subsidiaries B and C by €13 million in order to match the amounts reclassified in respect of the hedging instrument and the net investment as would have been the case if the direct method of consolidation had been used, if that was its accounting

policy. An entity that had not hedged its net investment could make the same reclassification.

Appendix E

Extinguishing Financial Liabilities with Equity Instruments

(This appendix is an integral part of Ind AS 39)

Background

1 A debtor and creditor might renegotiate the terms of a financial liability with the result that the debtor extinguishes the liability fully or partially by issuing equity instruments to the creditor. These transactions are sometimes referred to as 'debt for equity swaps'.

Scope

2 This Appendix addresses the accounting by an entity when the terms of a financial liability are renegotiated and result in the entity issuing equity instruments to a creditor of the entity to extinguish all or part of the financial liability. It does not address the accounting by the creditor.

3 An entity shall not apply this Appendix to transactions in situations where:

(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.

(c) extinguishing the financial liability by issuing equity shares is in accordance with the original terms of the financial liability.

Issues

4 This Appendix addresses the following issues:

(a) Are an entity's equity instruments issued to extinguish all or part of a financial liability 'consideration paid' in accordance with paragraph 41 of Ind AS 39?

(b) How should an entity initially measure the equity instruments issued to extinguish such a financial liability?

(c) How should an entity account for any difference between the carrying amount of the financial liability extinguished and the initial measurement amount of the equity instruments issued?

Accounting principles

5 The issue of an entity's equity instruments to a creditor to extinguish all or part of a financial liability is consideration paid in accordance with paragraph 41 of Ind AS 39. An entity shall remove a financial liability (or part of a financial liability) from its balance sheet when, and only when, it is extinguished in accordance with paragraph 39 of Ind AS 39.

6 When equity instruments issued to a creditor to extinguish all or part of a financial liability are recognised initially, an entity shall measure them at the fair value of the equity instruments issued, unless that fair value cannot be reliably measured.

7 If the fair value of the equity instruments issued cannot be reliably measured then the equity instruments shall be measured to reflect the fair value of the financial liability extinguished. In measuring the fair value of a financial liability extinguished that includes a demand feature (eg a demand deposit), paragraph 49 of Ind AS 39 is not applied.

8 If only part of the financial liability is extinguished, the entity shall assess whether some of the consideration paid relates to a modification of the terms of the liability that remains outstanding. If part of the consideration paid does relate 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 of the liability that remains outstanding. The entity shall consider all relevant facts and circumstances relating to the transaction in making this allocation.

9 The difference between the carrying amount of the financial liability (or part of a financial liability) extinguished, and the consideration paid, shall be recognised in profit or loss, in accordance with paragraph 41 of Ind AS 39. The equity instruments issued shall be recognised initially and measured at the date the financial liability (or part of that liability) is extinguished.

10 When only part of the financial liability is extinguished, consideration shall be allocated in accordance with paragraph 8. The consideration allocated to the remaining liability shall form part of the assessment of whether the terms of that remaining liability have been substantially modified. 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 40 of Ind AS 39.

11 An entity shall disclose a gain or loss recognised in accordance with paragraphs 9 and 10 as a separate line item in profit or loss or in the notes.

Appendix F

Ind AS 39 *Financial Instruments: Recognition and Measurement* Illustrative example

This example accompanies, but is not part of,Ind AS 39.

Facts

IE1 On 1 January 20X1, Entity A identifies a portfolio comprising assets and liabilities whose interest rate risk it wishes to hedge. The liabilities include demandable deposit liabilities that the depositor may withdraw at any time without notice. For risk management purposes, the entity views all of the items in the portfolio as fixed rate items.

IE2 For risk management purposes, Entity A analyses the assets and liabilities in the portfolio into repricing time periods based on expected repricing dates. The entity uses monthly time periods and schedules items for the next five years (ie it has 60 separate monthly time periods).[13] The assets in the portfolio are prepayable assets that Entity A allocates into time periods based on the expected prepayment dates, by allocating a percentage of all of the assets, rather than individual items, into each time period. The portfolio also includes demandable liabilities that the entity expects, on a portfolio basis, to repay between one month and five years and, for risk management purposes, are scheduled into time periods on this basis. On the basis of this analysis, Entity A decides what amount it wishes to hedge in each time period.

IE3 This example deals only with the repricing time period expiring in three months' time, ie the time period maturing on 31 March 20X1 (a similar procedure would be applied for each of the other 59 time periods). Entity A has scheduled assets of Rs.100 million and liabilities of Rs.80 million into this time period. All of the liabilities are repayable on demand.

IE4 Entity A decides, for risk management purposes, to hedge the net position of Rs.20 million and accordingly enters into an interest rate swap on 1 January 20X1 to pay a fixed rate and receive MIBOR, with a notional principal[14] amount of Rs.20 million and a fixed life of three months.

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

IE5 This example makes the following simplifying assumptions:

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

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

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

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

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

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

	1 Jan 20X1	**31 Jan 20X1**	**1 Feb 20X1**	**28 Feb 20X1**	**31 Mar 20X1**
Fair value (asset) (Rs.)	20,000,000	20,047,408	20,047,408	20,023,795	Nil

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

	1 Jan 20X1	**31 Jan 20X1**	**1 Feb 20X1**	**28 Feb 20X1**	**31 Mar 20X1**
Fair value (liability) (Rs.)	Nil	(47,408)	(47,408)	(23,795)	Nil

Accounting treatment

IE9 On 1 January 20X1, Entity A designates as the hedged item an amount of Rs.20 million of assets in the three-month time period. It designates as the hedged risk the change in the value of the hedged item (ie the Rs.20 million of assets) that is attributable to changes in MIBOR . It also complies with the other designation requirements set out in paragraphs 88(d) and AG119 of the Standard.

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

End of month 1 (31 January 20X1)

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

IE11 On 31 January 20X1 (at the end of month 1) when Entity A tests effectiveness, MIBOR has decreased. Based on historical prepayment experience, Entity A estimates that, as a consequence, prepayments will occur faster than previously estimated. As a result it re-estimates the amount of assets scheduled into this time period (excluding new assets originated during the month) as Rs.96 million.

IE12 The fair value of the designated interest rate swap with a notional principal of Rs.20 million is (Rs.47,408)[15] (the swap is a liability).

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

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

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

(c) Third, it calculates the change in the fair value of this revised estimate of the hedged item (Rs.19.2 million) that is attributable to changes in MIBOR. This is Rs.45,511 (Rs.47,408[16] × (Rs.19.2 million ÷ Rs.20 million)).

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

Dr Cash	Rs.172,097	
Cr Profit or loss (interest income)[17]		Rs.172,097

To recognise the interest received on the hedged amount (Rs.19.2 million).

Dr Profit or loss (interest expense)	Rs.179,268	
Cr Profit or loss (interest income)		Rs.179,268
Cr Cash		Nil

To recognise the interest received and paid on the swap designated as the hedging instrument.

Dr Profit or loss (loss)	Rs.47,408	
Cr Derivative liability		Rs.47,408

To recognise the change in the fair value of the swap.

Dr Separate line item in the balance sheet	Rs.45,511	

[15] see paragraph IE8.

[16] ie Rs.20,047,408 – Rs.20,000,000. See paragraph IE7.

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

	Cr Profit or loss (gain)	Rs.45,511

To recognise the change in the fair value of the hedged amount.

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

Beginning of month 2

IE16 On 1 February 20X1 Entity A sells a proportion of the assets in the various time periods. Entity A calculates that it has sold $8^1/_3$ per cent of the entire portfolio of assets. Because the assets were allocated into time periods by allocating a percentage of the assets (rather than individual assets) into each time period, Entity A determines that it cannot ascertain into which specific time periods the sold assets were scheduled. Hence it uses a systematic and rational basis of allocation. Based on the fact that it sold a representative selection of the assets in the portfolio, Entity A allocates the sale proportionately over all time periods.

IE17 On this basis, Entity A computes that it has sold $8^1/_3$ per cent of the assets allocated to the three-month time period, ie Rs.8 million ($8^1/_3$ per cent of Rs.96 million). The proceeds received are Rs.8,018,400, equal to the fair value of the assets.[18] On derecognition of the assets, Entity A also removes from the separate line item in the balance sheet an amount that represents the change in the fair value of the hedged assets that it has now sold. This is $8^1/_3$ per cent of the total line item balance of Rs.45,511, ie Rs.3,793.

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

Dr	Cash	Rs.8,018,400	
	Cr Asset		Rs.8,000,000
	Cr Separate line item in the balance sheet		Rs.3,793
	Cr Profit or loss (gain)		Rs.14,607

To recognise the sale of the asset at fair value and to recognise a gain on sale.

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

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

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

IE20 Entity A decides to adjust the hedging instrument by designating only a proportion of the original swap as the hedging instrument. Accordingly, it designates as the hedging instrument Rs.8 million or 40 per cent of the notional amount of the original swap with a remaining life of two months and a fair value of Rs.18,963.[19] It also complies with the other designation requirements in paragraphs 88(a) and AG119 of the Standard. The Rs.12 million of the notional amount of the swap that is no longer designated as the hedging instrument is either classified as held for trading with changes in fair value recognised in profit or loss, or is designated as the hedging instrument in a different hedge.[20]

IE21 As at 1 February 20X1 and after accounting for the sale of assets, the separate line item in the balance sheet is Rs.41,718 (Rs.45,511 – Rs.3,793), which represents the cumulative change in fair value of Rs.17.6[21] million of assets. However, as at 1 February 20X1, Entity A is hedging only Rs.8 million of assets that have a cumulative change in fair value of Rs.18,963.[22] The remaining separate line item in the balance sheet of Rs.22,755[23] relates to an amount of assets that Entity A still holds but is no longer hedging. Accordingly Entity A amortises this amount over the remaining life of the time period, ie it amortises Rs.22,755 over two months.

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

End of month 2 (28 February 20X1)

IE23 On 28 February 20X1 when Entity A next tests effectiveness, MIBOR is unchanged. Entity A does not revise its prepayment expectations. The fair value of the designated interest rate swap with a notional principal of Rs.8 million is (Rs.9,518)[24] (the swap is a liability). Also, Entity A calculates the fair value of the Rs.8 million of the hedged assets as at 28 February 20X1 as Rs.8,009,518.[25]

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

Dr	Cash	Rs.71,707

[19] Rs.47,408 × 40 per cent

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

[21] Rs.19.2 million – ($8^1/_3$% × Rs.19.2 million)

[22] Rs.41,718 × (Rs.8 million ÷ Rs.17.6 million)

[23] Rs.41,718 – Rs.18,963

[24] Rs.23,795 [see paragraph IE8] × (Rs.8 million ÷ Rs.20 million)

[25] Rs.20,023,795 [see paragraph IE7] × (Rs.8 million ÷ Rs.20 million)

	Cr Profit or loss (interest income)		Rs.71,707

To recognise the interest received on the hedged amount (Rs.8 million).

Dr	Profit or loss (interest expense)	Rs.71,707	
	Cr Profit or loss (interest income)		Rs.62,115
	Cr Cash		Rs.9,592

To recognise the interest received and paid on the portion of the swap designated as the hedging instrument (Rs.8 million).

Dr	Derivative liability	Rs.9,445	
	Cr Profit or loss (gain)		Rs.9,445

To recognise the change in the fair value of the portion of the swap designated as the hedging instrument (Rs.8 million) (Rs.9,518 – Rs.18,963).

Dr	Profit or loss (loss)	Rs.9,445	
	Cr Separate line item in the balance sheet		Rs.9,445

To recognise the change in the fair value of the hedged amount (Rs.8,009,518 – Rs.8,018,963)

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

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

Dr	Profit or loss (loss)	Rs.11,378	
	Cr Separate line item in the balance sheet		Rs.11,378[26]

To recognise the amortisation charge for the period.

End of month 3

IE27 During the third month there is no further change in the amount of assets or liabilities in the three-month time period. On 31 March 20X1 the assets and the swap mature and all balances are recognised in profit or loss.

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

Dr	Cash	Rs.8,071,707	
	Cr Asset (balance sheet)		Rs.8,000,000
	Cr Profit or loss (interest income)		Rs.71,707

To recognise the interest and cash received on maturity of the hedged amount

[26] Rs.22,755 ÷ 2

(Rs.8 million).

Dr	Profit or loss (interest expense)	Rs.71,707	
	Cr Profit or loss (interest income)		Rs.62,115
	Cr Cash		Rs.9,592

To recognise the interest received and paid on the portion of the swap designated as the hedging instrument (Rs.8 million).

Dr	Derivative liability	Rs.9,518	
	Cr Profit or loss (gain)		Rs.9,518

To recognise the expiry of the portion of the swap designated as the hedging instrument (Rs.8 million).

Dr	Profit or loss (loss)	Rs.9,518	
	Cr Separate line item in the balance sheet		Rs.9,518

To remove the remaining line item balance on expiry of the time period.

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

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

Dr	Profit or loss (loss)	Rs.11,377	
	Cr Separate line item in the balance sheet		Rs.11,377[27]

To recognise the amortisation charge for the period.

Summary

IE31 The tables below summarise:

(a) changes in the separate line item in the balance sheet;

(b) the fair value of the derivative;

(c) the profit or loss effect of the hedge for the entire three-month period of the hedge; and

(d) interest income and interest expense relating to the amount designated as hedged.

Description	1 Jan 20X1	31 Jan 20X1	1 Feb 20X1	28 Feb 20X1	31 Mar 20X1

[27] Rs.22,755 ÷ 2

	Rs.	Rs.	Rs.	Rs.	Rs.
Amount of asset hedged	**20,000,000**	**19,200,000**	**8,000,000**	**8,000,000**	**8,000,000**
(a) Changes in the separate line item in the balance sheet					
Brought forward:					
Balance to be amortised	Nil	Nil	Nil	22,755	11,377
Remaining balance	Nil	Nil	45,511	18,963	9,518
Less: Adjustment on sale of asset	Nil	Nil	(3,793)	Nil	Nil
Adjustment for change in fair value of the hedged asset	Nil	45,511	Nil	(9,445)	(9,518)
Amortisation	Nil	Nil	Nil	(11,378)	(11,377)
Carried forward:					
Balance to be amortised	**Nil**	**Nil**	**22,755**	**11,377**	**Nil**
Remaining balance	**Nil**	**45,511**	**18,963**	**9,518**	**Nil**
(b) The fair value of the derivative					
	1 Jan 20X1	**31 Jan 20X1**	**1 Feb 20X1**	**28 Feb 20X1**	**31 Mar 20X1**
Rs.20,000,000	Nil	47,408	–	–	–
Rs.12,000,000	Nil	–	28,445	No longer designated as the hedging instrument.	
Rs.8,000,000	Nil	–	18,963	9,518	Nil
Total	**Nil**	**47,408**	**47,408**	**9,518**	**Nil**
(d) Profit or loss effect of the hedge					
	1 Jan 20X1	**31 Jan 20X1**	**1 Feb 20X1**	**28 Feb 20X1**	**31 Mar 20X1**
Change in line item: asset	Nil	45,511	N/A	(9,445)	(9,518)

Change in line item: asset					
Change in derivative fair value	Nil	(47,408)	N/A	9,445	9,518
Net effect	**Nil**	**(1,897)**	**N/A**	**Nil**	**Nil**
Amortisation	**Nil**	**Nil**	**N/A**	**(11,378)**	**(11,377)**
In addition, there is a gain on sale of assets of Rs.14,607 at 1 February 20X1.					
(c) Interest income and interest expense relating to the amount designated as hedged					
Profit or loss recognised for the amount hedged	**1 Jan 20X1**	**31 Jan 20X1**	**1 Feb 20X1**	**28 Feb 20X1**	**31 Mar 20X1**
Interest income					
– on the asset	Nil	172,097	N/A	71,707	71,707
– on the swap	Nil	179,268	N/A	62,115	62,115
Interest expense					
– on the swap	Nil	(179,268)	N/A	(71,707)	(71,707)

Appendix G

Guidance on implementing Ind AS 39 *Financial Instruments: Recognition and Measurement*

GUIDANCE ON IMPLEMENTING Ind AS 39 *FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT*

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Guidance on implementing Ind AS 39 *Financial Instruments: Recognition and Measurement*

This guidance accompanies, but is not part of,Ind AS 39.

Section A Scope

A.1 Practice of settling net: forward contract to purchase a commodity

Entity XYZ enters into a fixed price forward contract to purchase one million kilograms of copper in accordance with its expected usage requirements. The contract permits XYZ to take physical delivery of the copper at the end of twelve months or to pay or receive a net settlement in cash, based on the change in fair value of copper. Is the contract accounted for as a derivative?

While such a contract meets the definition of a derivative, it is not necessarily accounted for as a derivative. The contract is a derivative instrument because there is no initial net investment, the contract is based on the price of copper, and it is to be settled at a future date. However, if XYZ intends to settle the contract by taking delivery and has no history for similar contracts of settling net in cash or of taking delivery of the copper and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin, the contract is not accounted for as a derivative under Ind AS 39. Instead, it is accounted for as an executory contract.

A.2 Option to put a non-financial asset

Entity XYZ owns an office building. XYZ enters into a put option with an investor that permits XYZ to put the building to the investor for Rs.150 million. The current value of the building is Rs.175 million. The option expires in five years. The option, if exercised, may be settled through physical delivery or net cash, at XYZ's option. How do both XYZ and the investor account for the option?

XYZ's accounting depends on XYZ's intention and past practice for settlement. Although the contract meets the definition of a derivative, XYZ does not account for it as a derivative if XYZ intends to settle the contract by delivering the building if XYZ exercises its option and there is no past practice of settling net (Ind AS 39.5 and Ind AS 39.AG10).

The investor, however, cannot conclude that the option was entered into to meet the investor's expected purchase, sale or usage requirements because the investor does not have the ability to require delivery (Ind AS 39.7). In addition, the option may be settled net in cash. Therefore, the investor has to account for the contract as a derivative. Regardless of past practices, the investor's intention does not affect whether settlement is by delivery or in cash. The investor has written an option, and a written option in which the holder has a choice of physical settlement or net cash settlement can never satisfy the normal delivery requirement for the exemption from Ind AS 39 because the option writer does not have the ability to require delivery.

However, if the contract were a forward contract rather than an option, and if the contract required physical delivery and the reporting entity had no past practice of settling net in

cash or of taking delivery of the building and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin, the contract would not be accounted for as a derivative.

Section B Definitions

B.1 Definition of a financial instrument: gold bullion

Is gold bullion a financial instrument (like cash) or is it a commodity?

It is a commodity. Although bullion is highly liquid, there is no contractual right to receive cash or another financial asset inherent in bullion.

B.2 Definition of a derivative: examples of derivatives and underlyings

What are examples of common derivative contracts and the identified underlying?

Ind AS 39 defines a derivative as follows:

A *derivative* is a financial instrument or other contract within the scope of this Standard with all three of the following characteristics:

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

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

(c) **it is settled at a future date.**

Type of contract	Main pricing-settlement variable (underlying variable)
Interest rate swap	Interest rates
Currency swap (foreign exchange swap)	Currency rates
Commodity swap	Commodity prices
Equity swap	Equity prices (equity of another entity)
Credit swap	Credit rating, credit index or credit price
Total return swap	Total fair value of the reference asset and interest rates
Purchased or written treasury bond option (call or put)	Interest rates
Purchased or written currency option (call	Currency rates

or put)	
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)

The above list provides examples of contracts that normally qualify as derivatives under Ind AS 39. The list is not exhaustive. Any contract that has an underlying may be a derivative. Moreover, even if an instrument meets the definition of a derivative contract, special provisions of Ind AS 39 may apply, for example, if it is a weather derivative (seeInd AS 39.AG1), a contract to buy or sell a non-financial item such as commodity (see Ind AS 39.5 and Ind AS 39.AG10) or a contract settled in an entity's own shares (see Ind AS 32.21–Ind AS 32.24). Therefore, an entity must evaluate the contract to determine whether the other characteristics of a derivative are present and whether special provisions apply.

B.3 Definition of a derivative: settlement at a future date, interest rate swap with net or gross settlement

For the purpose of determining whether an interest rate swap is a derivative financial instrument under Ind AS 39, does it make a difference whether the parties pay the interest payments to each other (gross settlement) or settle on a net basis?

No. The definition of a derivative does not depend on gross or net settlement.

To illustrate: Entity ABC enters into an interest rate swap with a counterparty (XYZ) that requires ABC to pay a fixed rate of 8 per cent and receive a variable amount based on three-month MIBOR, reset on a quarterly basis. The fixed and variable amounts are determined based on a Rs.100 million notional amount. ABC and XYZ do not exchange the notional amount. ABC pays or receives a net cash amount each quarter based on the difference between 8 per cent and three-month MIBOR. Alternatively, settlement may be on a gross basis.

The contract meets the definition of a derivative regardless of whether there is net or gross settlement because its value changes in response to changes in an underlying variable (MIBOR), there is no initial net investment, and settlements occur at future dates.

B.4 Definition of a derivative: prepaid interest rate swap (fixed rate payment obligation prepaid at inception or subsequently)

If a party prepays its obligation under a pay-fixed, receive-variable interest rate swap at inception, is the swap a derivative financial instrument?

Yes.

To illustrate: Entity S enters into a Rs.100 million notional amount five-year pay-fixed, receive-variable interest rate swap with Counterparty C. The interest rate of the variable part of the swap is reset on a quarterly basis to three-month MIBOR-. The interest rate of the fixed part of the swap is 10 per cent per year. Entity S prepays its fixed obligation under the swap of Rs.50 million (Rs.100 million × 10 per cent × 5 years) at inception, discounted using market interest rates, while retaining the right to receive interest payments on the Rs.100 million reset quarterly based on three-month MIBOR over the life of the swap.

The initial net investment in the interest rate swap is significantly less than the notional amount on which the variable payments under the variable leg will be calculated. The contract requires an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, such as a variable rate bond. Therefore, the contract fulfils the 'no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors' provision of Ind AS 39. Even though Entity S has no future performance obligation, the ultimate settlement of the contract is at a future date and the value of the contract changes in response to changes in the MIBOR index. Accordingly, the contract is regarded as a derivative contract.

Would the answer change if the fixed rate payment obligation is prepaid subsequent to initial recognition?

If the fixed leg is prepaid during the term, that would be regarded as a termination of the old swap and an origination of a new instrument that is evaluated under Ind AS 39.

B.5 Definition of a derivative: prepaid pay-variable, receive-fixed interest rate swap

If a party prepays its obligation under a pay-variable, receive-fixed interest rate swap at inception of the contract or subsequently, is the swap a derivative financial instrument?

No. A prepaid pay-variable, receive-fixed interest rate swap is not a derivative if it is prepaid at inception and it is no longer a derivative if it is prepaid after inception because it provides a return on the prepaid (invested) amount comparable to the return on a debt instrument with fixed cash flows. The prepaid amount fails the 'no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors' criterion of a derivative.

To illustrate: Entity S enters into a Rs.100 million notional amount five-year pay-variable, receive-fixed interest rate swap with Counterparty C. The variable leg of the swap is

reset on a quarterly basis to three-month MIBOR. The fixed interest payments under the swap are calculated as 10 per cent times the swap's notional amount, ie Rs.10 million per year. Entity S prepays its obligation under the variable leg of the swap at inception at current market rates, while retaining the right to receive fixed interest payments of 10 per cent on Rs.100 million per year.

The cash inflows under the contract are equivalent to those of a financial instrument with a fixed annuity stream since Entity S knows it will receive Rs.10 million per year over the life of the swap. Therefore, all else being equal, the initial investment in the contract should equal that of other financial instruments that consist of fixed annuities. Thus, the initial net investment in the pay-variable, receive-fixed interest rate swap is equal to the investment required in a non-derivative contract that has a similar response to changes in market conditions. For this reason, the instrument fails the 'no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors' criterion of Ind AS 39. Therefore, the contract is not accounted for as a derivative under Ind AS 39. By discharging the obligation to pay variable interest rate payments, Entity S in effect provides a loan to Counterparty C.

B.6 Definition of a derivative: offsetting loans

Entity A makes a five-year fixed rate loan to Entity B, while B at the same time makes a five-year variable rate loan for the same amount to A. There are no transfers of principal at inception of the two loans, since A and B have a netting agreement. Is this a derivative under Ind AS 39?

Yes. This meets the definition of a derivative (that is to say, there is an underlying variable, no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and future settlement). The contractual effect of the loans is the equivalent of an interest rate swap arrangement with no initial net investment. Non-derivative transactions are aggregated and treated as a derivative when the transactions result, in substance, in a derivative. Indicators of this would include:

- they are entered into at the same time and in contemplation of one another
- they have the same counterparty
- they relate to the same risk

there is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.

The same answer would apply if Entity A and Entity B did not have a netting agreement, because the definition of a derivative instrument in Ind AS 39.9 does not require net settlement.

B.7 Definition of a derivative: option not expected to be exercised

The definition of a derivative in Ind AS 39.9 requires that the instrument 'is settled at a future date'. Is this criterion met even if an option is expected not to be exercised, for example, because it is out of the money?

Yes. An option is settled upon exercise or at its maturity. Expiry at maturity is a form of settlement even though there is no additional exchange of consideration.

B.8 Definition of a derivative: foreign currency contract based on sales volume

Entity XYZ, whose functional currency is the US dollar, sells products in France denominated in euro. XYZ enters into a contract with an investment bank to convert euro to US dollars at a fixed exchange rate. The contract requires XYZ to remit euro based on its sales volume in France in exchange for US dollars at a fixed exchange rate of 6.00. Is that contract a derivative?

Yes. The contract has two underlying variables (the foreign exchange rate and the volume of sales), no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and a payment provision. Ind AS 39 does not exclude from its scope derivatives that are based on sales volume.

B.9 Definition of a derivative: prepaid forward

An entity enters into a forward contract to purchase shares of stock in one year at the forward price. It prepays at inception based on the current price of the shares. Is the forward contract a derivative?

No. The forward contract fails the 'no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors' test for a derivative.

To illustrate: Entity XYZ enters into a forward contract to purchase one million T ordinary shares in one year. The current market price of T is Rs.50 per share; the one-year forward price of T is Rs.55 per share. XYZ is required to prepay the forward contract at inception with a Rs.50 million payment. The initial investment in the forward contract of Rs.50 million is less than the notional amount applied to the underlying, one million shares at the forward price of Rs.55 per share, ie Rs.55 million. However, the initial net investment approximates the investment that would be required for other types of contracts that would be expected to have a similar response to changes in market factors because T's shares could be purchased at inception for the same price of Rs.50. Accordingly, the prepaid forward contract does not meet the initial net investment criterion of a derivative instrument.

B.10 Definition of a derivative: initial net investment

Many derivative instruments, such as futures contracts and exchange traded written options, require margin accounts. Is the margin account part of the initial net investment?

No. The margin account is not part of the initial net investment in a derivative instrument. Margin accounts are a form of collateral for the counterparty or clearing house and may take the form of cash, securities or other specified assets, typically liquid assets. Margin accounts are separate assets that are accounted for separately.

B.11 Definition of held for trading: portfolio with a recent actual pattern of short-term profit-taking

The definition of a financial asset or financial liability held for trading states that 'a financial asset or financial liability is classified as held for trading if it is … part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking'. What is a 'portfolio' for the purposes of applying this definition?

Although the term 'portfolio' is not explicitly defined in Ind AS 39, the context in which it is used suggests that a portfolio is a group of financial assets or financial liabilities that are managed as part of that group (Ind AS 39.9). If there is evidence of a recent actual pattern of short-term profit-taking on financial instruments included in such a portfolio, those financial instruments qualify as held for trading even though an individual financial instrument may in fact be held for a longer period of time.

B.12 Definition of held for trading: balancing a portfolio

Entity A has an investment portfolio of debt and equity instruments. The documented portfolio management guidelines specify that the equity exposure of the portfolio should be limited to between 30 and 50 per cent of total portfolio value. The investment manager of the portfolio is authorised to balance the portfolio within the designated guidelines by buying and selling equity and debt instruments. Is Entity A permitted to classify the instruments as available for sale?

It depends on Entity A's intentions and past practice. If the portfolio manager is authorised to buy and sell instruments to balance the risks in a portfolio, but there is no intention to trade and there is no past practice of trading for short-term profit, the instruments can be classified as available for sale. If the portfolio manager actively buys and sells instruments to generate short-term profits, the financial instruments in the portfolio are classified as held for trading.

B.13 Definition of held-to-maturity financial assets: index-linked principal

Entity A purchases a five-year equity-index-linked note with an original issue price of Rs.10 at a market price of Rs.12 at the time of purchase. The note requires no interest payments before maturity. At maturity, the note requires payment of the original issue price of Rs.10 plus a supplemental redemption amount that depends on whether a specified share price index exceeds a predetermined level at the maturity date. If the share index does not exceed or is equal to the predetermined level, no supplemental redemption amount is paid. If the share index exceeds the predetermined level, the supplemental redemption amount equals the product of 1.15 and the difference between the level of the share index at maturity and the level of the share index when the note was issued divided by the level of the share index at the time of issue. Entity A has the positive intention and ability to hold the note to maturity. Can Entity A classify the note as a held-to-maturity investment?

Yes. The note can be classified as a held-to-maturity investment because it has a fixed payment of Rs.10 and fixed maturity and Entity A has the positive intention and ability to hold it to maturity (Ind AS 39.9). However, the equity index feature is a call option not closely related to the debt host, which must be separated as an embedded derivative under Ind AS 39.11. The purchase price of Rs.12 is allocated between the host debt instrument and the embedded derivative. For example, if the fair value of the embedded option at acquisition is Rs.4, the host debt instrument is measured at Rs.8 on initial recognition. In this case, the discount of Rs.2 that is implicit in the host bond (principal of Rs.10 minus the original carrying amount of Rs.8) is amortised to profit or loss over the term to maturity of the note using the effective interest method.

B.14 Definition of held-to-maturity financial assets: index-linked interest

Can a bond with a fixed payment at maturity and a fixed maturity date be classified as a held-to-maturity investment if the bond's interest payments are indexed to the price of a commodity or equity, and the entity has the positive intention and ability to hold the bond to maturity?

Yes. However, the commodity-indexed or equity-indexed interest payments result in an embedded derivative that is separated and accounted for as a derivative at fair value (Ind AS 39.11). Ind AS 39.12 is not applicable since it should be straightforward to separate the host debt investment (the fixed payment at maturity) from the embedded derivative (the index-linked interest payments).

B.15 Definition of held-to-maturity financial assets: sale following rating downgrade

Would a sale of a held-to-maturity investment following a downgrade of the issuer's credit rating by a rating agency raise a question about the entity's intention to hold other investments to maturity?

Not necessarily. A downgrade is likely to indicate a decline in the issuer's creditworthiness. Ind AS 39 specifies that a sale due to a significant deterioration in the issuer's creditworthiness could satisfy the condition in Ind AS 39 and therefore not raise a question about the entity's intention to hold other investments to maturity. However, the deterioration in creditworthiness must be significant judged by reference to the credit rating at initial recognition. Also, the rating downgrade must not have been reasonably anticipated when the entity classified the investment as held to maturity in order to meet the condition inInd AS 39. A credit downgrade of a notch within a class or from one rating class to the immediately lower rating class could often be regarded as reasonably anticipated. If the rating downgrade in combination with other information provides evidence of impairment, the deterioration in creditworthiness often would be regarded as significant.

B.16 Definition of held-to-maturity financial assets: permitted sales

Would sales of held-to-maturity financial assets due to a change in management compromise the classification of other financial assets as held to maturity?

Yes. A change in management is not identified under Ind AS 39.AG22 as an instance where sales or transfers from held-to-maturity do not compromise the classification as held to maturity. Sales in response to such a change in management would, therefore, call into question the entity's intention to hold investments to maturity.

To illustrate: Entity X has a portfolio of financial assets that is classified as held to maturity. In the current period, at the direction of the board of directors, the senior management team has been replaced. The new management wishes to sell a portion of the held-to-maturity financial assets in order to carry out an expansion strategy designated and approved by the board. Although the previous management team had been in place since the entity's inception and Entity X had never before undergone a major restructuring, the sale nevertheless calls into question Entity X's intention to hold remaining held-to-maturity financial assets to maturity.

B.17 Definition of held-to-maturity investments: sales in response to *entity-specific* capital requirements

In some countries, regulators of banks or other industries may set *entity-specific* capital requirements that are based on an assessment of the risk in that particular entity.Ind AS 39.AG22(e) indicates that an entity that sells held-to-maturity investments in response to an unanticipated significant increase by the regulator in the *industry's* capital requirements may do so under Ind AS 39 without necessarily raising a question about its intention to hold other investments to maturity. Would sales of held-to-maturity investments that are due to a significant increase in *entity-specific* capital requirements imposed by regulators (ie capital requirements applicable to a particular entity, but not to the industry) raise such doubt?

Yes, such sales 'taint' the entity's intention to hold other financial assets as held to maturity unless it can be demonstrated that the sales fulfil the condition in Ind AS 39.9 in that they result from an increase in capital requirements, which is an isolated event that is beyond the entity's control, is non-recurring and could not have been reasonably anticipated by the entity.
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B.18 Definition of held-to-maturity financial assets: pledged collateral, repurchase agreements (repos) and securities lending agreements

An entity cannot have a demonstrated ability to hold to maturity an investment if it is subject to a constraint that could frustrate its intention to hold the financial asset to maturity. Does this mean that a debt instrument that has been pledged as collateral, or transferred to another party under a repo or securities lending transaction, and continues to be recognised cannot be classified as a held-to-maturity investment?

No. An entity's intention and ability to hold debt instruments to maturity is not necessarily constrained if those instruments have been pledged as collateral or are subject to a repurchase agreement or securities lending agreement. However, an entity does not have the positive intention and ability to hold the debt instruments until maturity if it does not expect to be able to maintain or recover access to the instruments.

B.19 Definition of held-to-maturity financial assets: 'tainting'

In response to unsolicited tender offers, Entity A sells a significant amount of financial assets classified as held to maturity on economically favourable terms. Entity A does not classify any financial assets acquired after the date of the sale as held to maturity. However, it does not reclassify the remaining held-to-maturity investments since it maintains that it still intends to hold them to maturity. Is Entity A in compliance with Ind AS 39?

No. Whenever a sale or transfer of more than an insignificant amount of financial assets classified as held to maturity (HTM) results in the conditions in Ind AS 39.9 and Ind AS 39.AG22 not being satisfied, no instruments should be classified in that category. Accordingly, any remaining HTM assets are reclassified as available-for-sale financial assets. The reclassification is recorded in the reporting period in which the sales or transfers occurred and is accounted for as a change in classification under Ind AS 39.51. Ind AS 39.9 makes it clear that at least two full financial years must pass before an entity can again classify financial assets as HTM.

B.20 Definition of held-to-maturity investments: sub-categorisation for the purpose of applying the 'tainting' rule

Can an entity apply the conditions for held-to-maturity classification in Ind AS 39.9 separately to different categories of held-to-maturity financial assets, such as debt instruments denominated in US dollars and debt instruments denominated in euro?

No. The 'tainting rule' in Ind AS 39.9 is clear. If an entity has sold or reclassified more than an insignificant amount of held-to-maturity investments, it cannot classify any financial assets as held-to-maturity financial assets.

B.21 Definition of held-to-maturity investments: application of the 'tainting' rule on consolidation

Can an entity apply the conditions in Ind AS 39.9 separately to held-to-maturity financial assets held by different entities in a consolidated group, for example, if those group entities are in different countries with different legal or economic environments?

No. If an entity has sold or reclassified more than an insignificant amount of investments classified as held-to-maturity in the consolidated financial statements, it cannot classify any financial assets as held-to-maturity financial assets in the consolidated financial statements unless the conditions in Ind AS 39.9 are met.

B.22 Definition of loans and receivables: equity instrument

Can an equity instrument, such as a preference share, with fixed or determinable payments be classified within loans and receivables by the holder?

Yes. If a non-derivative equity instrument would be recorded as a liability by the issuer, and it has fixed or determinable payments and is not quoted in an active market, it can be classified within loans and receivables by the holder, provided the definition is otherwise met. Ind AS 32.15–Ind AS 32.22 provide guidance about the classification of a

financial instrument as a liability or as equity from the perspective of the issuer of a financial instrument. If an instrument meets the definition of an equity instrument under Ind AS 32, it cannot be classified within loans and receivables by the holder.

B.23 Definition of loans and receivables: banks' deposits in other banks

Banks make term deposits with a central bank or other banks. Sometimes, the proof of deposit is negotiable, sometimes not. Even if negotiable, the depositor bank may or may not intend to sell it. Would such a deposit fall within loans and receivables under Ind AS 39.9?

Such a deposit meets the definition of loans and receivables, whether or not the proof of deposit is negotiable, unless the depositor bank intends to sell the instrument immediately or in the near term, in which case the deposit is classified as a financial asset held for trading.

B.24 Definition of amortised cost: perpetual debt instruments with fixed or market-based variable rate

Sometimes entities purchase or issue debt instruments that are required to be measured at amortised cost and in respect of which the issuer has no obligation to repay the principal amount. Interest may be paid either at a fixed rate or at a variable rate. Would the difference between the initial amount paid or received and zero ('the maturity amount') be amortised immediately on initial recognition for the purpose of determining amortised cost if the rate of interest is fixed or specified as a market-based variable rate?

No. Since there are no repayments of principal, there is no amortisation of the difference between the initial amount and the maturity amount if the rate of interest is fixed or specified as a market-based variable rate. Because interest payments are fixed or market-based and will be paid in perpetuity, the amortised cost (the present value of the stream of future cash payments discounted at the effective interest rate) equals the principal amount in each period (Ind AS 39.9).

B.25 Definition of amortised cost: perpetual debt instruments with decreasing interest rate

If the stated rate of interest on a perpetual debt instrument decreases over time, would amortised cost equal the principal amount in each period?

No. From an economic perspective, some or all of the interest payments are repayments of the principal amount. For example, the interest rate may be stated as 16 per cent for the first ten years and as zero per cent in subsequent periods. In that case, the initial amount is amortised to zero over the first ten years using the effective interest method, since a portion of the interest payments represents repayments of the principal amount. The amortised cost is zero after year 10 because the present value of the stream of future cash payments in subsequent periods is zero (there are no further cash payments of either principal or interest in subsequent periods).

B.26 Example of calculating amortised cost: financial asset

Financial assets that are excluded from fair valuation and have a fixed maturity should be measured at amortised cost. How is amortised cost calculated?

Under Ind AS 39, amortised cost is calculated using the effective interest method. The effective interest rate inherent in a financial instrument is the rate that exactly discounts the estimated cash flows associated with the financial instrument through the expected life of the instrument or, where appropriate, a shorter period to the net carrying amount at initial recognition. The computation includes all fees and points paid or received that are an integral part of the effective interest rate, directly attributable transaction costs and all other premiums or discounts.

The following example illustrates how amortised cost is calculated using the effective interest method. Entity A purchases a debt instrument with five years remaining to maturity for its fair value of Rs.1,000 (including transaction costs). The instrument has a principal amount of Rs.1,250 and carries fixed interest of 4.7 per cent that is paid annually (Rs.1,250 × 4.7 per cent = Rs.59 per year). The contract also specifies that the borrower has an option to prepay the instrument and that no penalty will be charged for prepayment. At inception, the entity expects the borrower not to prepay.

It can be shown that in order to allocate interest receipts and the initial discount over the term of the debt instrument at a constant rate on the carrying amount, they must be accrued at the rate of 10 per cent annually. The table below provides information about the amortised cost, interest income and cash flows of the debt instrument in each reporting period.

Year	**(a)**	**(b = a × 10%)**	**(c)**	**(d = a + b – c)**
	Amortised cost at the beginning of the year	**Interest income**	**Cash flows**	**Amortised cost at the end of the year**
20X0	1,000	100	59	1,041
20X1	1,041	104	59	1,086
20X2	1,086	109	59	1,136
20X3	1,136	113	59	1,190
20X4	1,190	119	1,250 + 59	–

On the first day of 20X2 the entity revises its estimate of cash flows. It now expects that 50 per cent of the principal will be prepaid at the end of 20X2 and the remaining 50 per cent at the end of 20X4. In accordance with Ind AS 39.AG8, the opening balance of the debt instrument in 20X2 is adjusted. The adjusted amount is calculated by discounting the amount the entity expects to receive in 20X2 and subsequent years using the original effective interest rate (10 per cent). This results in the new opening balance in 20X2 of Rs.1138. The adjustment of Rs.52 (Rs.1,138 – Rs.1,086) is recorded in profit or loss in 20X2. The table below provides information about the amortised cost, interest income and cash flows as they would be adjusted taking into account the change in estimate.

Year	**(a)**	**(b = a × 10%)**	**(c)**	**(d = a + b – c)**
	Amortised cost at the beginning of the year	**Interest income**	**Cash flows**	**Amortised cost at the end of the year**
20X0	1,000	100	59	1,041

20X1	1,041	104	59	1,086
20X2	1,086 + 52	114	625 + 59	568
20X3	568	57	30	595
20X4	595	60	625 + 30	–

If the debt instrument becomes impaired, say, at the end of 20X3, the impairment loss is calculated as the difference between the carrying amount (Rs.595) and the present value of estimated future cash flows discounted at the original effective interest rate (10 per cent).

B.27 Example of calculating amortised cost: debt instruments with stepped interest payments

Sometimes entities purchase or issue debt instruments with a predetermined rate of interest that increases or decreases progressively ('stepped interest') over the term of the debt instrument. If a debt instrument with stepped interest and no embedded derivative is issued at Rs.1,250 and has a maturity amount of Rs.1,250, would the amortised cost equal Rs.1,250 in each reporting period over the term of the debt instrument?

No. Although there is no difference between the initial amount and maturity amount, an entity uses the effective interest method to allocate interest payments over the term of the debt instrument to achieve a constant rate on the carrying amount (Ind AS 39.9).

The following example illustrates how amortised cost is calculated using the effective interest method for an instrument with a predetermined rate of interest that increases or decreases over the term of the debt instrument ('stepped interest').

On 1 January 20X0, Entity A issues a debt instrument for a price of Rs.1,250. The principal amount is Rs.1,250 and the debt instrument is repayable on 31 December 20X4. The rate of interest is specified in the debt agreement as a percentage of the principal amount as follows: 6.0 per cent in 20X0 (Rs.75), 8.0 per cent in 2001 (Rs.100), 10.0 per cent in 20X2 (Rs.125), 12.0 per cent in 20X3 (Rs.150), and 16.4 per cent in 20X4 (Rs.205). In this case, the interest rate that exactly discounts the stream of future cash payments through maturity is 10 per cent. Therefore, cash interest payments are reallocated over the term of the debt instrument for the purposes of determining amortised cost in each period. In each period, the amortised cost at the beginning of the period is multiplied by the effective interest rate of 10 per cent and added to the amortised cost. Any cash payments in the period are deducted from the resulting number. Accordingly, the amortised cost in each period is as follows:

Year	**(a) Amortised cost at the beginning of the year**	**(b = a × 10%) Interest income**	**(c) Cash flows**	**(d = a + b – c) Amortised cost at the end of the year**
20X0	1,250	125	75	1,300
20X1	1,300	130	100	1,330
20X2	1,330	133	125	1,338
20X3	1,338	134	150	1,322
20X4	1,322	133	1,250 + 205	–

B.28 Regular way contracts: no established market

Can a contract to purchase a financial asset be a regular way contract if there is no established market for trading such a contract?

Yes. Ind AS 39.9 refers to terms that require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned. Marketplace, as that term is used in Ind AS 39.9, is not limited to a formal stock exchange or organised over-the-counter market. Rather, it means the environment in which the financial asset is customarily exchanged. An acceptable time frame would be the period reasonably and customarily required for the parties to complete the transaction and prepare and execute closing documents.

For example, a market for private issue financial instruments can be a marketplace.

B.29 Regular way contracts: forward contract

Entity ABC enters into a forward contract to purchase one million of M's ordinary shares in two months for Rs.10 per share. The contract is with an individual and is not an exchange-traded contract. The contract requires ABC to take physical delivery of the shares and pay the counterparty Rs.10 million in cash. M's shares trade in an active public market at an average of 100,000 shares a day. Regular way delivery is three days. Is the forward contract regarded as a regular way contract?

No. The contract must be accounted for as a derivative because it is not settled in the way established by regulation or convention in the marketplace concerned.

B.30 Regular way contracts: which customary settlement provisions apply?

If an entity's financial instruments trade in more than one active market, and the settlement provisions differ in the various active markets, which provisions apply in assessing whether a contract to purchase those financial instruments is a regular way contract?

The provisions that apply are those in the market in which the purchase actually takes place.

To illustrate: Entity XYZ purchases one million shares of Entity ABC on a US stock exchange, for example, through a broker. The settlement date of the contract is six business days later. Trades for equity shares on US exchanges customarily settle in three business days. Because the trade settles in six business days, it does not meet the exemption as a regular way trade.

However, if XYZ did the same transaction on a foreign exchange that has a customary settlement period of six business days, the contract would meet the exemption for a regular way trade.

B.31 Regular way contracts: share purchase by call option

Entity A purchases a call option in a public market permitting it to purchase 100 shares of Entity XYZ at any time over the next three months at a price of Rs.100 per share. If Entity A exercises its option, it has 14 days to settle the

transaction according to regulation or convention in the options market. XYZ shares are traded in an active public market that requires three-day settlement. Is the purchase of shares by exercising the option a regular way purchase of shares?

Yes. The settlement of an option is governed by regulation or convention in the marketplace for options and, therefore, upon exercise of the option it is no longer accounted for as a derivative because settlement by delivery of the shares within 14 days is a regular way transaction.

B.32 Recognition and derecognition of financial liabilities using trade date or settlement date accounting

Ind AS 39 has special rules about recognition and derecognition of financial assets using trade date or settlement date accounting. Do these rules apply to transactions in financial instruments that are classified as financial liabilities, such as transactions in deposit liabilities and trading liabilities?

No. Ind AS 39 does not contain any specific requirements about trade date accounting and settlement date accounting in the case of transactions in financial instruments that are classified as financial liabilities. Therefore, the general recognition and derecognition requirements inInd AS 39.14 and Ind AS 39.39 apply. Ind AS 39.14 states that financial liabilities are recognised on the date the entity 'becomes a party to the contractual provisions of the instrument'. Such contracts generally are not recognised unless one of the parties has performed or the contract is a derivative contract not exempted from the scope of Ind AS 39. Ind AS 39.39 specifies that financial liabilities are derecognised only when they are extinguished, ie when the obligation specified in the contract is discharged or cancelled or expires.

Section C Embedded derivatives

C.1 Embedded derivatives: separation of host debt instrument

If an embedded non-option derivative is required to be separated from a host debt instrument, how are the terms of the host debt instrument and the embedded derivative identified? For example, would the host debt instrument be a fixed rate instrument, a variable rate instrument or a zero coupon instrument?

The terms of the host debt instrument reflect the stated or implied substantive terms of the hybrid instrument. In the absence of implied or stated terms, the entity makes its own judgement of the terms. However, an entity may not identify a component that is not specified or may not establish terms of the host debt instrument in a manner that would result in the separation of an embedded derivative that is not already clearly present in the hybrid instrument, that is to say, it cannot create a cash flow that does not exist. For example, if a five-year debt instrument has fixed interest payments of Rs.40,000 annually and a principal payment at maturity of Rs.1,000,000 multiplied by the change in an equity price index, it would be inappropriate to identify a floating rate host contract and an embedded equity swap that has an offsetting floating rate leg in lieu of identifying a fixed rate host. In that example, the host contract is a fixed rate debt instrument that pays Rs.40,000 annually because there are no floating interest rate cash flows in the hybrid instrument.

In addition, the terms of an embedded non-option derivative, such as a forward or swap, must be determined so as to result in the embedded derivative having a fair value of zero at the inception of the hybrid instrument. If it were permitted to separate embedded non-option derivatives on other terms, a single hybrid instrument could be decomposed into an infinite variety of combinations of host debt instruments and embedded derivatives, for example, by separating embedded derivatives with terms that create leverage, asymmetry or some other risk exposure not already present in the hybrid instrument. Therefore, it is inappropriate to separate an embedded non-option derivative on terms that result in a fair value other than zero at the inception of the hybrid instrument. The determination of the terms of the embedded derivative is based on the conditions existing when the financial instrument was issued.

C.2 Embedded derivatives: separation of embedded option

The response to Question C.1 states that the terms of an embedded non-option derivative should be determined so as to result in the embedded derivative having a fair value of zero at the initial recognition of the hybrid instrument. When an embedded option-based derivative is separated, must the terms of the embedded option be determined so as to result in the embedded derivative having either a fair value of zero or an intrinsic value of zero (that is to say, be at the money) at the inception of the hybrid instrument?

No. The economic behaviour of a hybrid instrument with an option-based embedded derivative depends critically on the strike price (or strike rate) specified for the option feature in the hybrid instrument, as discussed below. Therefore, the separation of an option-based embedded derivative (including any embedded put, call, cap, floor, caption, floortion or swaption feature in a hybrid instrument) should be based on the stated terms of the option feature documented in the hybrid instrument. As a result, the embedded derivative would not necessarily have a fair value or intrinsic value equal to zero at the initial recognition of the hybrid instrument.

If an entity were required to identify the terms of an embedded option-based derivative so as to achieve a fair value of the embedded derivative of zero, the strike price (or strike rate) generally would have to be determined so as to result in the option being infinitely out of the money. This would imply a zero probability of the option feature being exercised. However, since the probability of the option feature in a hybrid instrument being exercised generally is not zero, it would be inconsistent with the likely economic behaviour of the hybrid instrument to assume an initial fair value of zero. Similarly, if an entity were required to identify the terms of an embedded option-based derivative so as to achieve an intrinsic value of zero for the embedded derivative, the strike price (or strike rate) would have to be assumed to equal the price (or rate) of the underlying variable at the initial recognition of the hybrid instrument. In this case, the fair value of the option would consist only of time value. However, such an assumption would not be consistent with the likely economic behaviour of the hybrid instrument, including the probability of the option feature being exercised, unless the agreed strike price was indeed equal to the price (or rate) of the underlying variable at the initial recognition of the hybrid instrument.

The economic nature of an option-based embedded derivative is fundamentally different from a forward-based embedded derivative (including forwards and swaps), because the terms of a forward are such that a payment based on the difference between the price of the underlying and the forward price will occur at a specified date, while the terms of an

option are such that a payment based on the difference between the price of the underlying and the strike price of the option may or may not occur depending on the relationship between the agreed strike price and the price of the underlying at a specified date or dates in the future. Adjusting the strike price of an option-based embedded derivative, therefore, alters the nature of the hybrid instrument. On the other hand, if the terms of a non-option embedded derivative in a host debt instrument were determined so as to result in a fair value of any amount other than zero at the inception of the hybrid instrument, that amount would essentially represent a borrowing or lending. Accordingly, as discussed in the answer to Question C.1, it is not appropriate to separate a non-option embedded derivative in a host debt instrument on terms that result in a fair value other than zero at the initial recognition of the hybrid instrument.

C.3 Embedded derivatives: accounting for a convertible bond

What is the accounting treatment of an investment in a bond (financial asset) that is convertible into shares of the issuing entity or another entity before maturity?

An investment in a convertible bond that is convertible before maturity generally cannot be classified as a held-to-maturity investment because that would be inconsistent with paying for the conversion feature—the right to convert into equity shares before maturity.

An investment in a convertible bond can be classified as an available-for-sale financial asset provided it is not purchased for trading purposes. The equity conversion option is an embedded derivative.

If the bond is classified as available for sale (ie fair value changes recognised in other comprehensive income until the bond is sold), the equity conversion option (the embedded derivative) is separated. The amount paid for the bond is split between the debt instrument without the conversion option and the equity conversion option. Changes in the fair value of the equity conversion option are recognised in profit or loss unless the option is part of a cash flow hedging relationship.

If the convertible bond is measured at fair value with changes in fair value recognised in profit or loss, separating the embedded derivative from the host bond is not permitted.

C.4 Embedded derivatives: equity kicker

In some instances, venture capital entities providing subordinated loans agree that if and when the borrower lists its shares on a stock exchange, the venture capital entity is entitled to receive shares of the borrowing entity free of charge or at a very low price (an 'equity kicker') in addition to interest and repayment of principal. As a result of the equity kicker feature, the interest on the subordinated loan is lower than it would otherwise be. Assuming that the subordinated loan is not measured at fair value with changes in fair value recognised in profit or loss (Ind AS 39.11(c)), does the equity kicker feature meet the definition of an embedded derivative even though it is contingent upon the future listing of the borrower?

Yes. The economic characteristics and risks of an equity return are not closely related to the economic characteristics and risks of a host debt instrument (Ind AS 39.11(a)). The equity kicker meets the definition of a derivative because it has a value that changes in response to the change in the price of the shares of the borrower, it requires no initial net

investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and it is settled at a future date (Ind AS 39.11(b) and Ind AS 39.9(a)). The equity kicker feature meets the definition of a derivative even though the right to receive shares is contingent upon the future listing of the borrower. Ind AS 39.AG9 states that a derivative could require a payment as a result of some future event that is unrelated to a notional amount. An equity kicker feature is similar to such a derivative except that it does not give a right to a fixed payment, but an option right, if the future event occurs.

C.5 Embedded derivatives: debt or equity host contract

Entity A purchases a five-year 'debt' instrument issued by Entity B with a principal amount of Rs.1 million that is indexed to the share price of Entity C. At maturity, Entity A will receive from Entity B the principal amount plus or minus the change in the fair value of 10,000 shares of Entity C. The current share price is Rs.110. No separate interest payments are made by Entity B. The purchase price is Rs.1 million. Entity A classifies the debt instrument as available for sale. Entity A concludes that the instrument is a hybrid instrument with an embedded derivative because of the equity-indexed principal. For the purposes of separating an embedded derivative, is the host contract an equity instrument or a debt instrument?

The host contract is a debt instrument because the hybrid instrument has a stated maturity, ie it does not meet the definition of an equity instrument (Ind AS 32.11 andInd AS 32.16). It is accounted for as a zero coupon debt instrument. Thus, in accounting for the host instrument, Entity A imputes interest on Rs.1 million over five years using the applicable market interest rate at initial recognition. The embedded non-option derivative is separated so as to have an initial fair value of zero (see Question C.1).

C.6 Embedded derivatives: synthetic instruments

Entity A acquires a five-year floating rate debt instrument issued by Entity B. At the same time, it enters into a five-year pay-variable, receive-fixed interest rate swap with Entity C. Entity A regards the combination of the debt instrument and swap as a synthetic fixed rate instrument and classifies the instrument as a held-to-maturity investment, since it has the positive intention and ability to hold it to maturity. Entity A contends that separate accounting for the swap is inappropriate since Ind AS 39.AG33(a) requires an embedded derivative to be classified together with its host instrument if the derivative is linked to an interest rate that can change the amount of interest that would otherwise be paid or received on the host debt contract. Is the entity's analysis correct?

No. Embedded derivative instruments are terms and conditions that are included in non-derivative host contracts. It is generally inappropriate to treat two or more separate financial instruments as a single combined instrument ('synthetic instrument' accounting) for the purpose of applying Ind AS 39. Each of the financial instruments has its own terms and conditions and each may be transferred or settled separately. Therefore, the debt instrument and the swap are classified separately. The transactions described here differ from the transactions discussed in Question B.6, which had no substance apart from the resulting interest rate swap.

C.7 Embedded derivatives: purchases and sales contracts in foreign currency instruments

A supply contract provides for payment in a currency other than (a) the functional currency of either party to the contract, (b) the currency in which the product is routinely denominated in commercial transactions around the world and (c) the currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place. Is there an embedded derivative that should be separated under Ind AS 39?

Yes. To illustrate: a Norwegian entity agrees to sell oil to an entity in France. The oil contract is denominated in Swiss francs, although oil contracts are routinely denominated in US dollars in commercial transactions around the world, and Norwegian krone are commonly used in contracts to purchase or sell non-financial items in Norway. Neither entity carries out any significant activities in Swiss francs. In this case, the Norwegian entity regards the supply contract as a host contract with an embedded foreign currency forward to purchase Swiss francs. The French entity regards the supply contact as a host contract with an embedded foreign currency forward to sell Swiss francs. Each entity includes fair value changes on the currency forward in profit or loss unless the reporting entity designates it as a cash flow hedging instrument, if appropriate.

C.8 Embedded foreign currency derivatives: unrelated foreign currency provision

Entity A, which measures items in its financial statements on the basis of the euro (its functional currency), enters into a contract with Entity B, which has the Norwegian krone as its functional currency, to purchase oil in six months for 1,000 US dollars. The host oil contract is not within the scope of Ind AS 39 because it was entered into and continues to be for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (Ind AS 39.5 and Ind AS 39 .AG10). The oil contract includes a leveraged foreign exchange provision that states that the parties, in addition to the provision of, and payment for, oil will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars. Under Ind AS 39.11, is that embedded derivative (the leveraged foreign exchange provision) regarded as closely related to the host oil contract?

No, that leveraged foreign exchange provision is separated from the host oil contract because it is not closely related to the host oil contract (Ind AS 39.AG33(d)).

The payment provision under the host oil contract of 1,000 US dollars can be viewed as a foreign currency derivative because the US dollar is neither Entity A's nor Entity B's functional currency. This foreign currency derivative would not be separated because it follows from Ind AS 39.AG33(d) that a crude oil contract that requires payment in US dollars is not regarded as a host contract with a foreign currency derivative.

The leveraged foreign exchange provision that states that the parties will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars is in addition to the required

payment for the oil transaction. It is unrelated to the host oil contract and therefore separated from the host oil contract and accounted for as an embedded derivative under Ind AS 39.11.

C.9 Embedded foreign currency derivatives: currency of international commerce

Ind AS 39.AG33(d) refers to the currency in which the price of the related goods or services is routinely denominated in commercial transactions around the world. Could it be a currency that is used for a certain product or service in commercial transactions within the local area of one of the substantial parties to the contract?

No. The currency in which the price of the related goods or services is routinely denominated in commercial transactions around the world is only a currency that is used for similar transactions all around the world, not just in one local area. For example, if cross-border transactions in natural gas in North America are routinely denominated in US dollars and such transactions are routinely denominated in euro in Europe, neither the US dollar nor the euro is a currency in which the goods or services are routinely denominated in commercial transactions around the world.

C.10 Embedded derivatives: holder permitted, but not required, to settle without recovering substantially all of its recognised investment

If the terms of a combined instrument permit, but do not require, the holder to settle the combined instrument in a manner that causes it not to recover substantially all of its recognised investment and the issuer does not have such a right (for example, a puttable debt instrument), does the contract satisfy the condition in Ind AS 39.AG33(a) that the holder would not recover substantially all of its recognised investment?

No. The condition that 'the holder would not recover substantially all of its recognised investment' is not satisfied if the terms of the combined instrument permit, but do not require, the investor to settle the combined instrument in a manner that causes it not to recover substantially all of its recognised investment and the issuer has no such right. Accordingly, an interest-bearing host contract with an embedded interest rate derivative with such terms is regarded as closely related to the host contract. The condition that 'the holder would not recover substantially all of its recognised investment' applies to situations in which the holder can be forced to accept settlement at an amount that causes the holder not to recover substantially all of its recognised investment.

C.11 Embedded derivatives: reliable determination of fair value

If an embedded derivative that is required to be separated cannot be reliably measured because it will be settled by an unquoted equity instrument whose fair value cannot be reliably measured, is the embedded derivative measured at cost?

No. In this case, the entire combined contract is treated as a financial instrument held for trading (Ind AS 39.12). If the fair value of the combined instrument can be reliably measured, the combined contract is measured at fair value. The entity might conclude, however, that the equity component of the combined instrument may be sufficiently

significant to preclude it from obtaining a reliable estimate of the entire instrument. In that case, the combined instrument is measured at cost less impairment.

Section D Recognition and derecognition

D.1 Initial recognition

D.1.1 Recognition: cash collateral

Entity B transfers cash to Entity A as collateral for another transaction with Entity A (for example, a securities borrowing transaction). The cash is not legally segregated from Entity A's assets. Should Entity A recognise the cash collateral it has received as an asset?

Yes. The ultimate realisation of a financial asset is its conversion into cash and, therefore, no further transformation is required before the economic benefits of the cash transferred by Entity B can be realised by Entity A. Therefore, Entity A recognises the cash as an asset and a payable to Entity B while Entity B derecognises the cash and recognises a receivable from Entity A.

D.2 Regular way purchase or sale of a financial asset

D.2.1 Trade date vs settlement date: amounts to be recorded for a purchase

How are the trade date and settlement date accounting principles in the Standard applied to a purchase of a financial asset?

The following example illustrates the application of the trade date and settlement date accounting principles in the Standard for a purchase of a financial asset. On 29 December 20X1, an entity commits itself to purchase a financial asset for Rs.1,000, which is its fair value on commitment (trade) date. Transaction costs are immaterial. On 31 December 20X1 (financial year-end) and on 4 January 20X2 (settlement date) the fair value of the asset is Rs.1,002 and Rs.1,003, respectively. The amounts to be recorded for the asset will depend on how it is classified and whether trade date or settlement date accounting is used, as shown in the two tables below.

Settlement date accounting			
Balances	**Held-to-maturity investments carried at amortised cost**	**Available-for-sale assets remeasured to fair value with changes in other comprehensive income**	**Assets at fair value through profit or loss remeasured to fair value with changes in profit or loss**
29 December 20X1			
Financial asset	–	–	–
Financial liability	–	–	–
31 December 20X1			
Receivable	–	2	2
Financial asset	–	–	–
Financial liability	–	–	–
Equity (fair value	–	(2)	–

adjustment)			
Retained earnings (through profit or loss)	–	–	(2)
4 January 20X2			
Receivable	–	–	–
Financial asset	1,000	1,003	1,003
Financial liability	–	–	–
Equity (fair value adjustment)	–	(3)	–
Retained earnings (through profit or loss)	–	–	(3)

Trade date accounting			
Balances	**Held-to-maturity investments carried at amortised cost**	**Available-for-sale assets remeasured to fair value with changes in other comprehensive income**	**Assets at fair value through profit or loss remeasured to fair value with changes in profit or loss**
29 December 20X1			
Financial asset	1,000	1,000	1,000
Financial liability	(1,000)	(1,000)	(1,000)
31 December 20X1			
Receivable	–	–	–
Financial asset	1,000	1,002	1,002
Financial liability	(1,000)	(1,000)	(1,000)
Equity (fair value adjustment)	–	(2)	–
Retained earnings (through profit or loss)	–	–	(2)
4 January 20X2			
Receivable	–	–	–
Financial asset	1,000	1,003	1,003
Financial liability	–	–	–
Equity (fair value adjustment)	–	(3)`	–
Retained earnings (through profit or loss)	–	–	(3)

D.2.2 Trade date vs settlement date: amounts to be recorded for a sale

How are the trade date and settlement date accounting principles in the Standard applied to a sale of a financial asset?

The following example illustrates the application of the trade date and settlement date accounting principles in the Standard for a sale of a financial asset. On 29 December 20X2 (trade date) an entity enters into a contract to sell a financial asset for its current fair value of Rs.1,010. The asset was acquired one year earlier for Rs.1,000 and its amortised cost is Rs.1,000. On 31 December 20X2 (financial year-end), the fair value of the asset is Rs.1,012. On 4 January 20X3 (settlement date), the fair value is Rs.1,013. The amounts to be recorded will depend on how the asset is classified and whether trade date or settlement date accounting is used as shown in the two tables below (any interest that might have accrued on the asset is disregarded).

A change in the fair value of a financial asset that is sold on a regular way basis is not recorded in the financial statements between trade date and settlement date even if the entity applies settlement date accounting because the seller's right to changes in the fair value ceases on the trade date.

Settlement date accounting			
Balances	**Held-to-maturity investments carried at amortised cost**	**Available-for-sale assets remeasured to fair value with changes in other comprehensive income**	**Assets at fair value through profit or loss remeasured to fair value with changes in profit or loss**
29 December 20X2			
Receivable	–	–	–
Financial asset	1,000	1,010	1,010
Equity (fair value adjustment)	–	10	–
Retained earnings (through profit or loss)	–	–	10
31 December 20X2			
Receivable	–	–	–
Financial asset	1,000	1,010	1,010
Equity (fair value adjustment)	–	10	–
Retained earnings (through profit or loss)	–	–	10
4 January 20X3			
Equity (fair value adjustment)	–	–	–
Retained earnings (through profit or loss)	10	10	10

Settlement date accounting			
Balances	**Held-to-maturity investments carried at amortised cost**	**Available-for-sale assets remeasured to fair value with changes in other comprehensive income**	**Assets at fair value through profit or loss remeasured to fair value with changes in profit or loss**
29 December 20X2			
Receivable	1,010	1,010	1,010
Financial asset	–	–	–
Equity (fair value adjustment)	–	–	–
Retained earnings (through profit or loss)	10	10	10
31 December 20X2			
Receivable	1,010	1,010	1,010
Financial asset	–	–	–
Equity (fair value adjustment)	–	–	–
Retained earnings (through profit or loss)	10	10	10
4 January 20X3			
Equity (fair value adjustment)	–	–	–
Retained earnings (through profit or loss)	10	10	10

D.2.3 Settlement date accounting: exchange of non-cash financial assets

If an entity recognises sales of financial assets using settlement date accounting, would a change in the fair value of a financial asset to be received in exchange for the non-cash financial asset that is sold be recognised in accordance with Ind AS 39.57?

It depends. Any change in the fair value of the financial asset to be received would be accounted for under Ind AS 39.57 if the entity applies settlement date accounting for that category of financial assets. However, if the entity classifies the financial asset to be received in a category for which it applies trade date accounting, the asset to be received is recognised on the trade date as described in Ind AS 39.AG55. In that case, the entity recognises a liability of an amount equal to the carrying amount of the financial asset to be delivered on settlement date.

To illustrate: on 29 December 20X2 (trade date) Entity A enters into a contract to sell Note Receivable A, which is carried at amortised cost, in exchange for Bond B, which

will be classified as held for trading and measured at fair value. Both assets have a fair value of Rs.1,010 on 29 December, while the amortised cost of Note Receivable A is Rs.1,000. Entity A uses settlement date accounting for loans and receivables and trade date accounting for assets held for trading. On 31 December 20X2 (financial year-end), the fair value of Note Receivable A is Rs.1,012 and the fair value of Bond B is Rs.1,009. On 4 January 20X3, the fair value of Note Receivable A is Rs.1,013 and the fair value of Bond B is Rs.1,007. The following entries are made:

29 December 20X2			
Dr Bond B		Rs.1,010	
	Cr Payable		Rs.1,010
31 December 20X2			
Dr Trading loss		Rs.1	
	Cr Bond B		Rs.1
4 January 20X3			
Dr Payable		Rs.1,010	
Dr Trading loss		Rs.2	
	Cr Note Receivable A		Rs.1,000
	Cr Bond B		Rs.2
	Cr Realisation gain		Rs.10

Section E Measurement

E.1 Initial measurement of financial assets and financial liabilities

E.1.1 Initial measurement: transaction costs

Transaction costs should be included in the initial measurement of financial assets and financial liabilities other than those at fair value through profit or loss. How should this requirement be applied in practice?

For financial assets, incremental costs that are directly attributable to the acquisition of the asset, for example fees and commissions, are added to the amount originally recognised. For financial liabilities, directly related costs of issuing debt are deducted from the amount of debt originally recognised. For financial instruments that are measured at fair value through profit or loss, transaction costs are not added to the fair value measurement at initial recognition.

For financial instruments that are carried at amortised cost, such as held-to-maturity investments, loans and receivables, and financial liabilities that are not at fair value through profit or loss, transaction costs are included in the calculation of amortised cost using the effective interest method and, in effect, amortised through profit or loss over the life of the instrument.

For available-for-sale financial assets, transaction costs are recognised in other comprehensive income as part of a change in fair value at the next remeasurement. If an available-for-sale financial asset has fixed or determinable payments and does not have an indefinite life, the transaction costs are amortised to profit or loss using the effective

interest method. If an available-for-sale financial asset does not have fixed or determinable payments and has an indefinite life, the transaction costs are recognised in profit or loss when the asset is derecognised or becomes impaired.

Transaction costs expected to be incurred on transfer or disposal of a financial instrument are not included in the measurement of the financial instrument.

E.2 Fair value measurement considerations

E.2.1 Fair value measurement considerations for investment funds

Ind AS 39.AG72 states that the current bid price is usually the appropriate price to be used in measuring the fair value of an asset held. The rules applicable to some investment funds require net asset values to be reported to investors on the basis of mid-market prices. In these circumstances, would it be appropriate for an investment fund to measure its assets on the basis of mid-market prices?

No. The existence of regulations that require a different measurement for specific purposes does not justify a departure from the general requirement in Ind AS 39.AG72 to use the current bid price in the absence of a matching liability position. In its financial statements, an investment fund measures its assets at current bid prices. In reporting its net asset value to investors, an investment fund may wish to provide a reconciliation between the fair values recognised in its balance sheet and the prices used for the net asset value calculation.

E.2.2 Fair value measurement: large holding

Entity A holds 15 per cent of the share capital in Entity B. The shares are publicly traded in an active market. The currently quoted price is Rs.100. Daily trading volume is 0.1 per cent of outstanding shares. Because Entity A believes that the fair value of the Entity B shares it owns, if sold as a block, is greater than the quoted market price, Entity A obtains several independent estimates of the price it would obtain if it sells its holding. These estimates indicate that Entity A would be able to obtain a price of Rs.105, ie a 5 per cent premium above the quoted price. Which figure should Entity A use for measuring its holding at fair value?

Under Ind AS 39.AG71, a published price quotation in an active market is the best estimate of fair value. Therefore, Entity A uses the published price quotation (Rs.100). Entity A cannot depart from the quoted market price solely because independent estimates indicate that Entity A would obtain a higher (or lower) price by selling the holding as a block.

E.3 Gains and losses

E.3.1 Available-for-sale financial assets: exchange of shares

Entity A holds a small number of shares in Entity B. The shares are classified as available for sale. On 20 December 20X0, the fair value of the shares is Rs.120 and the cumulative gain recognised in other comprehensive income is Rs.20. On the same day, Entity B is acquired by Entity C, a large public entity. As a result, Entity A receives shares in Entity C in exchange for those it had in Entity B of equal fair value. Under Ind AS 39.55(b), should Entity A reclassify the cumulative gain of

Rs.20 recognised in other comprehensive income from equity to profit or loss as a reclassification adjustment?

Yes. The transaction qualifies for derecognition under Ind AS 39. Ind AS 39.55(b) requires the cumulative gain or loss on an available-for-sale financial asset that has been recognised in other comprehensive income to be reclassified from equity to profit or loss when the asset is derecognised. In the exchange of shares, Entity A disposes of the shares it had in Entity B and receives shares in Entity C.

E.3.2 Ind AS 39 and Ind AS 21 Available-for-sale financial assets: separation of currency component

For an available-for-sale monetary financial asset, the entity recognises changes in the carrying amount relating to changes in foreign exchange rates in profit or loss in accordance with Ind AS 21.23(a) and Ind AS 21.28 and other changes in the carrying amount in other comprehensive income in accordance with Ind AS 39. How is the cumulative gain or loss that is recognised in other comprehensive income determined?

It is the difference between the amortised cost (adjusted for impairment, if any) and fair value of the available-for-sale monetary financial asset in the functional currency of the reporting entity. For the purpose of applying Ind AS 21.28 the asset is treated as an asset measured at amortised cost in the foreign currency.

To illustrate: on 31 December 20X1 Entity A acquires a bond denominated in a foreign currency (FC) for its fair value of FC1,000. The bond has five years remaining to maturity and a principal amount of FC1,250, carries fixed interest of 4.7 per cent that is paid annually (FC1,250 × 4.7 per cent = FC59 per year), and has an effective interest rate of 10 per cent. Entity A classifies the bond as available for sale, and thus recognises gains and losses in other comprehensive income. The entity's functional currency is its local currency (LC). The exchange rate is FC1 to LC1.5 and the carrying amount of the bond is LC1,500 (= FC1,000 × 1.5).

Dr	Bond	LC1,500	
	Cr	Cash	LC1,500

On 31 December 20X2, the foreign currency has appreciated and the exchange rate is FC1 to LC2. The fair value of the bond is FC1,060 and thus the carrying amount is LC2,120 (= FC1,060 × 2). The amortised cost is FC1,041 (= LC2,082). In this case, the cumulative gain or loss to be recognised in other comprehensive income and accumulated in equity is the difference between the fair value and the amortised cost on 31 December 20X2, ie LC38 (= LC2,120 – LC2,082).

Interest received on the bond on 31 December 20X2 is FC59 (= LC118). Interest income determined in accordance with the effective interest method is FC100 (= 1,000 × 10 per cent). The average exchange rate during the year is FC1 to LC1.75. For the purpose of this question, it is assumed that the use of the average exchange rate provides a reliable approximation of the spot rates applicable to the accrual of interest income during the year (Ind AS 21.22). Thus, reported interest income is LC175 (= FC100 × 1.75) including accretion of the initial discount of LC72 (= [FC100 – FC59] × 1.75). Accordingly, the exchange difference on the bond that is recognised in profit or

loss is LC510 (= LC2,082 – LC1,500 – LC72). Also, there is an exchange gain on the interest receivable for the year of LC15 (= FC59 × [2.00 – 1.75]).

Dr Bond		LC620	
Dr Cash		LC118	
	Cr Interest income		LC175
	Cr Exchange gain		LC525
	Cr Fair value change in other comprehensive income		LC38

On 31 December 20X3, the foreign currency has appreciated further and the exchange rate is FC1 to LC2.50. The fair value of the bond is FC1,070 and thus the carrying amount is LC2,675 (= FC1,070 × 2.50). The amortised cost is FC1,086 (= LC2,715). The cumulative gain or loss to be accumulated in equity is the difference between the fair value and the amortised cost on 31 December 20X3, ie negative LC40 (= LC2,675 – LC2,715). Thus, the amount recognised in other comprehensive income equals the change in the difference during 20X3 of LC78 (= LC40 + LC38).

Interest received on the bond on 31 December 20X3 is FC59 (= LC148). Interest income determined in accordance with the effective interest method is FC104 (= FC1,041 × 10 per cent). The average exchange rate during the year is FC1 to LC2.25. For the purpose of this question, it is assumed that the use of the average exchange rate provides a reliable approximation of the spot rates applicable to the accrual of interest income during the year (Ind AS 21.22). Thus, recognised interest income is LC234 (= FC104 × 2.25) including accretion of the initial discount of LC101 (= [FC104 – FC59] × 2.25). Accordingly, the exchange difference on the bond that is recognised in profit or loss is LC532 (= LC2,715 – LC2,082 – LC101). Also, there is an exchange gain on the interest receivable for the year of LC15 (= FC59 × [2.50 – 2.25]).

Dr Bond		LC555	
Dr Cash		LC148	
Dr Fair value change in other comprehensive income		LC78	
	Cr Interest income		LC234
	Cr Exchange gain		LC547

E.3.3 Ind AS 39 and Ind AS 21 Exchange differences arising on translation of foreign entities: other comprehensive income or profit or loss?

Ind AS 21.32 andInd AS 21.48 states that all exchange differences resulting from translating the financial statements of a foreign operation should be recognised in other comprehensive income until disposal of the net investment. This would include exchange differences arising from financial instruments carried at fair value, which would include both financial assets classified as at fair value through profit or loss and financial assets that are available for sale.

Ind AS 39.55 requires that changes in fair value of financial assets classified as at fair value through profit or loss should be recognised in profit or loss and changes in fair value of available-for-sale investments should be recognised in other comprehensive income.

If the foreign operation is a subsidiary whose financial statements are consolidated with those of its parent, in the consolidated financial statements how are Ind AS 39.55 andInd AS 21.39 applied?

Ind AS 39 applies in the accounting for financial instruments in the financial statements of a foreign operation and Ind AS 21 applies in translating the financial statements of a foreign operation for incorporation in the financial statements of the reporting entity.

To illustrate: Entity A is domiciled in Country X and its functional currency and presentation currency are the local currency of Country X (LCX). A has a foreign subsidiary (Entity B) in Country Y whose functional currency is the local currency of Country Y (LCY). B is the owner of a debt instrument, which is held for trading and therefore carried at fair value under Ind AS 39.

In B's financial statements for year 20X0, the fair value and carrying amount of the debt instrument is LCY100 in the local currency of Country Y. In A's consolidated financial statements, the asset is translated into the local currency of Country X at the spot exchange rate applicable at the end of the reporting period (2.00). Thus, the carrying amount is LCX200 (= LCY100 × 2.00) in the consolidated financial statements.

At the end of year 20X1, the fair value of the debt instrument has increased to LCY110 in the local currency of Country Y. B recognises the trading asset at LCY110 in its balance sheet and recognises a fair value gain of LCY10 in its profit or loss. During the year, the spot exchange rate has increased from 2.00 to 3.00 resulting in an increase in the fair value of the instrument from LCX200 to LCX330 (= LCY110 × 3.00) in the currency of Country X. Therefore, Entity A recognises the trading asset at LCX330 in its consolidated financial statements.

Entity A translates the statement of profit and loss of B 'at the exchange rates at the dates of the transactions' (Ind AS 21.39(b)). Since the fair value gain has accrued through the year, A uses the average rate as a practical approximation ([3.00 + 2.00] / 2 = 2.50, in accordance with Ind AS 21.22). Therefore, while the fair value of the trading asset has increased by LCX130 (= LCX330 – LCX200), Entity A recognises only LCX25 (= LCY10 × 2.5) of this increase in consolidated profit or loss to comply with Ind AS 21.39(b). The resulting exchange difference, ie the remaining increase in the fair value of the debt instrument (LCX130 – LCX25 = LCX105), is accumulated in equity until the disposal of the net investment in the foreign operation in accordance with Ind AS 21.48.

E.3.4 Ind AS 39 and Ind AS 21 Interaction between Ind AS 39 and Ind AS 21

Ind AS 39 includes requirements about the measurement of financial assets and financial liabilities and the recognition of gains and losses on remeasurement in profit or loss. Ind AS 21 includes rules about the reporting of foreign currency items and the recognition of exchange differences in profit or loss. In what order are Ind AS 21 and Ind AS 39 applied?

Statement of financial position

Generally, the measurement of a financial asset or financial liability at fair value, cost or amortised cost is first determined in the foreign currency in which the item is denominated in accordance with Ind AS 39. Then, the foreign currency amount is translated into the functional currency using the closing rate or a historical rate in

accordance with Ind AS 21 (Ind AS 39.AG83). For example, if a monetary financial asset (such as a debt instrument) is carried at amortised cost under Ind AS 39, amortised cost is calculated in the currency of denomination of that financial asset. Then, the foreign currency amount is recognised using the closing rate in the entity's financial statements (Ind AS 21.23). That applies regardless of whether a monetary item is measured at cost, amortised cost or fair value in the foreign currency (Ind AS 21.24). A non-monetary financial asset (such as an investment in an equity instrument) is translated using the closing rate if it is carried at fair value in the foreign currency (Ind AS 21.23(c)) and at a historical rate if it is not carried at fair value under Ind AS 39 because its fair value cannot be reliably measured (Ind AS 21.23(b) and Ind AS 39.46(c)).

As an exception, if the financial asset or financial liability is designated as a hedged item in a fair value hedge of the exposure to changes in foreign currency rates underInd AS 39, the hedged item is remeasured for changes in foreign currency rates even if it would otherwise have been recognised using a historical rate under Ind AS 21 (Ind AS 39.89), ie the foreign currency amount is recognised using the closing rate. This exception applies to non-monetary items that are carried in terms of historical cost in the foreign currency and are hedged against exposure to foreign currency rates (Ind AS 21.23(b)).

Profit or loss

The recognition of a change in the carrying amount of a financial asset or financial liability in profit or loss depends on a number of factors, including whether it is an exchange difference or other change in carrying amount, whether it arises on a monetary item (for example, most debt instruments) or non-monetary item (such as most equity investments), whether the associated asset or liability is designated as a cash flow hedge of an exposure to changes in foreign currency rates, and whether it results from translating the financial statements of a foreign operation. The issue of recognising changes in the carrying amount of a financial asset or financial liability held by a foreign operation is addressed in a separate question (see Question E.3.3).

Any exchange difference arising on recognising a *monetary item* at a rate different from that at which it was initially recognised during the period, or recognised in previous financial statements, is recognised in profit or loss or in other comprehensive income in accordance with Ind AS 21 (Ind AS 39.AG83,Ind AS 21.28 andInd AS 21.32), unless the monetary item is designated as a cash flow hedge of a highly probable forecast transaction in foreign currency, in which case the requirements for recognition of gains and losses on cash flow hedges in Ind AS 39 apply (Ind AS 39.95). Differences arising from recognising a monetary item at a foreign currency amount different from that at which it was previously recognised are accounted for in a similar manner, since all changes in the carrying amount relating to foreign currency movements should be treated consistently. All other changes in the balance sheet measurement of a monetary item are recognised in profit or loss or in other comprehensive income in accordance withInd AS 39. For example, although an entity recognises gains and losses on available-for-sale monetary financial assets in other comprehensive income (Ind AS 39.55(b)), the entity nevertheless recognises the changes in the carrying amount relating to changes in foreign exchange rates in profit or loss (Ind AS 21.23(a)).

Any changes in the carrying amount of a *non-monetary item* are recognised in profit or loss or in other comprehensive income in accordance with Ind AS 39 (Ind AS 39.AG83). For example, for available-for-sale financial assets the entire change in the carrying amount, including the effect of changes in foreign currency rates, is recognised in other

comprehensive income. If the non-monetary item is designated as a cash flow hedge of an unrecognised firm commitment or a highly probable forecast transaction in foreign currency, the requirements for recognition of gains and losses on cash flow hedges in Ind AS 39 apply (Ind AS 39.95).

When some portion of the change in carrying amount is recognised in other comprehensive income and some portion is recognised in profit or loss, for example, if the amortised cost of a foreign currency bond classified as available for sale has increased in foreign currency (resulting in a gain in profit or loss) but its fair value has decreased in the functional currency (resulting in a loss recognised in other comprehensive income), an entity cannot offset those two components for the purposes of determining gains or losses that should be recognised in profit or loss or in other comprehensive income.

E.4 Impairment and uncollectibility of financial assets

E.4.1 Objective evidence of impairment

Does Ind AS 39 require that an entity be able to identify a single, distinct past causative event to conclude that it is probable that an impairment loss on a financial asset has been incurred?

No.Ind AS 39.59 states 'It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment.' Also,Ind AS 39.60 states that 'a downgrade of an entity's credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information'. Other factors that an entity considers in determining whether it has objective evidence that an impairment loss has been incurred include information about the debtors' or issuers' liquidity, solvency and business and financial risk exposures, levels of and trends in delinquencies for similar financial assets, national and local economic trends and conditions, and the fair value of collateral and guarantees. These and other factors may, either individually or taken together, provide sufficient objective evidence that an impairment loss has been incurred in a financial asset or group of financial assets.

E.4.2 Impairment: future losses

Does Ind AS 39 permit the recognition of an impairment loss through the establishment of an allowance for future losses when a loan is given? For example, if Entity A lends Rs.1,000 to Customer B, can it recognise an immediate impairment loss of Rs.10 if Entity A, based on historical experience, expects that 1 per cent of the principal amount of loans given will not be collected?

No.Ind AS 39.43 requires a financial asset to be initially measured at fair value. For a loan asset, the fair value is the amount of cash lent adjusted for any fees and costs (unless a portion of the amount lent is compensation for other stated or implied rights or privileges). In addition,Ind AS 39.58 requires that an impairment loss is recognised only if there is objective evidence of impairment as a result of a past event that occurred after initial recognition. Accordingly, it is inconsistent with Ind AS 39.43 and Ind AS 39.58 to reduce the carrying amount of a loan asset on initial recognition through the recognition of an immediate impairment loss.

E.4.3 Assessment of impairment: principal and interest

Because of Customer B's financial difficulties, Entity A is concerned that Customer B will not be able to make all principal and interest payments due on a loan in a timely manner. It negotiates a restructuring of the loan. Entity A expects that Customer B will be able to meet its obligations under the restructured terms. Would Entity A recognise an impairment loss if the restructured terms are as reflected in any of the following cases?

(a) **Customer B will pay the full principal amount of the original loan five years after the original due date, but none of the interest due under the original terms.**

(b) **Customer B will pay the full principal amount of the original loan on the original due date, but none of the interest due under the original terms.**

(c) **Customer B will pay the full principal amount of the original loan on the original due date with interest only at a lower interest rate than the interest rate inherent in the original loan.**

(d) **Customer B will pay the full principal amount of the original loan five years after the original due date and all interest accrued during the original loan term, but no interest for the extended term.**

(e) **Customer B will pay the full principal amount of the original loan five years after the original due date and all interest, including interest for both the original term of the loan and the extended term.**

Ind AS 39.58 indicates that an impairment loss has been incurred if there is objective evidence of impairment. The amount of the impairment loss for a loan measured at amortised cost is the difference between the carrying amount of the loan and the present value of future principal and interest payments discounted at the loan's original effective interest rate. In cases (a)–(d) above, the present value of the future principal and interest payments discounted at the loan's original effective interest rate will be lower than the carrying amount of the loan. Therefore, an impairment loss is recognised in those cases.

In case (e), even though the timing of payments has changed, the lender will receive interest on interest, and the present value of the future principal and interest payments discounted at the loan's original effective interest rate will equal the carrying amount of the loan. Therefore, there is no impairment loss. However, this fact pattern is unlikely given Customer B's financial difficulties.

E.4.4 Assessment of impairment: fair value hedge

A loan with fixed interest rate payments is hedged against the exposure to interest rate risk by a receive-variable, pay-fixed interest rate swap. The hedge relationship qualifies for fair value hedge accounting and is reported as a fair value hedge. Thus, the carrying amount of the loan includes an adjustment for fair value changes attributable to movements in interest rates. Should an assessment of impairment in the loan take into account the fair value adjustment for interest rate risk?

Yes. The loan's original effective interest rate before the hedge becomes irrelevant once the carrying amount of the loan is adjusted for any changes in its fair value attributable to interest rate movements. Therefore, the original effective interest rate and amortised cost of the loan are adjusted to take into account recognised fair value changes. The adjusted effective interest rate is calculated using the adjusted carrying amount of the loan.

An impairment loss on the hedged loan is calculated as the difference between its carrying amount after adjustment for fair value changes attributable to the risk being hedged and the estimated future cash flows of the loan discounted at the adjusted effective interest rate. When a loan is included in a portfolio hedge of interest rate risk, the entity should allocate the change in the fair value of the hedged portfolio to the loans (or groups of similar loans) being assessed for impairment on a systematic and rational basis.

E.4.5 Impairment: provision matrix

A financial institution calculates impairment in the unsecured portion of loans and receivables on the basis of a provision matrix that specifies fixed provision rates for the number of days a loan has been classified as non-performing (zero per cent if less than 90 days, 20 per cent if 90–180 days, 50 per cent if 181–365 days and 100 per cent if more than 365 days). Can the results be considered to be appropriate for the purpose of calculating the impairment loss on loans and receivables under Ind AS 39.63?

Not necessarily.Ind AS 39.63 requires impairment or bad debt losses to be calculated as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial instrument's original effective interest rate.

E.4.6 Impairment: excess losses

Does Ind AS 39 permit an entity to recognise impairment or bad debt losses in excess of impairment losses that are determined on the basis of objective evidence about impairment in identified individual financial assets or identified groups of similar financial assets?

No. Ind AS 39 does not permit an entity to recognise impairment or bad debt losses in addition to those that can be attributed to individually identified financial assets or identified groups of financial assets with similar credit risk characteristics (Ind AS 39.64) on the basis of objective evidence about the existence of impairment in those assets (Ind AS 39.58). Amounts that an entity might want to set aside for additional possible impairment in financial assets, such as reserves that cannot be supported by objective evidence about impairment, are not recognised as impairment or bad debt losses under Ind AS 39. However, if an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics (Ind AS 39.64).

E.4.7 Recognition of impairment on a portfolio basis

Ind AS 39.63 requires that impairment be recognised for financial assets carried at amortised cost.Ind AS 39.64 states that impairment may be measured and recognised individually or on a portfolio basis for a group of similar financial

assets. If one asset in the group is impaired but the fair value of another asset in the group is above its amortised cost, does Ind AS 39 allow non-recognition of the impairment of the first asset?

No. If an entity knows that an individual financial asset carried at amortised cost is impaired,Ind AS 39.63 requires that the impairment of that asset should be recognised. It states: 'the amount of the loss is measured as the difference between *the asset's* carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate' (emphasis added). Measurement of impairment on a portfolio basis under Ind AS 39.64 may be applied to groups of small balance items and to financial assets that are individually assessed and found not to be impaired when there is indication of impairment in a group of similar assets and impairment cannot be identified with an individual asset in that group.

E.4.8 Impairment: recognition of collateral

If an impaired financial asset is secured by collateral that does not meet the recognition criteria for assets in other Standards, is the collateral recognised as an asset separate from the impaired financial asset?

No. The measurement of the impaired financial asset reflects the fair value of the collateral. The collateral is not recognised as an asset separate from the impaired financial asset unless it meets the recognition criteria for an asset in another Standard.

E.4.9 Impairment of non-monetary available-for-sale financial asset

If a non-monetary financial asset, such as an equity instrument, measured at fair value with gains and losses recognised in other comprehensive income becomes impaired, should the cumulative net loss recognised in other comprehensive income, including any portion attributable to foreign currency changes, be reclassified from equity to profit or loss as a reclassification adjustment?

Yes. Ind AS 39.67 states that when a decline in the fair value of an available-for-sale financial asset has been recognised in other comprehensive income and there is objective evidence that the asset is impaired, the cumulative net loss that had been recognised in other comprehensive income should be reclassified from equity to profit or loss even though the asset has not been derecognised. Any portion of the cumulative net loss that is attributable to foreign currency changes on that asset that had been recognised in other comprehensive income is also reclassified from equity to profit or loss. Any subsequent losses, including any portion attributable to foreign currency changes, are also reclassified from equity to profit or loss until the asset is derecognised.

E.4.10 Impairment: whether the available-for-sale reserve in equity can be negative

Ind AS 39 requires that gains and losses arising from changes in fair value on available-for-sale financial assets are recognised in other comprehensive income. If the aggregate fair value of such assets is less than their carrying amount, should the aggregate net loss that has been recognised in other comprehensive income be reclassified from equity to profit or loss as a reclassification adjustment?

Not necessarily. The relevant criterion is not whether the aggregate fair value is less than the carrying amount, but whether there is objective evidence that a financial asset or group of assets is impaired. An entity assesses at the end of each reporting period whether there is any objective evidence that a financial asset or group of assets may be impaired, in accordance with Ind AS 39.59–61. Ind AS 39.60 states that a downgrade of an entity's credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information. Additionally, a decline in the fair value of a financial asset below its cost or amortised cost is not necessarily evidence of impairment (for example, a decline in the fair value of an investment in a debt instrument that results from an increase in the basic, risk-free interest rate).

Section F Hedging

F.1 Hedging instruments

F.1.1 Hedging the fair value exposure of a bond denominated in a foreign currency

Entity J, whose functional currency is the Japanese yen, has issued 5 million five-year US dollar fixed rate debt. Also, it owns a 5 million five-year fixed rate US dollar bond which it has classified as available for sale. Can Entity J designate its US dollar liability as a hedging instrument in a fair value hedge of the entire fair value exposure of its US dollar bond?

No.Ind AS 39.72 permits a non-derivative to be used as a hedging instrument only for a hedge of a foreign currency risk. Entity J's bond has a fair value exposure to foreign currency and interest rate changes and credit risk.

Alternatively, can the US dollar liability be designated as a fair value hedge or cash flow hedge of the foreign currency component of the bond?

Yes. However, hedge accounting is unnecessary because the amortised cost of the hedging instrument and the hedged item are both remeasured using closing rates. Regardless of whether Entity J designates the relationship as a cash flow hedge or a fair value hedge, the effect on profit or loss is the same. Any gain or loss on the non-derivative hedging instrument designated as a cash flow hedge is immediately recognised in profit or loss to correspond with the recognition of the change in spot rate on the hedged item in profit or loss as required by Ind AS 21

F.1.2 Hedging with a non-derivative financial asset or liability

Entity J's functional currency is the Japanese yen. It has issued a fixed rate debt instrument with semi-annual interest payments that matures in two years with principal due at maturity of 5 million US dollars. It has also entered into a fixed price sales commitment for 5 million US dollars that matures in two years and is not accounted for as a derivative because it meets the exemption for normal sales in paragraph 5. Can Entity J designate its US dollar liability as a fair value hedge of the entire fair value exposure of its fixed price sales commitment and qualify for hedge accounting?

No. Ind AS 39.72 permits a non-derivative asset or liability to be used as a hedging instrument only for a hedge of a foreign currency risk.

Alternatively, can Entity J designate its US dollar liability as a cash flow hedge of the foreign currency exposure associated with the future receipt of US dollars on the fixed price sales commitment?

Yes. Ind AS 39 permits the designation of a non-derivative asset or liability as a hedging instrument in either a cash flow hedge or a fair value hedge of the exposure to changes in foreign exchange rates of a firm commitment (Ind AS 39.87). Any gain or loss on the non-derivative hedging instrument that is recognised in other comprehensive income during the period preceding the future sale is reclassified from equity to profit or loss as a reclassification adjustment when the sale takes place (Ind AS 39.95).

Alternatively, can Entity J designate the sales commitment as the hedging instrument instead of the hedged item?

No. Only a derivative instrument or a non-derivative financial asset or liability can be designated as a hedging instrument in a hedge of a foreign currency risk. A firm commitment cannot be designated as a hedging instrument. However, if the foreign currency component of the sales commitment is required to be separated as an embedded derivative underInd AS 39.11 andInd AS 39.AG33(d), it could be designated as a hedging instrument in a hedge of the exposure to changes in the fair value of the maturity amount of the debt attributable to foreign currency risk.

F.1.3 Hedge accounting: use of written options in combined hedging instruments

Issue (a) – Does Ind AS 39.AG94 preclude the use of an interest rate collar or other derivative instrument that combines a written option component and a purchased option component as a hedging instrument?

It depends. An interest rate collar or other derivative instrument that includes a written option cannot be designated as a hedging instrument if it is a net written option, becauseInd AS 39.AG94 precludes the use of a written option as a hedging instrument unless it is designated as an offset to a purchased option. An interest rate collar or other derivative instrument that includes a written option may be designated as a hedging instrument, however, if the combination is a net purchased option or zero cost collar.

Issue (b) – What factors indicate that an interest rate collar or other derivative instrument that combines a written option component and a purchased option component is not a net written option?

The following factors taken together suggest that an interest rate collar or other derivative instrument that includes a written option is not a net written option.

(a) No net premium is received either at inception or over the life of the combination of options. The distinguishing feature of a written option is the receipt of a premium to compensate the writer for the risk incurred.

(b) Except for the strike prices, the critical terms and conditions of the written option component and the purchased option component are the same (including underlying variable or variables, currency denomination and maturity date). Also,

the notional amount of the written option component is not greater than the notional amount of the purchased option component.

F.1.4 Internal hedges

Some entities use internal derivative contracts (internal hedges) to transfer risk exposures between different companies within a group or divisions within a single legal entity. DoesInd AS 39.73 prohibit hedge accounting in such cases?

Yes, if the derivative contracts are internal to the entity being reported on. Ind AS 39 does not specify how an entity should manage its risk. However, it states that internal hedging transactions do not qualify for hedge accounting. This applies both (a) in consolidated financial statements for intragroup hedging transactions, and (b) in the individual or separate financial statements of a legal entity for hedging transactions between divisions in the entity. The principles of preparing consolidated financial statements in Ind AS 27.24 require that 'intragroup balances, transactions, income and expenses shall be eliminated in full'.

On the other hand, an intragroup hedging transaction may be designated as a hedge in the individual or separate financial statements of a group entity, if the intragroup transaction is an external transaction from the perspective of the group entity. In addition, if the internal contract is offset with an external party the external contract may be regarded as the hedging instrument and the hedging relationship may qualify for hedge accounting.

The following summarises the application of Ind AS 39 to internal hedging transactions.

- Ind AS 39 does not preclude an entity from using internal derivative contracts for risk management purposes and it does not preclude internal derivatives from being accumulated at the treasury level or some other central location so that risk can be managed on an entity-wide basis or at some higher level than the separate legal entity or division.
- Internal derivative contracts between two separate entities within a consolidated group can qualify for hedge accounting by those entities in their individual or separate financial statements, even though the internal contracts are not offset by derivative contracts with a party external to the consolidated group.
- Internal derivative contracts between two separate divisions within the same legal entity can qualify for hedge accounting in the individual or separate financial statements of that legal entity only if those contracts are offset by derivative contracts with a party external to the legal entity.
- Internal derivative contracts between separate divisions within the same legal entity and between separate entities within the consolidated group can qualify for hedge accounting in the consolidated financial statements only if the internal contracts are offset by derivative contracts with a party external to the consolidated group.
- If the internal derivative contracts are not offset by derivative contracts with external parties, the use of hedge accounting by group entities and divisions using internal contracts must be reversed on consolidation.

To illustrate: the banking division of Entity A enters into an internal interest rate swap with the trading division of the same entity. The purpose is to hedge the interest rate risk exposure of a loan (or group of similar loans) in the loan portfolio. Under the swap, the banking division pays fixed interest payments to the trading division and receives variable interest rate payments in return.

If a hedging instrument is not acquired from an external party, Ind AS 39 does not allow hedge accounting treatment for the hedging transaction undertaken by the banking and trading divisions.Ind AS 39.73 indicates that only derivatives that involve a party external to the entity can be designated as hedging instruments and, further, that any gains or losses on intragroup or intra-entity transactions should be eliminated on consolidation. Therefore, transactions between different divisions within Entity A do not qualify for hedge accounting treatment in the financial statements of Entity A. Similarly, transactions between different entities within a group do not qualify for hedge accounting treatment in consolidated financial statements.

However, if in addition to the internal swap in the above example the trading division enters into an interest rate swap or other contract with an external party that offsets the exposure hedged in the internal swap, hedge accounting is permitted underInd AS 39. For the purposes ofInd AS 39, the hedged item is the loan (or group of similar loans) in the banking division and the hedging instrument is the external interest rate swap or other contract.

The trading division may aggregate several internal swaps or portions of them that are not offsetting each other and enter into a single third party derivative contract that offsets the aggregate exposure. Under Ind AS 39, such external hedging transactions may qualify for hedge accounting treatment provided that the hedged items in the banking division are identified and the other conditions for hedge accounting are met. It should be noted, however, that Ind AS 39.79 does not permit hedge accounting treatment for held-to-maturity investments if the hedged risk is the exposure to interest rate changes.

F.1.5 Offsetting internal derivative contracts used to manage interest rate risk

If a central treasury function enters into internal derivative contracts with subsidiaries and various divisions within the consolidated group to manage interest rate risk on a centralised basis, can those contracts qualify for hedge accounting in the consolidated financial statements if, before laying off the risk, the internal contracts are first netted against each other and only the net exposure is offset in the marketplace with external derivative contracts?

No. An internal contract designated at the subsidiary level or by a division as a hedge results in the recognition of changes in the fair value of the item being hedged in profit or loss (a fair value hedge) or in the recognition of the changes in the fair value of the internal derivative in other comprehensive income (a cash flow hedge). There is no basis for changing the measurement attribute of the item being hedged in a fair value hedge unless the exposure is offset with an external derivative. There is also no basis for recognising the gain or loss on the internal derivative in other comprehensive income for one entity and recognising it in profit or loss by the other entity unless it is offset with an external derivative. In cases where two or more internal derivatives are used to manage interest rate risk on assets or liabilities at the subsidiary or division level and those internal derivatives are offset at the treasury level, the effect of designating the internal

derivatives as hedging instruments is that the hedged non-derivative exposures at the subsidiary or division levels would be used to offset each other on consolidation. Accordingly, since Ind AS 39.72 does not permit designating non-derivatives as hedging instruments, except for foreign currency exposures, the results of hedge accounting from the use of internal derivatives at the subsidiary or division level that are not laid off with external parties must be reversed on consolidation.

It should be noted, however, that there will be no effect on profit or loss and other comprehensive income of reversing the effect of hedge accounting in consolidation for internal derivatives that offset each other at the consolidation level if they are used in the same type of hedging relationship at the subsidiary or division level and, in the case of cash flow hedges, where the hedged items affect profit or loss in the same period. Just as the internal derivatives offset at the treasury level, their use as fair value hedges by two separate entities or divisions within the consolidated group will also result in the offset of the fair value amounts recognised in profit or loss, and their use as cash flow hedges by two separate entities or divisions within the consolidated group will also result in the fair value amounts being offset against each other in other comprehensive income. However, there may be an effect on individual line items in both the consolidated statement of profit and loss and the consolidated balance sheet, for example when internal derivatives that hedge assets (or liabilities) in a fair value hedge are offset by internal derivatives that are used as a fair value hedge of other assets (or liabilities) that are recognised in a different line item in the balance sheet or statement of profit and loss. In addition, to the extent that one of the internal contracts is used as a cash flow hedge and the other is used in a fair value hedge, gains and losses recognised would not offset since the gain (or loss) on the internal derivative used as a fair value hedge would be recognised in profit or loss and the corresponding loss (or gain) on the internal derivative used as a cash flow hedge would be recognised in other comprehensive income.

Question F.1.4 describes the application of Ind AS 39 to internal hedging transactions.

F.1.6 Offsetting internal derivative contracts used to manage foreign currency risk

If a central treasury function enters into internal derivative contracts with subsidiaries and various divisions within the consolidated group to manage foreign currency risk on a centralised basis, can those contracts be used as a basis for identifying external transactions that qualify for hedge accounting in the consolidated financial statements if, before laying off the risk, the internal contracts are first netted against each other and only the net exposure is offset by entering into a derivative contract with an external party?

It depends. Ind AS 27 *Consolidated and Separate Financial Statements* requires all internal transactions to be eliminated in consolidated financial statements. As stated in Ind AS 39.73, internal hedging transactions do not qualify for hedge accounting in the consolidated financial statements of the group. Therefore, if an entity wishes to achieve hedge accounting in the consolidated financial statements, it must designate a hedging relationship between a qualifying external hedging instrument and a qualifying hedged item.

As discussed in Question F.1.5, the accounting effect of two or more internal derivatives that are used to manage interest rate risk at the subsidiary or division level and are

offset at the treasury level is that the hedged non-derivative exposures at those levels would be used to offset each other on consolidation. There is no effect on profit of loss or other comprehensive income if (a) the internal derivatives are used in the same type of hedge relationship (ie fair value or cash flow hedges) and (b), in the case of cash flow hedges, any derivative gains and losses that are initially recognised in other comprehensive income are reclassified from equity to profit or loss in the same period(s). When these two conditions are met, the gains and losses on the internal derivatives that are recognised in profit or loss or in other comprehensive income will offset on consolidation resulting in the same profit or loss and other comprehensive income as if the derivatives had been eliminated. However, there may be an effect on individual line items, in both the consolidated statement of profit and loss and the consolidated balance sheet, that would need to be eliminated. In addition, there is an effect on profit or loss and other comprehensive income if some of the offsetting internal derivatives are used in cash flow hedges, while others are used in fair value hedges. There is also an effect on profit or loss and other comprehensive income for offsetting internal derivatives that are used in cash flow hedges if the derivative gains and losses that are initially recognised in other comprehensive income are reclassified from equity to profit or loss in different periods (because the hedged items affect profit or loss in different periods).

As regards foreign currency risk, provided that the internal derivatives represent the transfer of foreign currency risk on underlying non-derivative financial assets or liabilities, hedge accounting can be applied because Ind AS 39.72 permits a non-derivative financial asset or liability to be designated as a hedging instrument for hedge accounting purposes for a hedge of a foreign currency risk. Accordingly, in this case the internal derivative contracts can be used as a basis for identifying external transactions that qualify for hedge accounting in the consolidated financial statements even if they are offset against each other. However, for consolidated financial statements, it is necessary to designate the hedging relationship so that it involves only external transactions.

Furthermore, the entity cannot apply hedge accounting to the extent that two or more offsetting internal derivatives represent the transfer of foreign currency risk on underlying forecast transactions or unrecognised firm commitments. This is because an unrecognised firm commitment or forecast transaction does not qualify as a hedging instrument under Ind AS 39. Accordingly, in this case the internal derivatives cannot be used as a basis for identifying external transactions that qualify for hedge accounting in the consolidated financial statements. As a result, any cumulative net gain or loss on an internal derivative that has been included in the initial carrying amount of an asset or liability (basis adjustment) or recognised in other comprehensive income would have to be reversed on consolidation if it cannot be demonstrated that the offsetting internal derivative represented the transfer of a foreign currency risk on a financial asset or liability to an external hedging instrument.

F.1.7 Internal derivatives: examples of applying Question F.1.6

In each case, FC = foreign currency, LC = local currency (which is the entity's functional currency), and TC = treasury centre.

Case 1 Offset of fair value hedges

Subsidiary A has trade receivables of FC100, due in 60 days, which it hedges using a forward contract with TC. Subsidiary B has payables of FC50, also due in 60 days, which it hedges using a forward contact with TC.

TC nets the two internal derivatives and enters into a net external forward contract to pay FC50 and receive LC in 60 days.

At the end of month 1, FC weakens against LC. A incurs a foreign exchange loss of LC10 on its receivables, offset by a gain of LC10 on its forward contract with TC. B makes a foreign exchange gain of LC5 on its payables offset by a loss of LC5 on its forward contract with TC. TC makes a loss of LC10 on its internal forward contract with A, a gain of LC5 on its internal forward contract with B, and a gain of LC5 on its external forward contract.

At the end of month 1, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting intragroup transactions or events are shown in italics.

A's entries			
Dr Foreign exchange loss		LC10	
	Cr Receivables		LC10
Dr Internal contract TC		*LC10*	
	Cr Internal gain TC		*LC10*
B's entries			
Dr Payables		LC5	
	Cr Foreign exchange gain		LC5
Dr Internal loss TC		*LC5*	
	Cr Internal contract TC		*LC5*
TC's entries			
Dr Internal loss A		*LC10*	
	Cr Internal contract A		*LC10*
Dr Internal contract B		*LC5*	
	Cr Internal gain B		*LC5*
Dr External forward contract		LC5	
	Cr Foreign exchange gain		LC5

Both A and B could apply hedge accounting in their individual financial statements provided all conditions in Ind AS 39 are met. However, in this case, no hedge accounting is required because gains and losses on the internal derivatives and the offsetting losses and gains on the hedged receivables and payables are recognised immediately in profit or loss of A and B without hedge accounting.

In the consolidated financial statements, the internal derivative transactions are eliminated. In economic terms, the payable in B hedges FC50 of the receivables in A. The external forward contract in TC hedges the remaining FC50 of the receivable in A. Hedge accounting is not necessary in the consolidated financial statements because monetary items are measured at spot foreign exchange rates under Ind AS 21 irrespective of whether hedge accounting is applied.

The net balances before and after elimination of the accounting entries relating to the internal derivatives are the same, as set out below. Accordingly, there is no need to make any further accounting entries to meet the requirements of Ind AS 39.

	Debit	*Credit*
Receivables	–	LC10
Payables	LC5	–
External forward contract	LC5	–
Gains and losses	–	–
Internal contracts	–	–

Case 2 Offset of cash flow hedges

To extend the example, A also has highly probable future revenues of FC200 on which it expects to receive cash in 90 days. B has highly probable future expenses of FC500 (advertising cost), also to be paid for in 90 days. A and B enter into separate forward contracts with TC to hedge these exposures and TC enters into an external forward contract to receive FC300 in 90 days.

As before, FC weakens at the end of month 1. A incurs a 'loss' of LC20 on its anticipated revenues because the LC value of these revenues decreases. This is offset by a 'gain' of LC20 on its forward contract with TC.

B incurs a 'gain' of LC50 on its anticipated advertising cost because the LC value of the expense decreases. This is offset by a 'loss' of LC50 on its transaction with TC.

TC incurs a 'gain' of LC50 on its internal transaction with B, a 'loss' of LC20 on its internal transaction with A and a loss of LC30 on its external forward contract.

A and B complete the necessary documentation, the hedges are effective, and both A and B qualify for hedge accounting in their individual financial statements. A recognises the gain of LC20 on its internal derivative transaction in other comprehensive income and B recognises the loss of LC50 in other comprehensive income. TC does not claim hedge accounting, but measures both its internal and external derivative positions at fair value, which net to zero.

At the end of month 1, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting intragroup transactions or events are shown in italics.

A's entries			
Dr Internal contract TC		*LC20*	

	Cr Other comprehensive income		*LC20*
B's entries			
Dr Other comprehensive income		*LC50*	
	Cr Internal contract TC		*LC50*
TC's entries			
Dr Internal loss A		*LC20*	
	Cr Internal contract A		*LC20*
Dr Internal contract B		*LC50*	
	Cr Internal gain B		*LC50*
Dr Foreign exchange loss		LC30	
Cr External forward contract			LC30

For the consolidated financial statements, TC's external forward contract on FC300 is designated, at the beginning of month 1, as a hedging instrument of the first FC300 of B's highly probable future expenses. Ind AS 39 requires that in the consolidated financial statements at the end of month 1, the accounting effects of the internal derivative transactions must be eliminated.

However, the net balances before and after elimination of the accounting entries relating to the internal derivatives are the same, as set out below. Accordingly, there is no need to make any further accounting entries in order for the requirements of Ind AS 39 to be met.

	Debit	*Credit*
External forward contract	–	LC30
Other comprehensive income	LC30	–
Gains and losses	–	–
Internal contracts	–	–

Case 3 Offset of fair value and cash flow hedges

Assume that the exposures and the internal derivative transactions are the same as in cases 1 and 2. However, instead of entering into two external derivatives to hedge separately the fair value and cash flow exposures, TC enters into a single net external derivative to receive FC250 in exchange for LC in 90 days.

TC has four internal derivatives, two maturing in 60 days and two maturing in 90 days. These are offset by a net external derivative maturing in 90 days. The interest rate differential between FC and LC is minimal, and therefore the ineffectiveness resulting from the mismatch in maturities is expected to have a minimal effect on profit or loss in TC.

As in cases 1 and 2, A and B apply hedge accounting for their cash flow hedges and TC measures its derivatives at fair value. A recognises a gain of LC20 on its internal

derivative transaction in other comprehensive income and B recognises a loss of LC50 on its internal derivative transaction in other comprehensive income.

At the end of month 1, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting intragroup transactions or events are shown in italics.

A's entries			
Dr Foreign exchange loss		LC10	
	Cr Receivables		LC10
Dr Internal contract TC		*LC10*	
	Cr Internal gain TC		*LC10*
Dr Internal contract TC		*LC20*	
	Cr Other comprehensive income		*LC20*
B's entries			
Dr Payables		LC5	
	Cr Foreign exchange gain		LC5
Dr Internal loss TC		*LC5*	
	Cr Internal contract TC		*LC5*
Dr Other comprehensive income		*LC50*	
	Cr Internal contract TC		*LC50*
TC's entries			
Dr Internal loss A		*LC10*	
	Cr Internal contract A		*LC10*
Dr Internal loss A		*LC20*	
	Cr Internal contract A		*LC20*
Dr Internal contract B		*LC5*	
	Cr Internal gain B		*LC5*
Dr Internal contract B		*LC50*	
	Cr Internal gain B		*LC50*
Dr Foreign exchange loss		LC25	
	Cr External forward contract		LC25

TOTAL (for the internal derivatives)	*A*	*B*	*Total*
	LC	*LC*	*LC*
Profit or loss (fair value hedges)	10	(5)	5
Other comprehensive income (cash flow hedges)	20	(50)	(30)

Total	30	(55)	(25)

Combining these amounts with the external transactions (ie those not marked in italics above) produces the total net balances before elimination of the internal derivatives as follows:

	Debit	*Credit*
Receivables	–	LC10
Payables	LC5	–
Forward contract	–	LC25
Other comprehensive income	LC30	–
Gains and losses	–	–
Internal contracts	–	–

For the consolidated financial statements, the following designations are made at the beginning of month 1:

- the payable of FC50 in B is designated as a hedge of the first FC50 of the highly probable future revenues in A. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Payable LC5; Cr Other comprehensive income LC5;
- the receivable of FC100 in A is designated as a hedge of the first FC100 of the highly probable future expenses in B. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Other comprehensive income LC10; Cr Receivable LC10; and
- the external forward contract on FC250 in TC is designated as a hedge of the next FC250 of highly probable future expenses in B. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Other comprehensive income LC25; Cr External forward contract LC25.

In the consolidated financial statements at the end of month 1, Ind AS 39 requires the accounting effects of the internal derivative transactions to be eliminated.

However, the total net balances before and after elimination of the accounting entries relating to the internal derivatives are the same, as set out below. Accordingly, there is no need to make any further accounting entries to meet the requirements of Ind AS 39.

	Debit	*Credit*
Receivables	–	LC10
Payables	LC5	–
Forward contract	–	LC25

Other comprehensive income	LC30	–
Gains and losses	–	–
Internal contracts	–	–

Case 4 Offset of fair value and cash flow hedges with adjustment to carrying amount of inventory

Assume similar transactions as in case 3, except that the anticipated cash outflow of FC500 in B relates to the purchase of inventory that is delivered after 60 days. Assume also that the entity has a policy of basis-adjusting hedged forecast non-financial items. At the end of month 2, there are no further changes in exchange rates or fair values. At that date, the inventory is delivered and the loss of LC50 on B's internal derivative, recognised in other comprehensive income in month 1, is adjusted against the carrying amount of inventory in B. The gain of LC20 on A's internal derivative is recognised in other comprehensive income as before.

In the consolidated financial statements, there is now a mismatch compared with the result that would have been achieved by unwinding and redesignating the hedges. The external derivative (FC250) and a proportion of the receivable (FC50) offset FC300 of the anticipated inventory purchase. There is a natural hedge between the remaining FC200 of anticipated cash outflow in B and the anticipated cash inflow of FC200 in A. This relationship does not qualify for hedge accounting under Ind AS 39 and this time there is only a partial offset between gains and losses on the internal derivatives that hedge these amounts.

At the end of months 1 and 2, the following entries are made in the individual or separate financial statements of A, B and TC. Entries reflecting intragroup transactions or events are shown in italics.

A's entries (all at the end of month 1)			
Dr Foreign exchange loss		LC10	
	Cr Receivables		LC10
Dr Internal contract TC		*LC10*	
	Cr Internal gain TC		*LC10*
Dr Internal contract TC		*LC20*	
	Cr Other comprehensive income		*LC20*
B's entries			
At the end of month 1:			
	Dr Payables	LC5	
	Cr Foreign exchange gain		LC5
Dr Internal loss TC		*LC5*	
	Cr Internal contract TC		*LC5*
Dr Other comprehensive income		*LC50*	
	Cr Internal contract T		*LC50*

At the end of month 2:			
Dr Inventory		LC50	
	Cr Other comprehensive income		LC50
TC's entries (all at the end of month 1)			
Dr Internal loss A		*LC10*	
	Cr Internal contract A		*LC10*
Dr Internal loss A		*LC20*	
	Cr Internal contract A		*LC20*
Dr Internal contract B		*LC5*	
	Cr Internal gain B		*LC5*
Dr Internal contract B		*LC50*	
	Cr Internal gain B		*LC50*
Dr Foreign exchange loss		LC25	
	Cr Forward		LC25

TOTAL (for the internal derivatives)	*A LC*	*B LC*	*Total TC*
Profit or loss (fair value hedges)	10	(5)	5
Other comprehensive income (cash flow hedges)	20	–	20
Basis adjustment (inventory)	–	(50)	(50)
Total	30	(55)	(25)

Combining these amounts with the external transactions (ie those not marked in italics above) produces the total net balances before elimination of the internal derivatives as follows:

	Debit	*Credit*
Receivables	–	LC10
Payables	LC5	–
Forward contract	–	LC25
Other comprehensive income	–	LC20
Basis adjustment (inventory)	LC50	–
Gains and losses	–	–
Internal contracts	–	–

For the consolidated financial statements, the following designations are made at the beginning of month 1:

- the payable of FC50 in B is designated as a hedge of the first FC50 of the highly probable future revenues in A. Therefore, at the end of month 1, the following

entry is made in the consolidated financial statements: Dr Payables LC5; Cr Other comprehensive income LC5.

- the receivable of FC100 in A is designated as a hedge of the first FC100 of the highly probable future expenses in B. Therefore, at the end of month 1, the following entries are made in the consolidated financial statements: Dr Other comprehensive income LC10; Cr Receivable LC10; and at the end of month 2, Dr Inventory LC10; Cr Other comprehensive income LC10.
- the external forward contract on FC250 in TC is designated as a hedge of the next FC250 of highly probable future expenses in B. Therefore, at the end of month 1, the following entry is made in the consolidated financial statements: Dr Other comprehensive income LC25; Cr External forward contract LC25; and at the end of month 2, Dr Inventory LC25; Cr Other comprehensive income LC25.

The total net balances after elimination of the accounting entries relating to the internal derivatives are as follows:

	Debit	*Credit*
Receivables	–	LC10
Payables	LC5	–
Forward contract	–	LC25
Other comprehensive income	–	LC5
Basis adjustment (inventory)	LC35	–
Gains and losses	–	–
Internal contracts	–	–

These total net balances are different from those that would be recognised if the internal derivatives were not eliminated, and it is these net balances that Ind AS 39 requires to be included in the consolidated financial statements. The accounting entries required to adjust the total net balances before elimination of the internal derivatives are as follows:

(a) to reclassify LC15 of the loss on B's internal derivative that is included in inventory to reflect that FC150 of the forecast purchase of inventory is not hedged by an external instrument (neither the external forward contract of FC250 in TC nor the external payable of FC100 in A); and

(b) to reclassify the gain of LC15 on A's internal derivative to reflect that the forecast revenues of FC150 to which it relates is not hedged by an external instrument.

The net effect of these two adjustments is as follows:

Dr Other comprehensive income		LC15	
	Cr Inventory		LC15

F.1.8 Combination of written and purchased options

In most cases,Ind AS 39.AG94 prohibits the use of written options as hedging instruments. If a combination of a written option and purchased option (such as an interest rate collar) is transacted as a single instrument with one counterparty, can an entity split the derivative instrument into its written option component and purchased option component and designate the purchased option component as a hedging instrument?

No.Ind AS 39.74 specifies that a hedging relationship is designated by an entity for a hedging instrument in its entirety. The only exceptions permitted are splitting the time value and intrinsic value of an option and splitting the interest element and spot price on a forward. Question F.1.3 addresses the issue of whether and when a combination of options is considered as a written option.

F.1.9 Delta-neutral hedging strategy

Does Ind AS 39 permit an entity to apply hedge accounting for a 'delta-neutral' hedging strategy and other dynamic hedging strategies under which the quantity of the hedging instrument is constantly adjusted in order to maintain a desired hedge ratio, for example, to achieve a delta-neutral position insensitive to changes in the fair value of the hedged item?

Yes. Ind AS 39.74 states that 'a dynamic hedging strategy that assesses both the intrinsic value and time value of an option contract can qualify for hedge accounting'. For example, a portfolio insurance strategy that seeks to ensure that the fair value of the hedged item does not drop below a certain level, while allowing the fair value to increase, may qualify for hedge accounting.

To qualify for hedge accounting, the entity must document how it will monitor and update the hedge and measure hedge effectiveness, be able to track properly all terminations and redesignations of the hedging instrument, and demonstrate that all other criteria for hedge accounting in Ind AS 39.88 are met. Also, it must be able to demonstrate an expectation that the hedge will be highly effective for a specified short period of time during which the hedge is not expected to be adjusted.

F.1.10 Hedging instrument: out of the money put option

Entity A has an investment in one share of Entity B, which it has classified as available for sale. To give itself partial protection against decreases in the share price of Entity B, Entity A acquires a put option on one share of Entity B and designates the change in the intrinsic value of the put as a hedging instrument in a fair value hedge of changes in the fair value of its share in Entity B. The put gives Entity A the right to sell one share of Entity B at a strike price of Rs.90. At the inception of the hedging relationship, the share has a quoted price of Rs.100. Since the put option gives Entity A the right to dispose of the share at a price of Rs.90, the put should normally be fully effective in offsetting price declines below Rs.90 on an intrinsic value basis. Price changes above Rs.90 are not hedged. In this case, are changes in the fair value of the share of Entity B for prices above Rs.90 regarded as hedge ineffectiveness under Ind AS 39.88 and recognised in profit or loss under Ind AS 39.89?

No. Ind AS 39.74 permits Entity A to designate changes in the intrinsic value of the option as the hedging instrument. The changes in the intrinsic value of the option provide protection against the risk of variability in the fair value of one share of Entity B below or

equal to the strike price of the put of Rs.90. For prices above Rs.90, the option is out of the money and has no intrinsic value. Accordingly, gains and losses on one share of Entity B for prices above Rs.90 are not attributable to the hedged risk for the purposes of assessing hedge effectiveness and recognising gains and losses on the hedged item.

Therefore, Entity A recognises changes in the fair value of the share in other comprehensive income if it is associated with variation in its price above Rs.90 (Ind AS 39.55 and Ind AS 39.90). Changes in the fair value of the share associated with price declines below Rs.90 form part of the designated fair value hedge and are recognised in profit or loss under Ind AS 39.89(b). Assuming the hedge is effective, those changes are offset by changes in the intrinsic value of the put, which are also recognised in profit or loss (Ind AS 39.89(a)). Changes in the time value of the put are excluded from the designated hedging relationship and recognised in profit or loss under Ind AS 39.55(a).

F.1.11 Hedging instrument: proportion of the cash flows of a cash instrument

In the case of foreign exchange risk, a non-derivative financial asset or non-derivative financial liability can potentially qualify as a hedging instrument. Can an entity treat the cash flows for specified periods during which a financial asset or financial liability that is designated as a hedging instrument remains outstanding as a proportion of the hedging instrument under Ind AS 39.75, and exclude the other cash flows from the designated hedging relationship?

No. Ind AS 39.75 indicates that a hedging relationship may not be designated for only a portion of the time period in which the hedging instrument is outstanding. For example, the cash flows during the first three years of a ten-year borrowing denominated in a foreign currency cannot qualify as a hedging instrument in a cash flow hedge of the first three years of revenue in the same foreign currency. On the other hand, a non-derivative financial asset or financial liability denominated in a foreign currency may potentially qualify as a hedging instrument in a hedge of the foreign currency risk associated with a hedged item that has a remaining time period until maturity that is equal to or longer than the remaining maturity of the hedging instrument (see Question F.2.17).

F.1.12 Hedges of more than one type of risk

Issue (a) – Normally a hedging relationship is designated between an entire hedging instrument and a hedged item so that there is a single measure of fair value for the hedging instrument. Does this preclude designating a single financial instrument simultaneously as a hedging instrument in both a cash flow hedge and a fair value hedge?

No. For example, entities commonly use a combined interest rate and currency swap to convert a variable rate position in a foreign currency to a fixed rate position in the functional currency. Ind AS 39.76 allows the swap to be designated separately as a fair value hedge of the currency risk and a cash flow hedge of the interest rate risk provided the conditions in Ind AS 39.76 are met.

Issue (b) – If a single financial instrument is a hedging instrument in two different hedges, is special disclosure required?

Ind AS 107.22 requires disclosures separately for designated fair value hedges, cash flow hedges and hedges of a net investment in a foreign operation. The instrument in

question would be reported in the Ind AS 107.22 disclosures separately for each type of hedge.

F.1.13 Hedging instrument: dual foreign currency forward exchange contract

Entity A's functional currency is the Japanese yen. Entity A has a five-year floating rate US dollar liability and a ten-year fixed rate pound sterling-denominated note receivable. The principal amounts of the asset and liability when converted into the Japanese yen are the same. Entity A enters into a single foreign currency forward contract to hedge its foreign currency exposure on both instruments under which it receives US dollars and pays pounds sterling at the end of five years. If Entity A designates the forward exchange contract as a hedging instrument in a cash flow hedge against the foreign currency exposure on the principal repayments of both instruments, can it qualify for hedge accounting?

Yes.Ind AS 39.76 permits designating a single hedging instrument as a hedge of multiple types of risk if three conditions are met. In this example, the derivative hedging instrument satisfies all of these conditions, as follows.

(a) The risks hedged can be identified clearly. The risks are the exposures to changes in the exchange rates between US dollars and yen, and yen and pounds, respectively.

(b) The effectiveness of the hedge can be demonstrated. For the pound sterling loan, the effectiveness is measured as the degree of offset between the fair value of the principal repayment in pounds sterling and the fair value of the pound sterling payment on the forward exchange contract. For the US dollar liability, the effectiveness is measured as the degree of offset between the fair value of the principal repayment in US dollars and the US dollar receipt on the forward exchange contract. Even though the receivable has a ten-year life and the forward protects it for only the first five years, hedge accounting is permitted for only a portion of the exposure as described in Question F.2.17.

(c) It is possible to ensure that there is specific designation of the hedging instrument and different risk positions. The hedged exposures are identified as the principal amounts of the liability and the note receivable in their respective currency of denomination.

F.1.14 Concurrent offsetting swaps and use of one as a hedging instrument

Entity A enters into an interest rate swap and designates it as a hedge of the fair value exposure associated with fixed rate debt. The fair value hedge meets the hedge accounting criteria of Ind AS 39. Entity A simultaneously enters into a second interest rate swap with the same swap counterparty that has terms that fully offset the first interest rate swap. Is Entity A required to view the two swaps as one unit and therefore precluded from applying fair value hedge accounting to the first swap?

It depends. Ind AS 39 is transaction-based. If the second swap was not entered into in contemplation of the first swap or there is a substantive business purpose for structuring the transactions separately, then the swaps are not viewed as one unit.

For example, some entities have a policy that requires a centralised dealer or treasury subsidiary to enter into third-party derivative contracts on behalf of other subsidiaries within the organisation to hedge the subsidiaries' interest rate risk exposures. The dealer or treasury subsidiary also enters into internal derivative transactions with those subsidiaries in order to track those hedges operationally within the organisation. Because the dealer or treasury subsidiary also enters into derivative contracts as part of its trading operations, or because it may wish to rebalance the risk of its overall portfolio, it may enter into a derivative contract with the same third party during the same business day that has substantially the same terms as a contract entered into as a hedging instrument on behalf of another subsidiary. In this case, there is a valid business purpose for entering into each contract.

Judgement is applied to determine whether there is a substantive business purpose for structuring the transactions separately. For example, if the sole purpose is to obtain fair value accounting treatment for the debt, there is no substantive business purpose.

F.2 Hedged items

F.2.1 Whether a derivative can be designated as a hedged item

Does Ind AS 39 permit designating a derivative instrument (whether a stand-alone or separately recognised embedded derivative) as a hedged item either individually or as part of a hedged group in a fair value or cash flow hedge, for example, by designating a pay-variable, receive-fixed Forward Rate Agreement (FRA) as a cash flow hedge of a pay-fixed, receive-variable FRA?

No. Derivative instruments are always deemed held for trading and measured at fair value with gains and losses recognised in profit or loss unless they are designated and effective hedging instruments (Ind AS 39.9). As an exception,Ind AS 39.AG94 permits the designation of a purchased option as the hedged item in a fair value hedge.

F.2.2 Cash flow hedge: anticipated issue of fixed rate debt

Is hedge accounting allowed for a hedge of an anticipated issue of fixed rate debt?

Yes. This would be a cash flow hedge of a highly probable forecast transaction that will affect profit or loss (Ind AS 39.86) provided that the conditions in Ind AS 39.88 are met.

To illustrate: Entity R periodically issues new bonds to refinance maturing bonds, provide working capital and for various other purposes. When Entity R decides it will be issuing bonds, it may hedge the risk of changes in the long-term interest rate from the date it decides to issue the bonds to the date the bonds are issued. If long-term interest rates go up, the bond will be issued either at a higher rate or with a higher discount or smaller premium than was originally expected. The higher rate being paid or decrease in proceeds is normally offset by the gain on the hedge. If long-term interest rates go down, the bond will be issued either at a lower rate or with a higher premium or a smaller

discount than was originally expected. The lower rate being paid or increase in proceeds is normally offset by the loss on the hedge.

For example, in August 20X0 Entity R decided it would issue Rs.200 million seven-year bonds in January 20X1. Entity R performed historical correlation studies and determined that a seven-year treasury bond adequately correlates to the bonds Entity R expected to issue, assuming a hedge ratio of 0.93 futures contracts to one debt unit. Therefore, Entity R hedged the anticipated issue of the bonds by selling (shorting) Rs.186 million worth of futures on seven-year treasury bonds. From August 20X0 to January 20X1 interest rates increased. The short futures positions were closed in January 20X1, the date the bonds were issued, and resulted in a Rs.1.2 million gain that will offset the increased interest payments on the bonds and, therefore, will affect profit or loss over the life of the bonds. The hedge qualifies as a cash flow hedge of the interest rate risk on the forecast issue of debt.

F.2.3 Hedge accounting: core deposit intangibles

Is hedge accounting treatment permitted for a hedge of the fair value exposure of core deposit intangibles?

It depends on whether the core deposit intangible is generated internally or acquired (eg as part of a business combination).

Internally generated core deposit intangibles are not recognised as intangible assets under Ind AS 38. Because they are not recognised, they cannot be designated as a hedged item.

If a core deposit intangible is acquired together with a related portfolio of deposits, the core deposit intangible is required to be recognised separately as an intangible asset (or as part of the related acquired portfolio of deposits) if it meets the recognition criteria in paragraph 21 of Ind AS 38 *Intangible Assets*. A recognised core deposit intangible asset could be designated as a hedged item, but only if it meets the conditions in paragraph 88, including the requirement in paragraph 88(d) that the effectiveness of the hedge can be measured reliably. Because it is often difficult to measure reliably the fair value of a core deposit intangible asset other than on initial recognition, it is unlikely that the requirement in paragraph 88(d) will be met.

F.2.4 Hedge accounting: hedging of future foreign currency revenue streams

Is hedge accounting permitted for a currency borrowing that hedges an expected but not contractual revenue stream in foreign currency?

Yes, if the revenues are highly probable. Under Ind AS 39.86(b) a hedge of an anticipated sale may qualify as a cash flow hedge. For example, an airline entity may use sophisticated models based on experience and economic data to project its revenues in various currencies. If it can demonstrate that forecast revenues for a period of time into the future in a particular currency are 'highly probable', as required by Ind AS 39.88, it may designate a currency borrowing as a cash flow hedge of the future revenue stream. The portion of the gain or loss on the borrowing that is determined to be an effective hedge is recognised in other comprehensive income until the revenues occur.

It is unlikely that an entity can reliably predict 100 per cent of revenues for a future year. On the other hand, it is possible that a portion of predicted revenues, normally those expected in the short term, will meet the 'highly probable' criterion.

F.2.5 Cash flow hedges: 'all in one' hedge

If a derivative instrument is expected to be settled gross by delivery of the underlying asset in exchange for the payment of a fixed price, can the derivative instrument be designated as the hedging instrument in a cash flow hedge of that gross settlement assuming the other cash flow hedge accounting criteria are met?

Yes. A derivative instrument that will be settled gross can be designated as the hedging instrument in a cash flow hedge of the variability of the consideration to be paid or received in the future transaction that will occur on gross settlement of the derivative contract itself because there would be an exposure to variability in the purchase or sale price without the derivative. This applies to all fixed price contracts that are accounted for as derivatives under Ind AS 39.

For example, if an entity enters into a fixed price contract to sell a commodity and that contract is accounted for as a derivative under Ind AS 39 (for example, because the entity has a practice of settling such contracts net in cash or of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin), the entity may designate the fixed price contract as a cash flow hedge of the variability of the consideration to be received on the sale of the asset (a future transaction) even though the fixed price contract is the contract under which the asset will be sold. Also, if an entity enters into a forward contract to purchase a debt instrument that will be settled by delivery, but the forward contract is a derivative because its term exceeds the regular way delivery period in the marketplace, the entity may designate the forward as a cash flow hedge of the variability of the consideration to be paid to acquire the debt instrument (a future transaction), even though the derivative is the contract under which the debt instrument will be acquired.

F.2.6 Hedge relationships: entity-wide risk

An entity has a fixed rate asset and a fixed rate liability, each having the same principal amount. Under the terms of the instruments, interest payments on the asset and liability occur in the same period and the net cash flow is always positive because the interest rate on the asset exceeds the interest rate on the liability. The entity enters into an interest rate swap to receive a floating interest rate and pay a fixed interest rate on a notional amount equal to the principal of the asset and designates the interest rate swap as a fair value hedge of the fixed rate asset. Does the hedging relationship qualify for hedge accounting even though the effect of the interest rate swap on an entity-wide basis is to create an exposure to interest rate changes that did not previously exist?

Yes. Ind AS 39 does not require risk reduction on an entity-wide basis as a condition for hedge accounting. Exposure is assessed on a transaction basis and, in this instance, the asset being hedged has a fair value exposure to interest rate increases that is offset by the interest rate swap.

F.2.7 Cash flow hedge: forecast transaction related to an entity's equity

Can a forecast transaction in the entity's own equity instruments or forecast dividend payments to shareholders be designated as a hedged item in a cash flow hedge?

No. To qualify as a hedged item, the forecast transaction must expose the entity to a particular risk that can affect profit or loss (Ind AS 39.86). The classification of financial instruments as liabilities or equity generally provides the basis for determining whether transactions or other payments relating to such instruments are recognised in profit or loss (Ind AS 32). For example, distributions to holders of an equity instrument are debited by the issuer directly to equity (Ind AS 32.35). Therefore, such distributions cannot be designated as a hedged item. However, a declared dividend that has not yet been paid and is recognised as a financial liability may qualify as a hedged item, for example, for foreign currency risk if it is denominated in a foreign currency.

F.2.8 Hedge accounting: risk of a transaction not occurring

Does Ind AS 39 permit an entity to apply hedge accounting to a hedge of the risk that a transaction will not occur, for example, if that would result in less revenue to the entity than expected?

No. The risk that a transaction will not occur is an overall business risk that is not eligible as a hedged item. Hedge accounting is permitted only for risks associated with recognised assets and liabilities, firm commitments, highly probable forecast transactions and net investments in foreign operations (Ind AS 39.86).

F.2.9 Held-to-maturity investments: hedging variable interest rate payments

Can an entity designate a pay-variable, receive-fixed interest rate swap as a cash flow hedge of a variable rate, held-to-maturity investment?

No. It is inconsistent with the designation of a debt investment as being held to maturity to designate a swap as a cash flow hedge of the debt investment's variable interest rate payments. Ind AS 39.79 states that a held-to-maturity investment cannot be a hedged item with respect to interest rate risk or prepayment risk 'because designation of an investment as held to maturity requires an intention to hold the investment until maturity without regard to changes in the fair value or cash flows of such an investment attributable to changes in interest rates'.

F.2.10 Hedged items: purchase of held-to-maturity investment

An entity forecasts the purchase of a financial asset that it intends to classify as held to maturity when the forecast transaction occurs. It enters into a derivative contract with the intent to lock in the current interest rate and designates the derivative as a hedge of the forecast purchase of the financial asset. Can the hedging relationship qualify for cash flow hedge accounting even though the asset will be classified as a held-to-maturity investment?

Yes. With respect to interest rate risk, Ind AS 39 prohibits hedge accounting for financial assets that are classified as held-to-maturity (Ind AS 39.79). However, even though the

entity intends to classify the asset as held to maturity, the instrument is not classified as such until the transaction occurs.

F.2.11 Cash flow hedges: reinvestment of funds obtained from held-to-maturity investments

An entity owns a variable rate asset that it has classified as held to maturity. It enters into a derivative contract with the intention to lock in the current interest rate on the reinvestment of variable rate cash flows, and designates the derivative as a cash flow hedge of the forecast future interest receipts on debt instruments resulting from the reinvestment of interest receipts on the held-to-maturity asset. Assuming that the other hedge accounting criteria are met, can the hedging relationship qualify for cash flow hedge accounting even though the interest payments that are being reinvested come from an asset that is classified as held to maturity?

Yes. Ind AS 39.79 states that a held-to-maturity investment cannot be a hedged item with respect to interest rate risk. Question F.2.9 specifies that this applies not only to fair value hedges, ie hedges of the exposure to fair value interest rate risk associated with held-to-maturity investments that pay fixed interest, but also to cash flow hedges, ie hedges of the exposure to cash flow interest rate risk associated with held-to-maturity investments that pay variable interest at current market rates. However, in this instance, the derivative is designated as an offset of the exposure to cash flow risk associated with forecast future interest receipts on debt instruments resulting from the forecast reinvestment of variable rate cash flows on the held-to-maturity investment. The source of the funds forecast to be reinvested is not relevant in determining whether the reinvestment risk can be hedged. Accordingly, designation of the derivative as a cash flow hedge is permitted. This answer applies also to a hedge of the exposure to cash flow risk associated with the forecast future interest receipts on debt instruments resulting from the reinvestment of interest receipts on a fixed rate asset classified as held to maturity.

F.2.12 Hedge accounting: prepayable financial asset

If the issuer has the right to prepay a financial asset, can the investor designate the cash flows after the prepayment date as part of the hedged item?

Cash flows after the prepayment date may be designated as the hedged item to the extent it can be demonstrated that they are 'highly probable' (Ind AS 39.88). For example, cash flows after the prepayment date may qualify as highly probable if they result from a group or pool of similar assets (for example, mortgage loans) for which prepayments can be estimated with a high degree of accuracy or if the prepayment option is significantly out of the money. In addition, the cash flows after the prepayment date may be designated as the hedged item if a comparable option exists in the hedging instrument.

F.2.13 Fair value hedge: risk that could affect profit or loss

Is fair value hedge accounting permitted for exposure to interest rate risk in fixed rate loans that are classified as loans and receivables?

Yes. UnderInd AS 39, loans and receivables are carried at amortised cost. Banking institutions in many countries hold the bulk of their loans and receivables until maturity. Thus, changes in the fair value of such loans and receivables that are due to changes in market interest rates will not affect profit or loss.Ind AS 39.86 specifies that a fair value hedge is a hedge of the exposure to changes in fair value that is attributable to a particular risk and that can affect profit or loss. Therefore,Ind AS 39.86 may appear to preclude fair value hedge accounting for loans and receivables. However, it follows from Ind AS 39.79 that loans and receivables can be hedged items with respect to interest rate risk since they are not designated as held-to-maturity investments. The entity could sell them and the change in fair values would affect profit or loss. Thus, fair value hedge accounting is permitted for loans and receivables.

F.2.14 Intragroup and intra-entity hedging transactions

An Australian entity, whose functional currency is the Australian dollar, has forecast purchases in Japanese yen that are highly probable. The Australian entity is wholly owned by a Swiss entity, which prepares consolidated financial statements (which include the Australian subsidiary) in Swiss francs. The Swiss parent entity enters into a forward contract to hedge the change in yen relative to the Australian dollar. Can that hedge qualify for hedge accounting in the consolidated financial statements, or must the Australian subsidiary that has the foreign currency exposure be a party to the hedging transaction?

The hedge can qualify for hedge accounting provided the other hedge accounting criteria in Ind AS 39 are met. Since the Australian entity did not hedge the foreign currency exchange risk associated with the forecast purchases in yen, the effects of exchange rate changes between the Australian dollar and the yen will affect the Australian entity's profit or loss and, therefore, would also affect consolidated profit or loss. Ind AS 39 does not require that the operating unit that is exposed to the risk being hedged be a party to the hedging instrument.

F.2.15 Internal contracts: single offsetting external derivative

An entity uses what it describes as internal derivative contracts to document the transfer of responsibility for interest rate risk exposures from individual divisions to a central treasury function. The central treasury function aggregates the internal derivative contracts and enters into a single external derivative contract that offsets the internal derivative contracts on a net basis. For example, if the central treasury function has entered into three internal receive-fixed, pay-variable interest rate swaps that lay off the exposure to variable interest cash flows on variable rate liabilities in other divisions and one internal receive-variable, pay-fixed interest rate swap that lays off the exposure to variable interest cash flows on variable rate assets in another division, it would enter into an interest rate swap with an external counterparty that exactly offsets the four internal swaps. Assuming that the hedge accounting criteria are met, in the entity's financial statements would the single offsetting external derivative qualify as a hedging instrument in a hedge of a part of the underlying items on a gross basis?

Yes, but only to the extent the external derivative is designated as an offset of cash inflows or cash outflows on a gross basis. Ind AS 39.84 indicates that a hedge of an overall net position does not qualify for hedge accounting. However, it does permit designating a part of the underlying items as the hedged position on a gross basis.

Therefore, even though the purpose of entering into the external derivative was to offset internal derivative contracts on a net basis, hedge accounting is permitted if the hedging relationship is defined and documented as a hedge of a part of the underlying cash inflows or cash outflows on a gross basis. An entity follows the approach outlined in Ind AS 39.84 and Ind AS 39.AG101 to designate part of the underlying cash flows as the hedged position.

F.2.16 Internal contracts: external derivative contracts that are settled net

Issue (a) – An entity uses internal derivative contracts to transfer interest rate risk exposures from individual divisions to a central treasury function. For each internal derivative contract, the central treasury function enters into a derivative contract with a single external counterparty that offsets the internal derivative contract. For example, if the central treasury function has entered into a receive-5 per cent-fixed, pay-MIBOR interest rate swap with another division that has entered into the internal contract with central treasury to hedge the exposure to variability in interest cash flows on a pay-MIBOR borrowing, central treasury would enter into a pay-5 per cent-fixed, receive-MIBOR interest rate swap on the same principal terms with the external counterparty. Although each of the external derivative contracts is formally documented as a separate contract, only the net of the payments on all of the external derivative contracts is settled since there is a netting agreement with the external counterparty. Assuming that the other hedge accounting criteria are met, can the individual external derivative contracts, such as the pay-5 per cent-fixed, receive-MIBOR interest rate swap above, be designated as hedging instruments of underlying gross exposures, such as the exposure to changes in variable interest payments on the pay-MIBOR borrowing above, even though the external derivatives are settled on a net basis?

Generally, yes. External derivative contracts that are legally separate contracts and serve a valid business purpose, such as laying off risk exposures on a gross basis, qualify as hedging instruments even if those external contracts are settled on a net basis with the same external counterparty, provided the hedge accounting criteria in Ind AS 39 are met. See also Question F.1.14.

Issue (b) – Treasury observes that by entering into the external offsetting contracts and including them in the centralised portfolio, it is no longer able to evaluate the exposures on a net basis. Treasury wishes to manage the portfolio of offsetting external derivatives separately from other exposures of the entity. Therefore, it enters into an additional, single derivative to offset the risk of the portfolio. Can the individual external derivative contracts in the portfolio still be designated as hedging instruments of underlying gross exposures even though a single external derivative is used to offset fully the market exposure created by entering into the external contracts?

Generally, yes. The purpose of structuring the external derivative contracts in this manner is consistent with the entity's risk management objectives and strategies. As indicated above, external derivative contracts that are legally separate contracts and serve a valid business purpose qualify as hedging instruments. Moreover, the answer to Question F.1.14 specifies that hedge accounting is not precluded simply because the entity has entered into a swap that mirrors exactly the terms of another swap with the

same counterparty if there is a substantive business purpose for structuring the transactions separately.

F.2.17 Partial term hedging

Ind AS 39.75 indicates that a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding. Is it permitted to designate a derivative as hedging only a portion of the time period to maturity of a hedged item?

Yes. A financial instrument may be a hedged item for only a portion of its cash flows or fair value, if effectiveness can be measured and the other hedge accounting criteria are met.

To illustrate: Entity A acquires a 10 per cent fixed rate government bond with a remaining term to maturity of ten years. Entity A classifies the bond as available for sale. To hedge itself against fair value exposure on the bond associated with the present value of the interest rate payments until year 5, Entity A acquires a five-year pay-fixed, receive-floating swap. The swap may be designated as hedging the fair value exposure of the interest rate payments on the government bond until year 5 and the change in value of the principal payment due at maturity to the extent affected by changes in the yield curve relating to the five years of the swap.

F.2.18 Hedging instrument: cross-currency interest rate swap

Entity A's functional currency is the Japanese yen. Entity A has a five-year floating rate US dollar liability and a 10-year fixed rate pound sterling-denominated note receivable. Entity A wishes to hedge the foreign currency exposure on its asset and liability and the fair value interest rate exposure on the receivable and enters into a matching cross-currency interest rate swap to receive floating rate US dollars and pay fixed rate pounds sterling and to exchange the dollars for the pounds at the end of five years. Can Entity A designate the swap as a hedging instrument in a fair value hedge against both foreign currency risk and interest rate risk, although both the pound sterling and US dollar are foreign currencies to Entity A?

Yes. Ind AS 39.81 permits hedge accounting for components of risk, if effectiveness can be measured. Also, Ind AS 39.76 permits designating a single hedging instrument as a hedge of more than one type of risk if the risks can be identified clearly, effectiveness can be demonstrated, and specific designation of the hedging instrument and different risk positions can be ensured. Therefore, the swap may be designated as a hedging instrument in a fair value hedge of the pound sterling receivable against exposure to changes in its fair value associated with changes in UK interest rates for the initial partial term of five years and the exchange rate between pounds and US dollars. The swap is measured at fair value with changes in fair value recognised in profit or loss. The carrying amount of the receivable is adjusted for changes in its fair value caused by changes in UK interest rates for the first five-year portion of the yield curve. The receivable and payable are remeasured using spot exchange rates under Ind AS 21 and the changes to their carrying amounts recognised in profit or loss.

F.2.19 Hedged items: hedge of foreign currency risk of publicly traded shares

Entity A acquires shares in Entity B on a foreign stock exchange for their fair value of 1,000 in foreign currency (FC). It classifies the shares as available for sale. To protect itself from the exposure to changes in the foreign exchange rate associated with the shares, it enters into a forward contract to sell FC750. Entity A intends to roll over the forward exchange contract for as long as it retains the shares. Assuming that the other hedge accounting criteria are met, could the forward exchange contract qualify as a hedge of the foreign exchange risk associated with the shares?

Yes, but only if there is a clear and identifiable exposure to changes in foreign exchange rates. Therefore, hedge accounting is permitted if (a) the equity instrument is not traded on an exchange (or in another established marketplace) where trades are denominated in the same currency as the functional currency of Entity A and (b) dividends to Entity A are not denominated in that currency. Thus, if a share is traded in multiple currencies and one of those currencies is the functional currency of the reporting entity, hedge accounting for the foreign currency component of the share price is not permitted.

If so, could the forward exchange contract be designated as a hedging instrument in a hedge of the foreign exchange risk associated with the portion of the fair value of the shares up to FC750 in foreign currency?

Yes. Ind AS 39 permits designating a portion of the cash flow or fair value of a financial asset as the hedged item if effectiveness can be measured (Ind AS 39.81). Therefore, Entity A may designate the forward exchange contract as a hedge of the foreign exchange risk associated with only a portion of the fair value of the shares in foreign currency. It could either be designated as a fair value hedge of the foreign exchange exposure of FC750 associated with the shares or as a cash flow hedge of a forecast sale of the shares, provided the timing of the sale is identified. Any variability in the fair value of the shares in foreign currency would not affect the assessment of hedge effectiveness unless the fair value of the shares in foreign currency was to fall below FC750.

F.2.20 Hedge accounting: stock index

An entity may acquire a portfolio of shares to replicate a stock index and a put option on the index to protect itself from fair value losses. Does Ind AS 39 permit designating the put on the stock index as a hedging instrument in a hedge of the portfolio of shares?

No. If similar financial instruments are aggregated and hedged as a group, Ind AS 39.83 states that the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group. In the scenario above, the change in the fair value attributable to the hedged risk for each individual item in the group (individual share prices) is not expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group.

F.2.21 Hedge accounting: netting of assets and liabilities

May an entity group financial assets together with financial liabilities for the purpose of determining the net cash flow exposure to be hedged for hedge accounting purposes?

An entity's hedging strategy and risk management practices may assess cash flow risk on a net basis but Ind AS 39.84 does not permit designating a net cash flow exposure as a hedged item for hedge accounting purposes. Ind AS 39.AG101 provides an example of how a bank might assess its risk on a net basis (with similar assets and liabilities grouped together) and then qualify for hedge accounting by hedging on a gross basis.

F.3 Hedge accounting

F.3.1 Cash flow hedge: fixed interest rate cash flows

An entity issues a fixed rate debt instrument and enters into a receive-fixed, pay-variable interest rate swap to offset the exposure to interest rate risk associated with the debt instrument. Can the entity designate the swap as a cash flow hedge of the future interest cash outflows associated with the debt instrument?

No. Ind AS 39.86(b) states that a cash flow hedge is 'a hedge of the exposure to variability in cash flows'. In this case, the issued debt instrument does not give rise to any exposure to variability in cash flows since the interest payments are fixed. The entity may designate the swap as a fair value hedge of the debt instrument, but it cannot designate the swap as a cash flow hedge of the future cash outflows of the debt instrument.

F.3.2 Cash flow hedge: reinvestment of fixed interest rate cash flows

An entity manages interest rate risk on a net basis. On 1 January 20X1, it forecasts aggregate cash inflows of Rs.100 on fixed rate assets and aggregate cash outflows of Rs.90 on fixed rate liabilities in the first quarter of 20X2. For risk management purposes it uses a receive-variable, pay-fixed Forward Rate Agreement (FRA) to hedge the forecast net cash inflow of Rs.10. The entity designates as the hedged item the first Rs.10 of cash inflows on fixed rate assets in the first quarter of 20X2. Can it designate the receive-variable, pay-fixed FRA as a cash flow hedge of the exposure to variability to cash flows in the first quarter of 20X2 associated with the fixed rate assets?

No. The FRA does not qualify as a cash flow hedge of the cash flow relating to the fixed rate assets because they do not have a cash flow exposure. The entity could, however, designate the FRA as a hedge of the fair value exposure that exists before the cash flows are remitted.

In some cases, the entity could also hedge the interest rate exposure associated with the forecast reinvestment of the interest and principal it receives on fixed rate assets (see Question F.6.2). However, in this example, the FRA does not qualify for cash flow hedge accounting because it increases rather than reduces the variability of interest cash flows resulting from the reinvestment of interest cash flows (for example, if market rates increase, there will be a cash inflow on the FRA and an increase in the expected interest cash inflows resulting from the reinvestment of interest cash inflows on fixed rate assets). However, potentially it could qualify as a cash flow hedge of a portion of the refinancing of cash outflows on a gross basis.

F.3.3 Foreign currency hedge

Entity A has a foreign currency liability payable in six months' time and it wishes to hedge the amount payable on settlement against foreign currency fluctuations. To that end, it takes out a forward contract to buy the foreign currency in six months' time. Should the hedge be treated as:

(a) **a fair value hedge of the foreign currency liability with gains and losses on revaluing the liability and the forward contract at the year-end both recognised in profit or loss; or**

(b) **a cash flow hedge of the amount to be settled in the future with gains and losses on revaluing the forward contract recognised in other comprehensive income?**

Ind AS 39 does not preclude either of these two methods. If the hedge is treated as a fair value hedge, the gain or loss on the fair value remeasurement of the hedging instrument and the gain or loss on the fair value remeasurement of the hedged item for the hedged risk are recognised immediately in profit or loss. If the hedge is treated as a cash flow hedge with the gain or loss on remeasuring the forward contract recognised in other comprehensive income, that amount is recognised in profit or loss in the same period or periods during which the hedged item (the liability) affects profit or loss, ie when the liability is remeasured for changes in foreign exchange rates. Therefore, if the hedge is effective, the gain or loss on the derivative is released to profit or loss in the same periods during which the liability is remeasured, not when the payment occurs. See Question F.3.4.

F.3.4 Foreign currency cash flow hedge

An entity exports a product at a price denominated in a foreign currency. At the date of the sale, the entity obtains a receivable for the sale price payable in 90 days and takes out a 90-day forward exchange contract in the same currency as the receivable to hedge its foreign currency exposure.

Under Ind AS 21, the sale is recorded at the spot rate at the date of sale, and the receivable is restated during the 90-day period for changes in exchange rates with the difference being taken to profit or loss (Ind AS 21.23 and Ind AS 21.28).

If the foreign exchange contract is designated as a hedging instrument, does the entity have a choice whether to designate the foreign exchange contract as a fair value hedge of the foreign currency exposure of the receivable or as a cash flow hedge of the collection of the receivable?

Yes. If the entity designates the foreign exchange contract as a fair value hedge, the gain or loss from remeasuring the forward exchange contract at fair value is recognised immediately in profit or loss and the gain or loss on remeasuring the receivable is also recognised in profit or loss.

If the entity designates the foreign exchange contract as a cash flow hedge of the foreign currency risk associated with the collection of the receivable, the portion of the gain or loss that is determined to be an effective hedge is recognised in other comprehensive income, and the ineffective portion in profit or loss (Ind AS 39.95). The amount recognised in other comprehensive income is reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which changes in the measurement of the receivable affect profit or loss (Ind AS 39.100).

F.3.5 Fair value hedge: variable rate debt instrument

Does Ind AS 39 permit an entity to designate a portion of the risk exposure of a variable rate debt instrument as a hedged item in a fair value hedge?

Yes. A variable rate debt instrument may have an exposure to changes in its fair value due to credit risk. It may also have an exposure to changes in its fair value relating to movements in the market interest rate in the periods between which the variable interest rate on the debt instrument is reset. For example, if the debt instrument provides for annual interest payments reset to the market rate each year, a portion of the debt instrument has an exposure to changes in fair value during the year.

F.3.6 Fair value hedge: inventory

Ind AS 39.86(a) states that a fair value hedge is 'a hedge of the exposure to changes in fair value of a recognised asset or liability ... that is attributable to a particular risk and could affect profit or loss'. Can an entity designate inventories, such as copper inventory, as the hedged item in a fair value hedge of the exposure to changes in the price of the inventories, such as the copper price, although inventories are measured at the lower of cost and net realisable value under Ind AS 2 *Inventories*?

Yes. The inventories may be hedged for changes in fair value due to changes in the copper price because the change in fair value of inventories will affect profit or loss when the inventories are sold or their carrying amount is written down. The adjusted carrying amount becomes the cost basis for the purpose of applying the lower of cost and net realisable value test under Ind AS 2 . The hedging instrument used in a fair value hedge of inventories may alternatively qualify as a cash flow hedge of the future sale of the inventory.

F.3.7 Hedge accounting: forecast transaction

For cash flow hedges, a forecast transaction that is subject to a hedge must be 'highly probable'. How should the term 'highly probable' be interpreted?

The term 'highly probable' indicates a much greater likelihood of happening than the term 'more likely than not'. An assessment of the likelihood that a forecast transaction will take place is not based solely on management's intentions because intentions are not verifiable. A transaction's probability should be supported by observable facts and the attendant circumstances.

In assessing the likelihood that a transaction will occur, an entity should consider the following circumstances:

(a) the frequency of similar past transactions;

(b) the financial and operational ability of the entity to carry out the transaction;

(c) substantial commitments of resources to a particular activity (for example, a manufacturing facility that can be used in the short run only to process a particular type of commodity);

(d) the extent of loss or disruption of operations that could result if the transaction does not occur;

(e) the likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose (for example, an entity that intends to raise cash may have several ways of doing so, ranging from a short-term bank loan to an offering of ordinary shares); and

(f) the entity's business plan.

The length of time until a forecast transaction is projected to occur is also a factor in determining probability. Other factors being equal, the more distant a forecast transaction is, the less likely it is that the transaction would be regarded as highly probable and the stronger the evidence that would be needed to support an assertion that it is highly probable.

For example, a transaction forecast to occur in five years may be less likely to occur than a transaction forecast to occur in one year. However, forecast interest payments for the next 20 years on variable rate debt would typically be highly probable if supported by an existing contractual obligation.

In addition, other factors being equal, the greater the physical quantity or future value of a forecast transaction in proportion to the entity's transactions of the same nature, the less likely it is that the transaction would be regarded as highly probable and the stronger the evidence that would be required to support an assertion that it is highly probable. For example, less evidence generally would be needed to support forecast sales of 100,000 units in the next month than 950,000 units in that month when recent sales have averaged 950,000 units per month for the past three months.

A history of having designated hedges of forecast transactions and then determining that the forecast transactions are no longer expected to occur would call into question both an entity's ability to predict forecast transactions accurately and the propriety of using hedge accounting in the future for similar forecast transactions.

F.3.8 Retrospective designation of hedges

Does Ind AS 39 permit an entity to designate hedge relationships retrospectively?

No. Designation of hedge relationships takes effect prospectively from the date all hedge accounting criteria inInd AS 39.88 are met. In particular, hedge accounting can be applied only from the date the entity has completed the necessary documentation of the hedge relationship, including identification of the hedging instrument, the related hedged item or transaction, the nature of the risk being hedged, and how the entity will assess hedge effectiveness.

F.3.9 Hedge accounting: designation at the inception of the hedge

Does Ind AS 39 permit an entity to designate and formally document a derivative contract as a hedging instrument after entering into the derivative contract?

Yes, prospectively. For hedge accounting purposes, Ind AS 39 requires a hedging instrument to be designated and formally documented as such from the inception of the hedge relationship (Ind AS 39.88); in other words, a hedge relationship cannot be designated retrospectively. Also, it precludes designating a hedging relationship for only

a portion of the time period during which the hedging instrument remains outstanding (Ind AS 39.75). However, it does not require the hedging instrument to be acquired at the inception of the hedge relationship.

F.3.10 Hedge accounting: identification of hedged forecast transaction

Can a forecast transaction be identified as the purchase or sale of the last 15,000 units of a product in a specified period or as a percentage of purchases or sales during a specified period?

No. The hedged forecast transaction must be identified and documented with sufficient specificity so that when the transaction occurs, it is clear whether the transaction is or is not the hedged transaction. Therefore, a forecast transaction may be identified as the sale of the first 15,000 units of a specific product during a specified three-month period, but it could not be identified as the last 15,000 units of that product sold during a three-month period because the last 15,000 units cannot be identified when they are sold. For the same reason, a forecast transaction cannot be specified solely as a percentage of sales or purchases during a period.

F.3.11 Cash flow hedge: documentation of timing of forecast transaction

For a hedge of a forecast transaction, should the documentation of the hedge relationship that is established at inception of the hedge identify the date on, or time period in which, the forecast transaction is expected to occur?

Yes. To qualify for hedge accounting, the hedge must relate to a specific identified and designated risk (Ind AS 39.AG110) and it must be possible to measure its effectiveness reliably (Ind AS 39.88(d)). Also, the hedged forecast transaction must be highly probable (Ind AS 39.88(c)). To meet these criteria, an entity is not required to predict and document the exact date a forecast transaction is expected to occur. However, it is required to identify and document the time period during which the forecast transaction is expected to occur within a reasonably specific and generally narrow range of time from a most probable date, as a basis for assessing hedge effectiveness. To determine that the hedge will be highly effective in accordance withInd AS 39.88(d), it is necessary to ensure that changes in the fair value of the expected cash flows are offset by changes in the fair value of the hedging instrument and this test may be met only if the timing of the cash flows occur within close proximity to each other. If the forecast transaction is no longer expected to occur, hedge accounting is discontinued in accordance with Ind AS 39.101(c).

F.4 Hedge effectiveness

F.4.1 Hedging on an after-tax basis

Hedging is often done on an after-tax basis. Is hedge effectiveness assessed after taxes?

Ind AS 39 permits, but does not require, assessment of hedge effectiveness on an after-tax basis. If the hedge is undertaken on an after-tax basis, it is so designated at inception as part of the formal documentation of the hedging relationship and strategy.

F.4.2 Hedge effectiveness: assessment on cumulative basis

Ind AS 39.88(b) requires that the hedge is expected to be highly effective. Should expected hedge effectiveness be assessed separately for each period or cumulatively over the life of the hedging relationship?

Expected hedge effectiveness may be assessed on a cumulative basis if the hedge is so designated, and that condition is incorporated into the appropriate hedging documentation. Therefore, even if a hedge is not expected to be highly effective in a particular period, hedge accounting is not precluded if effectiveness is expected to remain sufficiently high over the life of the hedging relationship. However, any ineffectiveness is required to be recognised in profit or loss as it occurs.

To illustrate: an entity designates a MIBOR-based interest rate swap as a hedge of a borrowing whose interest rate is a UK base rate plus a margin. The UK base rate changes, perhaps, once each quarter or less, in increments of 25–50 basis points, while MIBOR changes daily. Over a period of 1–2 years, the hedge is expected to be almost perfect. However, there will be quarters when the UK base rate does not change at all, while MIBOR has changed significantly. This would not necessarily preclude hedge accounting.

F.4.3 Hedge effectiveness: counterparty credit risk

Must an entity consider the likelihood of default by the counterparty to the hedging instrument in assessing hedge effectiveness?

Yes. An entity cannot ignore whether it will be able to collect all amounts due under the contractual provisions of the hedging instrument. When assessing hedge effectiveness, both at the inception of the hedge and on an ongoing basis, the entity considers the risk that the counterparty to the hedging instrument will default by failing to make any contractual payments to the entity. For a cash flow hedge, if it becomes probable that a counterparty will default, an entity would be unable to conclude that the hedging relationship is expected to be highly effective in achieving offsetting cash flows. As a result, hedge accounting would be discontinued. For a fair value hedge, if there is a change in the counterparty's creditworthiness, the fair value of the hedging instrument will change, which affects the assessment of whether the hedge relationship is effective and whether it qualifies for continued hedge accounting.

F.4.4 Hedge effectiveness: effectiveness tests

How should hedge effectiveness be measured for the purposes of initially qualifying for hedge accounting and for continued qualification?

Ind AS 39 does not provide specific guidance about how effectiveness tests are performed. Ind AS 39.AG105 specifies that a hedge is normally regarded as highly effective only if (a) at inception and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated, and (b) the actual results are within a range of 80–125 per cent. Ind AS 39.AG105 also states that the expectation in (a) can be demonstrated in various ways.

The appropriateness of a given method of assessing hedge effectiveness will depend on the nature of the risk being hedged and the type of hedging instrument used. The method of assessing effectiveness must be reasonable and consistent with other similar hedges unless different methods are explicitly justified. An entity is required to document at the inception of the hedge how effectiveness will be assessed and then to apply that effectiveness test on a consistent basis for the duration of the hedge.

Several mathematical techniques can be used to measure hedge effectiveness, including ratio analysis, ie a comparison of hedging gains and losses with the corresponding gains and losses on the hedged item at a point in time, and statistical measurement techniques such as regression analysis. If regression analysis is used, the entity's documented policies for assessing effectiveness must specify how the results of the regression will be assessed.

F.4.5 Hedge effectiveness: less than 100 per cent offset

If a cash flow hedge is regarded as highly effective because the actual risk offset is within the allowed 80–125 per cent range of deviation from full offset, is the gain or loss on the ineffective portion of the hedge recognised in other comprehensive income?

No. Ind AS 39.95(a) indicates that only the effective portion is recognised in other comprehensive income. Ind AS 39.95(b) requires the ineffective portion to be recognised in profit or loss.

F.4.7 Assuming perfect hedge effectiveness

If the principal terms of the hedging instrument and of the entire hedged asset or liability or hedged forecast transaction are the same, can an entity assume perfect hedge effectiveness without further effectiveness testing?

No. Ind AS 39.88(e) requires an entity to assess hedges on an ongoing basis for hedge effectiveness. It cannot assume hedge effectiveness even if the principal terms of the hedging instrument and the hedged item are the same, since hedge ineffectiveness may arise because of other attributes such as the liquidity of the instruments or their credit risk (Ind AS 39.AG109). It may, however, designate only certain risks in an overall exposure as being hedged and thereby improve the effectiveness of the hedging relationship. For example, for a fair value hedge of a debt instrument, if the derivative hedging instrument has a credit risk that is equivalent to the AA-rate, it may designate only the risk related to AA-rated interest rate movements as being hedged, in which case changes in credit spreads generally will not affect the effectiveness of the hedge.

F.5 Cash flow hedges

F.5.1 Hedge accounting: non-derivative monetary asset or non-derivative monetary liability used as a hedging instrument

If an entity designates a non-derivative monetary asset as a foreign currency cash flow hedge of the repayment of the principal of a non-derivative monetary liability, would the exchange differences on the hedged item be recognised in profit or loss (Ind AS 21.28) and the exchange differences on the hedging instrument be

recognised in other comprehensive income until the repayment of the liability (Ind AS 39.95)?

No. Exchange differences on the monetary asset and the monetary liability are both recognised in profit or loss in the period in which they arise (Ind AS 21.28).Ind AS 39.AG83 specifies that if there is a hedge relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in fair values of those financial instruments are recognised in profit or loss.

F.5.2 Cash flow hedges: performance of hedging instrument (1)

Entity A has a floating rate liability of Rs.1,000 with five years remaining to maturity. It enters into a five-year pay-fixed, receive-floating interest rate swap in the same currency and with the same principal terms as the liability to hedge the exposure to variable cash flow payments on the floating rate liability attributable to interest rate risk. At inception, the fair value of the swap is zero. Subsequently, there is an increase of Rs.49 in the fair value of the swap. This increase consists of a change of Rs.50 resulting from an increase in market interest rates and a change of minus Rs.1 resulting from an increase in the credit risk of the swap counterparty. There is no change in the fair value of the floating rate liability, but the fair value (present value) of the future cash flows needed to offset the exposure to variable interest cash flows on the liability increases by Rs.50. Assuming that Entity A determines that the hedge is still highly effective, is there ineffectiveness that should be recognised in profit or loss?

No. A hedge of interest rate risk is not fully effective if part of the change in the fair value of the derivative is attributable to the counterparty's credit risk (Ind AS 39.AG109). However, because Entity A determines that the hedge relationship is still highly effective, it recognises the effective portion of the change in fair value of the swap, ie the net change in fair value of Rs.49, in other comprehensive income. There is no debit to profit or loss for the change in fair value of the swap attributable to the deterioration in the credit quality of the swap counterparty, because the cumulative change in the present value of the future cash flows needed to offset the exposure to variable interest cash flows on the hedged item, ie Rs.50, exceeds the cumulative change in value of the hedging instrument, ie Rs.49.

Dr Swap		Rs.49	
	Cr Other comprehensive income		Rs.49

If Entity A concludes that the hedge is no longer highly effective, it discontinues hedge accounting prospectively as from the date the hedge ceased to be highly effective in accordance with Ind AS 39.101.

Would the answer change if the fair value of the swap instead increases to Rs.51 of which Rs.50 results from the increase in market interest rates and Rs.1 from a decrease in the credit risk of the swap counterparty?

Yes. In this case, there is a credit to profit or loss of Rs.1 for the change in fair value of the swap attributable to the improvement in the credit quality of the swap counterparty. This is because the cumulative change in the value of the hedging instrument, ie Rs.51, exceeds the cumulative change in the present value of the future cash flows needed to offset the exposure to variable interest cash flows on the hedged item, ie Rs.50. The

difference of Rs.1 represents the excess ineffectiveness attributable to the derivative hedging instrument, the swap, and is recognised in profit or loss.

Dr Swap		Rs.51	
	Cr Other comprehensive income		Rs.50
	Cr Profit or loss		Rs.1

F.5.3 Cash flow hedges: performance of hedging instrument (2)

On 30 September 20X1, Entity A hedges the anticipated sale of 24 tonnes of pulp on 1 March 20X2 by entering into a short forward contract on 24 tonnes of pulp. The contract requires net settlement in cash determined as the difference between the future spot price of pulp on a specified commodity exchange and Rs.1,000. Entity A expects to sell the pulp in a different, local market. Entity A determines that the forward contract is an effective hedge of the anticipated sale and that the other conditions for hedge accounting are met. It assesses hedge effectiveness by comparing the entire change in the fair value of the forward contract with the change in the fair value of the expected cash inflows. On 31 December, the spot price of pulp has increased both in the local market and on the exchange. The increase in the local market exceeds the increase on the exchange. As a result, the present value of the expected cash inflow from the sale on the local market is Rs.1,100. The fair value of Entity A's forward contract is negative Rs.80. Assuming that Entity A determines that the hedge is still highly effective, is there ineffectiveness that should be recognised in profit or loss?

No. In a cash flow hedge, ineffectiveness is not recognised in the financial statements when the cumulative change in the fair value of the hedged cash flows exceeds the cumulative change in the value of the hedging instrument. In this case, the cumulative change in the fair value of the forward contract is Rs.80, while the fair value of the cumulative change in expected future cash flows on the hedged item is Rs.100. Since the fair value of the cumulative change in expected future cash flows on the hedged item from the inception of the hedge exceeds the cumulative change in fair value of the hedging instrument (in absolute amounts), no portion of the gain or loss on the hedging instrument is recognised in profit or loss (Ind AS 39.95(b)). Because Entity A determines that the hedge relationship is still highly effective, it recognises the entire change in fair value of the forward contract (Rs.80) in other comprehensive income.

Dr Other comprehensive income		Rs.80	
	Cr Forward		Rs.80

If Entity A concludes that the hedge is no longer highly effective, it discontinues hedge accounting prospectively as from the date the hedge ceases to be highly effective in accordance with Ind AS 39.101.

F.5.4 Cash flow hedges: forecast transaction occurs before the specified period

An entity designates a derivative as a hedging instrument in a cash flow hedge of a forecast transaction, such as a forecast sale of a commodity. The hedging relationship meets all the hedge accounting conditions, including the requirement to identify and document the period in which the transaction is expected to occur

within a reasonably specific and narrow range of time (see Question F.2.17). If, in a subsequent period, the forecast transaction is expected to occur in an earlier period than originally anticipated, can the entity conclude that this transaction is the same as the one that was designated as being hedged?

Yes. The change in timing of the forecast transaction does not affect the validity of the designation. However, it may affect the assessment of the effectiveness of the hedging relationship. Also, the hedging instrument would need to be designated as a hedging instrument for the whole remaining period of its existence in order for it to continue to qualify as a hedging instrument (see Ind AS 39.75 and Question F.2.17).

F.5.5 Cash flow hedges: measuring effectiveness for a hedge of a forecast transaction in a debt instrument

A forecast investment in an interest-earning asset or forecast issue of an interest-bearing liability creates a cash flow exposure to interest rate changes because the related interest payments will be based on the market rate that exists when the forecast transaction occurs. The objective of a cash flow hedge of the exposure to interest rate changes is to offset the effects of future changes in interest rates so as to obtain a single fixed rate, usually the rate that existed at the inception of the hedge that corresponds with the term and timing of the forecast transaction. During the period of the hedge, it is not possible to determine what the market interest rate for the forecast transaction will be at the time the hedge is terminated or when the forecast transaction occurs. In this case, how is the effectiveness of the hedge assessed and measured?

During this period, effectiveness can be measured on the basis of changes in interest rates between the designation date and the interim effectiveness measurement date. The interest rates used to make this measurement are the interest rates that correspond with the term and occurrence of the forecast transaction that existed at the inception of the hedge and that exist at the measurement date as evidenced by the term structure of interest rates.

Generally it will not be sufficient simply to compare cash flows of the hedged item with cash flows generated by the derivative hedging instrument as they are paid or received, since such an approach ignores the entity's expectations of whether the cash flows will offset in subsequent periods and whether there will be any resulting ineffectiveness.

The discussion that follows illustrates the mechanics of establishing a cash flow hedge and measuring its effectiveness. For the purpose of the illustrations, assume that an entity expects to issue a Rs.100,000 one-year debt instrument in three months. The instrument will pay interest quarterly with principal due at maturity. The entity is exposed to interest rate increases and establishes a hedge of the interest cash flows of the debt by entering into a forward starting interest rate swap. The swap has a term of one year and will start in three months to correspond with the terms of the forecast debt issue. The entity will pay a fixed rate and receive a variable rate, and the entity designates the risk being hedged as the MIBOR-based interest component in the forecast issue of the debt.

Yield curve

The yield curve provides the foundation for computing future cash flows and the fair value of such cash flows both at the inception of, and during, the hedging relationship. It is based on current market yields on applicable reference bonds that are traded in the marketplace. Market yields are converted to spot interest rates ('spot rates' or 'zero coupon rates') by eliminating the effect of coupon payments on the market yield. Spot rates are used to discount future cash flows, such as principal and interest rate payments, to arrive at their fair value. Spot rates also are used to compute forward interest rates that are used to compute variable and estimated future cash flows. The relationship between spot rates and one-period forward rates is shown by the following formula:

Spot-forward relationship

$$F = \frac{(1 + SR_t)^t}{(1 + SR_{t-1})^{t-1}} - 1$$

where F = forward rate (%)

SR = spot rate (%)

t = period in time (eg 1, 2, 3, 4, 5)

Also, for the purpose of this illustration, assume that the following quarterly-period term structure of interest rates using quarterly compounding exists at the inception of the hedge.

Yield curve at inception – (beginning of period 1)					
Forward periods	*1*	2	3	4	5
Spot rates	3.75%	4.50%	5.50%	6.00%	6.25%
Forward rates	3.75%	5.25%	7.51%	7.50%	7.25%

The one-period forward rates are computed on the basis of spot rates for the applicable maturities. For example, the current forward rate for Period 2 calculated using the formula above is equal to $[1.0450^2/1.0375] - 1 = 5.25$ per cent. The current one-period forward rate for Period 2 is different from the current spot rate for Period 2, since the spot rate is an interest rate from the beginning of Period 1 (spot) to the end of Period 2, while the forward rate is an interest rate from the beginning of Period 2 to the end of Period 2.

Hedged item

In this example, the entity expects to issue a Rs.100,000 one-year debt instrument in three months with quarterly interest payments. The entity is exposed to interest rate increases and would like to eliminate the effect on cash flows of interest rate changes that may happen before the forecast transaction takes place. If that risk is eliminated, the entity would obtain an interest rate on its debt issue that is equal to the one-year forward coupon rate currently available in the marketplace in three months. That forward coupon rate, which is different from the forward (spot) rate, is 6.86 per cent, computed from the term structure of interest rates shown above. It is the market rate of interest that exists at the inception of the hedge, given the terms of the forecast debt instrument. It results in the fair value of the debt being equal to par at its issue.

At the inception of the hedging relationship, the expected cash flows of the debt instrument can be calculated on the basis of the existing term structure of interest rates. For this purpose, it is assumed that interest rates do not change and that the debt would be issued at 6.86 per cent at the beginning of Period 2. In this case, the cash flows and fair value of the debt instrument would be as follows at the beginning of Period 2.

Issue of fixed rate debt **Beginning of period 2 - No rate changes (spot based on forward rates)**						
		Total				
Original forward periods		*1*	*2*	*3*	*4*	*5*
Remaining periods			*1*	*2*	*3*	*4*
Spot rates			5.25%	6.38%	6.75%	6.88%
Forward rates			5.25%	7.51%	7.50%	7.25%
	Rs.		*Rs.*	*Rs.*	*Rs.*	*Rs.*
Cash flows:						
Fixed interest @6.86%			1,716	1,716	1,716	1,716
Principal						100,000
Fair value:						
Interest	6,592		1,694	1,663	1,632	1,603
Principal	93,408					93,408[28]
Total	100,000					

Since it is assumed that interest rates do not change, the fair value of the interest and principal amounts equals the par amount of the forecast transaction. The fair value amounts are computed on the basis of the spot rates that exist at the inception of the hedge for the applicable periods in which the cash flows would occur had the debt been issued at the date of the forecast transaction. They reflect the effect of discounting those cash flows on the basis of the periods that will remain after the debt instrument is issued. For example, the spot rate of 6.38 per cent is used to discount the interest cash flow that is expected to be paid in Period 3, but it is discounted for only two periods because it will occur two periods after the forecast transaction.

The forward interest rates are the same as shown previously, since it is assumed that interest rates do not change. The spot rates are different but they have not actually changed. They represent the spot rates one period forward and are based on the applicable forward rates.

Hedging instrument

The objective of the hedge is to obtain an overall interest rate on the forecast transaction and the hedging instrument that is equal to 6.86 per cent, which is the market rate at the inception of the hedge for the period from Period 2 to Period 5. This objective is accomplished by entering into a forward starting interest rate swap that has a fixed rate of 6.86 per cent. Based on the term structure of interest rates that exist at the inception of the hedge, the interest rate swap will have such a rate. At the inception of the hedge, the fair value of the fixed rate payments on the interest rate swap will equal the fair value of the variable rate payments, resulting in the interest rate swap having a fair value of zero. The expected cash flows of the interest rate swap and the related fair value amounts are shown as follows.

[28] Rs.100,000/(1 + [0.0688/4]) [4]

Interest rate swap						
		Total				
Original forward periods		*1*	*2*	*3*	*4*	*5*
Remaining periods			*1*	*2*	*3*	*4*
			Rs.	*Rs.*	*Rs.*	*Rs.*
Cash flows:						
Fixed interest @6.86%			1,716	1,716	1,716	1,716
Forecast variable interest			1,313	1,877	1,876	1,813
Forecast based on forward rate			*5.25%*	*7.51%*	*7.50%*	*7.25%*
Net interest			(403)	161	160	97
Fair value:						
Discount rate (spot)			*5.25%*	*6.38%*	*6.75%*	*6.88%*
Fixed interest	6,592		1,694	1,663	1,632	1,603
Forecast variable interest	6,592		1,296	1,819	1,784	1,693
Fair value of interest rate swap	0		(398)	156	152	90

At the inception of the hedge, the fixed rate on the forward swap is equal to the fixed rate the entity would receive if it could issue the debt in three months under terms that exist today.

Measuring hedge effectiveness

If interest rates change during the period the hedge is outstanding, the effectiveness of the hedge can be measured in various ways.

Assume that interest rates change as follows immediately before the debt is issued at the beginning of Period 2.

Yield curve - Rates increase 200 basis points					
Forward periods	*1*	*2*	*3*	*4*	*5*
Remaining periods		*1*	*2*	*3*	*4*
Spot rates		5.75%	6.50%	7.50%	8.00%
Forward rates		5.75%	7.25%	9.51%	9.50%

Under the new interest rate environment, the fair value of the pay-fixed at 6.86 per cent, receive-variable interest rate swap that was designated as the hedging instrument would be as follows.

Fair value of interest rate swap						
		Total				
Original forward periods		*1*	*2*	*3*	*4*	*5*
Remaining periods			*1*	*2*	*3*	*4*
	Rs.	*Rs.*	*Rs.*	*Rs.*	*Rs.*	*Rs.*
Cash flows:						
Fixed interest @6.86%			1,716	1,716	1,716	1,716
Forecast variable interest			1,438	1,813	2,377	2,376
Forecast based on new forward			*5.25%*	*7.25%*	*9.51%*	*9.50%*

rate						
Net interest			(279)	97	661	660
Fair value:						
New discount rate (spot)			*5.75%*	*6.50%*	*7.50%*	*8.00%*
Fixed interest	6,562		1,692	1,662	1,623	1,585
Forecast variable interest	7,615		1,417	1,755	2,248	2,195
Fair value of net interest	1,053		(275)	93	625	610

In order to compute the effectiveness of the hedge, it is necessary to measure the change in the present value of the cash flows or the value of the hedged forecast transaction. There are at least two methods of accomplishing this measurement.

Method A Compute change in fair value of debt						
	Total					
Original forward periods		*1*	*2*	*3*	*4*	*5*
Remaining periods			*1*	*2*	*3*	*4*
		Rs.	*Rs.*	*Rs.*	*Rs.*	*Rs.*
Cash flows:						
Fixed interest @6.86%			1,716	1,716	1,716	1,716
Principal						100,000
Fair value:						
New discount rate (spot)			*5.75%*	*6.50%*	*7.50%*	*8.00%*
Interest	6,562		1,692	1,662	1,623	1,585
Principal	92,385					92,385[29]
Total	98,947					
Fair value at inception	100,000					
Fair value difference	(1,053)					

Under Method A, a computation is made of the fair value in the new interest rate environment of debt that carries interest that is equal to the coupon interest rate that existed at the inception of the hedging relationship (6.86 per cent). This fair value is compared with the expected fair value as of the beginning of Period 2 that was calculated on the basis of the term structure of interest rates that existed at the inception of the hedging relationship, as illustrated above, to determine the change in the fair value. Note that the difference between the change in the fair value of the swap and the change in the expected fair value of the debt exactly offset in this example, since the terms of the swap and the forecast transaction match each other.

Method B Compute change in fair value of cash flows					
	Total				
Original forward periods	*1*	*2*	*3*	*4*	*5*
Remaining periods		*1*	*2*	*3*	*4*

[29] Rs.100,000/(1 + [0.08/4]) [4]

Market rate at inception		6.86%	6.86%	6.86%	6.86%
Current forward rate		5.75%	7.25%	9.51%	9.50%
Rate difference		1.11%	(0.39%)	(2.64%)	(2.64%)
Cash flow difference		Rs.279	(Rs.97)	(Rs.661)	(Rs.660)
(principal × rate)					
Discount rate (spot)		5.75%	6.50%	7.50%	8.00%
Fair value of difference	(Rs.1,053)	Rs.275	(Rs.93)	(Rs.625)	(Rs.610)

Under Method B, the present value of the change in cash flows is computed on the basis of the difference between the forward interest rates for the applicable periods at the effectiveness measurement date and the interest rate that would have been obtained if the debt had been issued at the market rate that existed at the inception of the hedge. The market rate that existed at the inception of the hedge is the one-year forward coupon rate in three months. The present value of the change in cash flows is computed on the basis of the current spot rates that exist at the effectiveness measurement date for the applicable periods in which the cash flows are expected to occur. This method also could be referred to as the 'theoretical swap' method (or 'hypothetical derivative' method) because the comparison is between the hedged fixed rate on the debt and the current variable rate, which is the same as comparing cash flows on the fixed and variable rate legs of an interest rate swap.

As before, the difference between the change in the fair value of the swap and the change in the present value of the cash flows exactly offset in this example, since the terms match.

Other considerations

There is an additional computation that should be performed to compute ineffectiveness before the expected date of the forecast transaction that has not been considered for the purpose of this illustration. The fair value difference has been determined in each of the illustrations as of the expected date of the forecast transaction immediately before the forecast transaction, ie at the beginning of Period 2. If the assessment of hedge effectiveness is done before the forecast transaction occurs, the difference should be discounted to the current date to arrive at the actual amount of ineffectiveness. For example, if the measurement date were one month after the hedging relationship was established and the forecast transaction is now expected to occur in two months, the amount would have to be discounted for the remaining two months before the forecast transaction is expected to occur to arrive at the actual fair value. This step would not be necessary in the examples provided above because there was no ineffectiveness. Therefore, additional discounting of the amounts, which net to zero, would not have changed the result.

Under Method B, ineffectiveness is computed on the basis of the difference between the forward coupon interest rates for the applicable periods at the effectiveness measurement date and the interest rate that would have been obtained if the debt had been issued at the market rate that existed at the inception of the hedge. Computing the change in cash flows based on the difference between the forward interest rates that existed at the inception of the hedge and the forward rates that exist at the effectiveness measurement date is inappropriate if the objective of the hedge is to establish a single fixed rate for a series of forecast interest payments. This objective is met by hedging the exposures with an interest rate swap as illustrated in the above example. The fixed interest rate on the swap is a blended interest rate composed of the forward rates over

the life of the swap. Unless the yield curve is flat, the comparison between the forward interest rate exposures over the life of the swap and the fixed rate on the swap will produce different cash flows whose fair values are equal only at the inception of the hedging relationship. This difference is shown in the table below.

		Total				
Original forward periods		*1*	*2*	*3*	*4*	*5*
Remaining periods			*1*	*2*	*3*	*4*
Forward rate at inception			5.25%	7.51%	7.50%	7.25%
Current forward rate			5.75%	7.25%	9.51%	9.50%
Rate difference			(0.50%)	0.26%	(2.00%)	(2.25%)
Cash flow difference (principal × rate)			(Rs.125)	Rs.64	(Rs.501)	(Rs.563)
Discount rate (spot)			5.75%	6.50%	7.50%	8.00%
Fair value of difference	(Rs.1,055)		(Rs.123)	Rs.62	(Rs.474)	(Rs.520)
Fair value of interest rate swap	Rs.1,053					
Ineffectiveness	(Rs.2)					

If the objective of the hedge is to obtain the forward rates that existed at the inception of the hedge, the interest rate swap is ineffective because the swap has a single blended fixed coupon rate that does not offset a series of different forward interest rates. However, if the objective of the hedge is to obtain the forward coupon rate that existed at the inception of the hedge, the swap is effective, and the comparison based on differences in forward interest rates suggests ineffectiveness when none may exist. Computing ineffectiveness based on the difference between the forward interest rates that existed at the inception of the hedge and the forward rates that exist at the effectiveness measurement date would be an appropriate measurement of ineffectiveness if the hedging objective is to lock in those forward interest rates. In that case, the appropriate hedging instrument would be a series of forward contracts each of which matures on a repricing date that corresponds with the date of the forecast transactions.

It also should be noted that it would be inappropriate to compare only the variable cash flows on the interest rate swap with the interest cash flows in the debt that would be generated by the forward interest rates. That methodology has the effect of measuring ineffectiveness only on a portion of the derivative, and Ind AS 39 does not permit the bifurcation of a derivative for the purposes of assessing effectiveness in this situation (Ind AS 39.74). It is recognised, however, that if the fixed interest rate on the interest rate swap is equal to the fixed rate that would have been obtained on the debt at inception, there will be no ineffectiveness assuming that there are no differences in terms and no change in credit risk or it is not designated in the hedging relationship.

F.5.6 Cash flow hedges: firm commitment to purchase inventory in a foreign currency

Entity A has the Local Currency (LC) as its functional currency and presentation currency. On 30 June 20X1, it enters into a forward exchange contract to receive Foreign Currency (FC) 100,000 and deliver LC109,600 on 30 June 20X2 at an initial cost and fair value of zero. It designates the forward exchange contract as a

hedging instrument in a cash flow hedge of a firm commitment to purchase a certain quantity of paper on 31 March 20X2 and the resulting payable of FC100,000, which is to be paid on 30 June 20X2. All hedge accounting conditions in Ind AS 39 are met.

As indicated in the table below, on 30 June 20X1, the spot exchange rate is LC1.072 to FC1, while the twelve-month forward exchange rate is LC1.096 to FC1. On 31 December 20X1, the spot exchange rate is LC1.080 to FC1, while the six-month forward exchange rate is LC1.092 to FC1. On 31 March 20X2, the spot exchange rate is LC1.074 to FC1, while the three-month forward rate is LC1.076 to FC1. On 30 June 20X2, the spot exchange rate is LC1.072 to FC1. The applicable yield curve in the local currency is flat at 6 per cent per year throughout the period. The fair value of the forward exchange contract is negative LC388 on 31 December 20X1 {([1.092 × 100,000] – 109,600)/$1.06^{(6/12)}$}, negative LC1.971 on 31 March 20X2 {([1.076 × 100,000] – 109,600)/$1.06^{(3/12)}$)}, and negative LC2,400 on 30 June 20X2 {1.072 × 100,000 – 109,600}.

Date	**Spot rate**	**Forward rate to 30 June 20X2**	**Fair value of forward contract**
30 June 20X1	1.072	1.096	–
31 December 20X1	1.080	1.092	(388)
31 March 20X2	1.074	1.076	(1,971)
30 June 20X2	1.072	–	(2,400)

Issue (a) – What is the accounting for these transactions if the hedging relationship is designated as being for changes in the fair value of the forward exchange contract and the entity's accounting policy is to apply basis adjustment to non-financial assets that result from hedged forecast transactions?

The accounting entries are as follows.

30 June 20X1			
Dr Forward		LC0	
	Cr Cash		LC0

To record the forward exchange contract at its initial amount of zero (Ind AS 39.43). The hedge is expected to be fully effective because the critical terms of the forward exchange contract and the purchase contract and the assessment of hedge effectiveness are based on the forward price (Ind AS 39.AG108).

31 December 20X1			
Dr Other comprehensive income		LC388	
	Cr Forward liability		LC388

To record the change in the fair value of the forward exchange contract between 30 June 20X1 and 31 December 20X1, ie LC388 – 0 = LC388, in other comprehensive income (Ind AS 39.95). The hedge is fully effective because the loss on the forward

exchange contract (LC388) exactly offsets the change in cash flows associated with the purchase contract based on the forward price [(LC388) = {([1.092 × 100,000] – 109,600)/$1.06^{(6/12)}$} – {([1.096 × 100,000] – 109,600)/1.06}].

31 March 20X2			
Dr Other comprehensive income		LC1,583	
	Cr Forward liability		LC1,583

To record the change in the fair value of the forward exchange contract between 1 January 20X2 and 31 March 20X2 (ie LC1,971 – LC388 = LC1,583) in other comprehensive income (Ind AS 39.95). The hedge is fully effective because the loss on the forward exchange contract (LC1,583) exactly offsets the change in cash flows associated with the purchase contract based on the forward price [(LC1,583) = {([1.076 × 100,000] – 109,600)/$1.06^{(3/12)}$} – {([1.092 × 100,000] – 109,600)/$1.06^{(6/12)}$}].

Dr Paper (purchase price)		LC107,400	
Dr Paper (hedging loss)		LC1,971	
	Cr Other comprehensive income		LC1,971
	Cr Payable		LC107,400

To recognise the purchase of the paper at the spot rate (1.074 × FC100,000) and remove the cumulative loss on the forward exchange contract that has been recognised in other comprehensive income (LC1,971) and include it in the initial measurement of the purchased paper. Accordingly, the initial measurement of the purchased paper is LC109,371 consisting of a purchase consideration of LC107,400 and a hedging loss of LC1,971.

30 June 20X2

Dr Payable		LC107,400	
	Cr Cash		LC107,200
	Cr Profit or loss		LC200

To record the settlement of the payable at the spot rate (FC100,000 × 1.072 = 107,200) and the associated exchange gain of LC200 (LC107,400 – LC107,200).

Dr Profit or loss		LC429	
	Cr Forward liability		LC429

To record the loss on the forward exchange contract between 1 April 20X2 and 30 June 20X2 (ie LC2,400 – LC1,971 = LC429) in profit or loss. The hedge is regarded as fully effective because the loss on the forward exchange contract (LC429) exactly offsets the change in the fair value of the payable based on the forward price (LC429 = ([1.072 × 100,000] – 109,600 – {([1.076 × 100,000] – 109,600)/$1.06^{(3/12)}$}).

Dr Forward liability		LC2,400	

	Cr Cash		LC2,400

To record the net settlement of the forward exchange contract.

Issue (b) – What is the accounting for these transactions if the hedging relationship instead is designated as being for changes in the spot element of the forward exchange contract and the interest element is excluded from the designated hedging relationship (Ind AS 39.74)?

The accounting entries are as follows.

30 June 20X1			
Dr Forward		LC0	
	Cr Cash		LC0

To record the forward exchange contract at its initial amount of zero (Ind AS 39.43). The hedge is expected to be fully effective because the critical terms of the forward exchange contract and the purchase contract are the same and the change in the premium or discount on the forward contract is excluded from the assessment of effectiveness (Ind AS 39.AG108).

31 December 20X1			
Dr Profit or loss (interest element)		LC1,165	
	Cr Other comprehensive income (spot element)		LC777
	Cr Forward liability		LC388

To record the change in the fair value of the forward exchange contract between 30 June 20X1 and 31 December 20X1, ie LC388 – 0 = LC388. The change in the present value of spot settlement of the forward exchange contract is a gain of LC777 ({([1.080 × 100,000] – 107,200)/$1.06^{(6/12)}$} – {([1.072 × 100,000] – 107,200)/1.06}), which is recognised in other comprehensive income (Ind AS 39.95(a)). The change in the interest element of the forward exchange contract (the residual change in fair value) is a loss of LC1,165 (388 + 777), which is recognised in profit or loss (Ind AS 39.74 and Ind AS 39.55(a)). The hedge is fully effective because the gain in the spot element of the forward contract (LC777) exactly offsets the change in the purchase price at spot rates (LC777 = {([1.080 × 100,000] – 107,200)/$1.06^{(6/12)}$} – {([1.072 × 100,000] – 107,200)/1.06}).

31 March 20X2			
Dr Other comprehensive income (spot element)		LC580	
Dr Profit or loss (interest element)		LC1,003	
	Cr Forward liability		LC1,583

To record the change in the fair value of the forward exchange contract between 1 January 20X2 and 31 March 20X2, ie LC1,971 – LC388 = LC1,583. The change in the present value of the spot settlement of the forward exchange contract is a loss of LC580 ({([1.074 × 100,000] – 107,200)/$1.06^{(3/12)}$} – {([1.080 × 100,000] – 107,200)/$1.06^{(6/12)}$}),

which is recognised in other comprehensive income (Ind AS 39.95(a)). The change in the interest element of the forward exchange contract (the residual change in fair value) is a loss of LC1,003 (LC1,583 – LC580), which is recognised in profit or loss (Ind AS 39.74 andInd AS 39.55(a)). The hedge is fully effective because the loss in the spot element of the forward contract (LC580) exactly offsets the change in the purchase price at spot rates [(580) = {([1.074 × 100,000] – 107,200)/$1.06^{(3/12)}$} – {([1.080 × 100,000] – 107,200) /$1.06^{(6/12)}$}].

Dr Paper (purchase price)		LC107,400	
Dr Other comprehensive income		LC197	
	Cr Paper (hedging gain)		LC197
	Cr Payable		LC107,400

To recognise the purchase of the paper at the spot rate (= 1.074 × FC100,000) and remove the cumulative gain on the spot element of the forward exchange contract that has been recognised in other comprehensive income (LC777 – LC580 = LC197) and include it in the initial measurement of the purchased paper. Accordingly, the initial measurement of the purchased paper is LC107,203, consisting of a purchase consideration of LC107,400 and a hedging gain of LC197.

30 June 20X2			
Dr Payable		LC107,400	
	Cr Cash		LC107,200
	Cr Profit or loss		LC200

To record the settlement of the payable at the spot rate (FC100,000 × 1.072 = LC107,200) and the associated exchange gain of LC200 (– [1.072 – 1.074] × FC100,000).

Dr Profit or loss (spot element)		LC197	
Dr Profit or loss (interest element)		LC232	
	Cr Forward liability		LC429

To record the change in the fair value of the forward exchange contract between 1 April 20X2 and 30 June 20X2 (ie LC2,400 – LC1,971 = LC429). The change in the present value of the spot settlement of the forward exchange contract is a loss of LC197 ([1.072 × 100,000] – 107,200 – {([1.074 × 100,000] – 107,200)/$1.06^{(3/12)}$}), which is recognised in profit or loss. The change in the interest element of the forward exchange contract (the residual change in fair value) is a loss of LC232 (LC429 – LC197), which is recognised in profit or loss. The hedge is fully effective because the loss in the spot element of the forward contract (LC197) exactly offsets the change in the present value of the spot settlement of the payable [(LC197) = {[1.072 × 100,000] – 107,200 – {([1.074 × 100,000] – 107,200)/$1.06^{(3/12)}$}].

Dr Forward liability		LC2,400	
	Cr Cash		LC2,400

To record the net settlement of the forward exchange contract.

The following table provides an overview of the components of the change in fair value of the hedging instrument over the term of the hedging relationship. It illustrates that the way in which a hedging relationship is designated affects the subsequent accounting for that hedging relationship, including the assessment of hedge effectiveness and the recognition of gains and losses.

Period ending	*Change in spot settlement*	*Fair value of change in spot settlement*	*Change in forward settlement*	*Fair value of change in forward settlement*	*Fair value of change in interest element*
	LC	*LC*	*LC*	*LC*	*LC*
June 20X1	–	–	–	–	–
December 20X1	800	777	(400)	(388)	`(1,165)
March 20X2	(600)	(580)	(1,600)	(1,583)	(1,003)
June 20X2	(200)	(197)	(400)	(429)	(232)
Total	–	–	(2,400)	(2,400)	(2,400)

F.6 Hedges: other issues

F.6.1 Hedge accounting: management of interest rate risk in financial institutions

Banks and other financial institutions often manage their exposure to interest rate risk on a net basis for all or parts of their activities. They have systems to accumulate critical information throughout the entity about their financial assets, financial liabilities and forward commitments, including loan commitments. This information is used to estimate and aggregate cash flows and to schedule such estimated cash flows into the applicable future periods in which they are expected to be paid or received. The systems generate estimates of cash flows based on the contractual terms of the instruments and other factors, including estimates of prepayments and defaults. For risk management purposes, many financial institutions use derivative contracts to offset some or all exposure to interest rate risk on a net basis.

If a financial institution manages interest rate risk on a net basis, can its activities potentially qualify for hedge accounting under Ind AS 39?

Yes. However, to qualify for hedge accounting the derivative hedging instrument that hedges the net position for risk management purposes must be designated for accounting purposes as a hedge of a gross position related to assets, liabilities, forecast cash inflows or forecast cash outflows giving rise to the net exposure (Ind AS 39.84,Ind AS 39.AG101 andInd AS 39.AG111). It is not possible to designate a net position as a hedged item under Ind AS 39 because of the inability to associate hedging gains and losses with a specific item being hedged and, correspondingly, to determine objectively the period in which such gains and losses should be recognised in profit or loss.

Hedging a net exposure to interest rate risk can often be defined and documented to meet the qualifying criteria for hedge accounting inInd AS 39.88 if the objective of the activity is to offset a specific, identified and designated risk exposure that ultimately

affects the entity's profit or loss (Ind AS 39.AG110) and the entity designates and documents its interest rate risk exposure on a gross basis. Also, to qualify for hedge accounting the information systems must capture sufficient information about the amount and timing of cash flows and the effectiveness of the risk management activities in accomplishing their

objective.

The factors an entity must consider for hedge accounting purposes if it manages interest rate risk on a net basis are discussed in Question F.6.2.

F.6.2 Hedge accounting considerations when interest rate risk is managed on a net basis

If an entity manages its exposure to interest rate risk on a net basis, what are the issues the entity should consider in defining and documenting its interest rate risk management activities to qualify for hedge accounting and in establishing and accounting for the hedge relationship?

Issues (a)–(l) below deal with the main issues. First, Issues (a) and (b) discuss the designation of derivatives used in interest rate risk management activities as fair value hedges or cash flow hedges. As noted there, hedge accounting criteria and accounting consequences differ between fair value hedges and cash flow hedges. Since it may be easier to achieve hedge accounting treatment if derivatives used in interest rate risk management activities are designated as cash flow hedging instruments, Issues (c)–(l) expand on various aspects of the accounting for cash flow hedges. Issues (c)–(f) consider the application of the hedge accounting criteria for cash flow hedges in Ind AS 39, and Issues (g) and (h) discuss the required accounting treatment. Finally, Issues (i)–(l) elaborate on other specific issues relating to the accounting for cash flow hedges.

Issue (a) – Can a derivative that is used to manage interest rate risk on a net basis be designated under Ind AS 39 as a hedging instrument in a fair value hedge or a cash flow hedge of a gross exposure?

Both types of designation are possible under Ind AS 39. An entity may designate the derivative used in interest rate risk management activities either as a fair value hedge of assets, liabilities and firm commitments or as a cash flow hedge of forecast transactions, such as the anticipated reinvestment of cash inflows, the anticipated refinancing or rollover of a financial liability, and the cash flow consequences of the resetting of interest rates for an asset or a liability.

In economic terms, it does not matter whether the derivative instrument is regarded as a fair value hedge or as a cash flow hedge. Under either perspective of the exposure, the derivative has the same economic effect of reducing the net exposure. For example, a receive-fixed, pay-variable interest rate swap can be considered to be a cash flow hedge of a variable rate asset or a fair value hedge of a fixed rate liability. Under either perspective, the fair value or cash flows of the interest rate swap offset the exposure to interest rate changes. However, accounting consequences differ depending on whether the derivative is designated as a fair value hedge or a cash flow hedge, as discussed in Issue (b).

To illustrate: a bank has the following assets and liabilities with a maturity of two years.

	Variable interest	Fixed interest
	Rs.	Rs.
Assets	60	100
Liabilities	(100)	(60)
Net	(40)	40

The bank takes out a two-year swap with a notional principal of Rs.40 to receive a variable interest rate and pay a fixed interest rate to hedge the net exposure. As discussed above, this may be regarded and designated either as a fair value hedge of Rs.40 of the fixed rate assets or as a cash flow hedge of Rs.40 of the variable rate liabilities.

Issue (b) – What are the critical considerations in deciding whether a derivative that is used to manage interest rate risk on a net basis should be designated as a hedging instrument in a fair value hedge or a cash flow hedge of a gross exposure?

Critical considerations include the assessment of hedge effectiveness in the presence of prepayment risk and the ability of the information systems to attribute fair value or cash flow changes of hedging instruments to fair value or cash flow changes, respectively, of hedged items, as discussed below.

For accounting purposes, the designation of a derivative as hedging a fair value exposure or a cash flow exposure is important because both the qualification requirements for hedge accounting and the recognition of hedging gains and losses for these categories are different. It is often easier to demonstrate high effectiveness for a cash flow hedge than for a fair value hedge.

Effects of prepayments

Prepayment risk inherent in many financial instruments affects the fair value of an instrument and the timing of its cash flows and impacts on the effectiveness test for fair value hedges and the highly probable test for cash flow hedges, respectively.

Effectiveness is often more difficult to achieve for fair value hedges than for cash flow hedges when the instrument being hedged is subject to prepayment risk. For a fair value hedge to qualify for hedge accounting, the changes in the fair value of the derivative hedging instrument must be expected to be highly effective in offsetting the changes in the fair value of the hedged item (Ind AS 39.88(b)). This test may be difficult to meet if, for example, the derivative hedging instrument is a forward contract having a fixed term and the financial assets being hedged are subject to prepayment by the borrower. Also, it may be difficult to conclude that, for a portfolio of fixed rate assets that are subject to prepayment, the changes in the fair value for each individual item in the group will be expected to be approximately proportional to the overall changes in fair value attributable to the hedged risk of the group. Even if the risk being hedged is a benchmark interest rate, to be able to conclude that fair value changes will be proportional for each item in the portfolio, it may be necessary to disaggregate the asset portfolio into categories based on term, coupon, credit, type of loan and other characteristics.

In economic terms, a forward derivative instrument could be used to hedge assets that are subject to prepayment but it would be effective only for small movements in interest rates. A reasonable estimate of prepayments can be made for a given interest rate environment and the derivative position can be adjusted as the interest rate environment changes. If an entity's risk management strategy is to adjust the amount of the hedging instrument periodically to reflect changes in the hedged position, the entity needs to demonstrate that the hedge is expected to be highly effective only for the period until the amount of the hedging instrument is next adjusted. However, for that period, the expectation of effectiveness has to be based on existing fair value exposures and the potential for interest rate movements without consideration of future adjustments to those positions. Furthermore, the fair value exposure attributable to prepayment risk can generally be hedged with options.

For a cash flow hedge to qualify for hedge accounting, the forecast cash flows, including the reinvestment of cash inflows or the refinancing of cash outflows, must be highly probable (Ind AS 39.88(c)) and the hedge expected to be highly effective in achieving offsetting changes in the cash flows of the hedged item and hedging instrument (Ind AS 39.88(b)). Prepayments affect the timing of cash flows and, therefore, the probability of occurrence of the forecast transaction. If the hedge is established for risk management purposes on a net basis, an entity may have sufficient levels of highly probable cash flows on a gross basis to support the designation for accounting purposes of forecast transactions associated with a portion of the gross cash flows as the hedged item. In this case, the portion of the gross cash flows designated as being hedged may be chosen to be equal to the amount of net cash flows being hedged for risk management purposes.

Systems considerations

The accounting for fair value hedges differs from that for cash flow hedges. It is usually easier to use existing information systems to manage and track cash flow hedges than it is for fair value hedges.

Under fair value hedge accounting, the assets or liabilities that are designated as being hedged are remeasured for those changes in fair values during the hedge period that are attributable to the risk being hedged. Such changes adjust the carrying amount of the hedged items and, for interest sensitive assets and liabilities, may result in an adjustment of the effective interest rate of the hedged item (Ind AS 39.89). As a consequence of fair value hedging activities, the changes in fair value have to be allocated to the assets or liabilities being hedged in order for the entity to be able to recompute their effective interest rate, determine the subsequent amortisation of the fair value adjustment to profit or loss, and determine the amount that should be reclassified from equity to profit or loss when assets are sold or liabilities extinguished (Ind AS 39.89 andInd AS 39.92). To comply with the requirements for fair value hedge accounting, it will generally be necessary to establish a system to track the changes in the fair value attributable to the hedged risk, associate those changes with individual hedged items, recompute the effective interest rate of the hedged items, and amortise the changes to profit or loss over the life of the respective hedged item.

Under cash flow hedge accounting, the cash flows relating to the forecast transactions that are designated as being hedged reflect changes in interest rates. The adjustment for changes in the fair value of a hedging derivative instrument is initially recognised in other comprehensive income (Ind AS 39.95). To comply with the requirements for cash flow hedge accounting, it is necessary to determine when the cumulative gains and

losses recognised in other comprehensive income from changes in the fair value of a hedging instrument should be reclassified to profit or loss(Ind AS 39.100 and Ind AS 39.101). For cash flow hedges, it is not necessary to create a separate system to make this determination. The system used to determine the extent of the net exposure provides the basis for scheduling the changes in the cash flows of the derivative and the recognition of such changes in profit or loss.

The timing of the recognition in profit or loss can be predetermined when the hedge is associated with the exposure to changes in cash flows. The forecast transactions that are being hedged can be associated with a specific principal amount in specific future periods composed of variable rate assets and cash inflows being reinvested or variable rate liabilities and cash outflows being refinanced, each of which creates a cash flow exposure to changes in interest rates. The specific principal amounts in specific future periods are equal to the notional amount of the derivative hedging instruments and are hedged only for the period that corresponds to the repricing or maturity of the derivative hedging instruments so that the cash flow changes resulting from changes in interest rates are matched with the derivative hedging instrument.Ind AS 39.100 specifies that the amounts recognised in other comprehensive income should be reclassified from equity to profit or loss in the same period or periods during which the hedged item affects profit or loss.

Issue (c) – If a hedging relationship is designated as a cash flow hedge relating to changes in cash flows resulting from interest rate changes, what would be included in the documentation required by Ind AS 39.88(a)?

The following would be included in the documentation.

The hedging relationship (The maturity schedule of cash flows used for risk management purposes to determine exposures to cash flow mismatches on a net basis would provide part of the documentation of the hedging relationship.)

The entity's risk management objective and strategy for undertaking the hedge (The entity's overall risk management objective and strategy for hedging exposures to interest rate risk would provide part of the documentation of the hedging objective and strategy.)

The type of hedge (The hedge is documented as a cash flow hedge.)

The hedged item (The hedged item is documented as a group of forecast transactions (interest cash flows) that are expected to occur with a high degree of probability in specified future periods, for example, scheduled on a monthly basis. The hedged item may include interest cash flows resulting from the reinvestment of cash inflows, including the resetting of interest rates on assets, or from the refinancing of cash outflows, including the resetting of interest rates on liabilities and rollovers of financial liabilities. As discussed in Issue (e), the forecast transactions meet the probability test if there are sufficient levels of highly probable cash flows in the specified future periods to encompass the amounts designated as being hedged on a gross basis.)

The hedged risk (The risk designated as being hedged is documented as a portion of the overall exposure to changes in a specified market interest rate, often the risk-free interest rate or an interbank offered rate, common to all items in the group. To help ensure that the hedge effectiveness test is met at inception of the hedge and subsequently, the designated hedged portion of the interest rate risk could be

documented as being based on the same yield curve as the derivative hedging instrument.)

The hedging instrument (Each derivative hedging instrument is documented as a hedge of specified amounts in specified future time periods corresponding with the forecast transactions occurring in the specified future time periods designated as being hedged.)

The method of assessing effectiveness (The effectiveness test is documented as being measured by comparing the changes in the cash flows of the derivatives allocated to the applicable periods in which they are designated as a hedge to the changes in the cash flows of the forecast transactions being hedged. Measurement of the cash flow changes is based on the applicable yield curves of the derivatives and hedged items.)

Issue (d) – If the hedging relationship is designated as a cash flow hedge, how does an entity satisfy the requirement for an expectation of high effectiveness in achieving offsetting changes in Ind AS 39.88(b)?

An entity may demonstrate an expectation of high effectiveness by preparing an analysis demonstrating high historical and expected future correlation between the interest rate risk designated as being hedged and the interest rate risk of the hedging instrument. Existing documentation of the hedge ratio used in establishing the derivative contracts may also serve to demonstrate an expectation of effectiveness.

Issue (e) – If the hedging relationship is designated as a cash flow hedge, how does an entity demonstrate a high probability of the forecast transactions occurring as required by Ind AS 39.88(c)?

An entity may do this by preparing a cash flow maturity schedule showing that there exist sufficient aggregate gross levels of expected cash flows, including the effects of the resetting of interest rates for assets or liabilities, to establish that the forecast transactions that are designated as being hedged are highly probable to occur. Such a schedule should be supported by management's stated intentions and past practice of reinvesting cash inflows and refinancing cash outflows.

For example, an entity may forecast aggregate gross cash inflows of Rs.100 and aggregate gross cash outflows of Rs.90 in a particular time period in the near future. In this case, it may wish to designate the forecast reinvestment of gross cash inflows of Rs.10 as the hedged item in the future time period. If more than Rs.10 of the forecast cash inflows are contractually specified and have low credit risk, the entity has strong evidence to support an assertion that gross cash inflows of Rs.10 are highly probable to occur and to support the designation of the forecast reinvestment of those cash flows as being hedged for a particular portion of the reinvestment period. A high probability of the forecast transactions occurring may also be demonstrated under other circumstances.

Issue (f) – If the hedging relationship is designated as a cash flow hedge, how does an entity assess and measure effectiveness under Ind AS 39.88(d) and Ind AS 39.88(e)?

Effectiveness is required to be measured at a minimum at the time an entity prepares its annual or interim financial reports. However, an entity may wish to measure it more frequently on a specified periodic basis, at the end of each month or other applicable reporting period. It is also measured whenever derivative positions designated as hedging instruments are changed or hedges are terminated to ensure that the

recognition in profit or loss of the changes in the fair value amounts on assets and liabilities and the recognition of changes in the fair value of derivative instruments designated as cash flow hedges are appropriate.

Changes in the cash flows of the derivative are computed and allocated to the applicable periods in which the derivative is designated as a hedge and are compared with computations of changes in the cash flows of the forecast transactions. Computations are based on yield curves applicable to the hedged items and the derivative hedging instruments and applicable interest rates for the specified periods being hedged.

The schedule used to determine effectiveness could be maintained and used as the basis for determining the period in which the hedging gains and losses recognised initially in other comprehensive income are reclassified from equity to profit or loss.

Issue (g) – If the hedging relationship is designated as a cash flow hedge, how does an entity account for the hedge?

The hedge is accounted for as a cash flow hedge in accordance with the provisions inInd AS 39.95–Ind AS 39.100, as follows:

(i) the portion of gains and losses on hedging derivatives determined to result from effective hedges is recognised in other comprehensive income whenever effectiveness is measured; and

(ii) the ineffective portion of gains and losses resulting from hedging derivatives is recognised in profit or loss.

Ind AS 39.100 specifies that the amounts recognised in other comprehensive income should be reclassified from equity to profit or loss in the same period or periods during which the hedged item affects profit or loss. Accordingly, when the forecast transactions occur, the amounts previously recognised in other comprehensive income are reclassified from equity to profit or loss. For example, if an interest rate swap is designated as a hedging instrument of a series of forecast cash flows, the changes in the cash flows of the swap are reclassified from equity to profit or loss in the periods when the forecast cash flows and the cash flows of the swap offset each other.

Issue (h) – If the hedging relationship is designated as a cash flow hedge, what is the treatment of any net cumulative gains and losses recognised in other comprehensive income if the hedging instrument is terminated prematurely, the hedge accounting criteria are no longer met, or the hedged forecast transactions are no longer expected to take place?

If the hedging instrument is terminated prematurely or the hedge no longer meets the criteria for qualification for hedge accounting, for example, the forecast transactions are no longer highly probable, the net cumulative gain or loss recognised in other comprehensive income remains in equity until the forecast transaction occurs (Ind AS 39.101(a) andInd AS 39.101(b)). If the hedged forecast transactions are no longer expected to occur, the net cumulative gain or loss is reclassified from equity to profit or loss (Ind AS 39.101(c)).

Issue (i) –Ind AS 39.75 states that a hedging relationship may not be designated for only a portion of the time period in which a hedging instrument is outstanding. If the hedging relationship is designated as a cash flow hedge, and the hedge

subsequently fails the test for being highly effective, doesInd AS 39.75 preclude redesignating the hedging instrument?

No.Ind AS 39.75 indicates that a derivative instrument may not be designated as a hedging instrument for only a portion of its remaining period to maturity.Ind AS 39.75 does not refer to the derivative instrument's original period to maturity. If there is a hedge effectiveness failure, the ineffective portion of the gain or loss on the derivative instrument is recognised immediately in profit or loss (Ind AS 39.95(b)) and hedge accounting based on the previous designation of the hedge relationship cannot be continued (Ind AS 39.101). In this case, the derivative instrument may be redesignated prospectively as a hedging instrument in a new hedging relationship provided this hedging relationship satisfies the necessary conditions. The derivative instrument must be redesignated as a hedge for the entire time period it remains outstanding.

Issue (j) – For cash flow hedges, if a derivative is used to manage a net exposure to interest rate risk and the derivative is designated as a cash flow hedge of forecast interest cash flows or portions of them on a gross basis, does the occurrence of the hedged forecast transaction give rise to an asset or liability that will result in a portion of the hedging gains and losses that were recognised in other comprehensive income remaining in equity?

No. In the hedging relationship described in Issue (c) above, the hedged item is a group of forecast transactions consisting of interest cash flows in specified future periods. The hedged forecast transactions do not result in the recognition of assets or liabilities and the effect of interest rate changes that are designated as being hedged is recognised in profit or loss in the period in which the forecast transactions occur. Although this is not relevant for the types of hedges described here, if instead the derivative is designated as a hedge of a forecast purchase of a financial asset or issue of a financial liability, the associated gains or losses that were recognised in other comprehensive income are reclassified from equity to profit or loss in the same period or periods during which the hedged forecast cash flows affect profit or loss (such as in the periods that interest expenses are recognised). However, if an entity expects at any time that all or a portion of a net loss recognised in other comprehensive income will not be recovered in one or more future periods, it shall reclassify immediately from equity to profit or loss the amount that is not expected to be recovered.

Issue (k) – In the answer to Issue (c) above it was indicated that the designated hedged item is a portion of a cash flow exposure. Does Ind AS 39 permit a portion of a cash flow exposure to be designated as a hedged item?

Yes. Ind AS 39 does not specifically address a hedge of a portion of a cash flow exposure for a forecast transaction. However,Ind AS 39.81 specifies that a financial asset or liability may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value, if effectiveness can be measured. The ability to hedge a portion of a cash flow exposure resulting from the resetting of interest rates for assets and liabilities suggests that a portion of a cash flow exposure resulting from the forecast reinvestment of cash inflows or the refinancing or rollover of financial liabilities can also be hedged. The basis for qualification as a hedged item of a portion of an exposure is the ability to measure effectiveness. This is further supported by Ind AS 39.82, which specifies that a non-financial asset or liability can be hedged only in its entirety or for foreign currency risk but not for a portion of other risks because of the difficulty of isolating and measuring the appropriate portion of the cash flows or fair value

changes attributable to a specific risk. Accordingly, assuming effectiveness can be measured, a portion of a cash flow exposure of forecast transactions associated with, for example, the resetting of interest rates for a variable rate asset or liability can be designated as a hedged item.

Issue (l) – In the answer to Issue (c) above it was indicated that the hedged item is documented as a group of forecast transactions. Since these transactions will have different terms when they occur, including credit exposures, maturities and option features, how can an entity satisfy the tests in Ind AS 39.78 and Ind AS 39.83 requiring the hedged group to have similar risk characteristics?

Ind AS 39.78 provides for hedging a group of assets, liabilities, firm commitments or forecast transactions with similar risk characteristics.Ind AS 39.83 provides additional guidance and specifies that portfolio hedging is permitted if two conditions are met, namely: the individual items in the portfolio share the same risk for which they are designated, and the change in the fair value attributable to the hedged risk for each individual item in the group will be expected to be approximately proportional to the overall change in fair value.

When an entity associates a derivative hedging instrument with a gross exposure, the hedged item typically is a group of forecast transactions. For hedges of cash flow exposures relating to a group of forecast transactions, the overall exposure of the forecast transactions and the assets or liabilities that are repriced may have very different risks. The exposure from forecast transactions may differ depending on the terms that are expected as they relate to credit exposures, maturities, options and other features. Although the overall risk exposures may be different for the individual items in the group, a specific risk inherent in each of the items in the group can be designated as being hedged.

The items in the portfolio do not necessarily have to have the same overall exposure to risk, provided they share the same risk for which they are designated as being hedged. A common risk typically shared by a portfolio of financial instruments is exposure to changes in the risk-free or benchmark interest rate or to changes in a specified rate that has a credit exposure equal to the highest credit-rated instrument in the portfolio (ie the instrument with the lowest credit risk). If the instruments that are grouped into a portfolio have different credit exposures, they may be hedged as a group for a portion of the exposure. The risk they have in common that is designated as being hedged is the exposure to interest rate changes from the highest credit rated instrument in the portfolio. This ensures that the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group. It is likely there will be some ineffectiveness if the hedging instrument has a credit quality that is inferior to the credit quality of the highest credit-rated instrument being hedged, since a hedging relationship is designated for a hedging instrument in its entirety (Ind AS 39.74). For example, if a portfolio of assets consists of assets rated A, BB and B, and the current market interest rates for these assets are MIBOR+20 basis points, MIBOR+40 basis points and MIBOR+60 basis points, respectively, an entity may use a swap that pays fixed interest rate and for which variable interest payments based on MIBOR are made to hedge the exposure to variable interest rates. If MIBOR is designated as the risk being hedged, credit spreads above MIBOR on the hedged items are excluded from the designated hedge relationship and the assessment of hedge effectiveness.

F.6.3 Illustrative example of applying the approach in Question F.6.2

The purpose of this example is to illustrate the process of establishing, monitoring and adjusting hedge positions and of qualifying for cash flow hedge accounting in applying the approach to hedge accounting described in Question F.6.2 when a financial institution manages its interest rate risk on an entity-wide basis. To this end, this example identifies a methodology that allows for the use of hedge accounting and takes advantage of existing risk management systems so as to avoid unnecessary changes to it and to avoid unnecessary bookkeeping and tracking.

The approach illustrated here reflects only one of a number of risk management processes that could be employed and could qualify for hedge accounting. Its use is not intended to suggest that other alternatives could not or should not be used. The approach being illustrated could also be applied in other circumstances (such as for cash flow hedges of commercial entities), for example, hedging the rollover of commercial paper financing.

Identifying, assessing and reducing cash flow exposures

The discussion and illustrations that follow focus on the risk management activities of a financial institution that manages its interest rate risk by analysing expected cash flows in a particular currency on an entity-wide basis. The cash flow analysis forms the basis for identifying the interest rate risk of the entity, entering into hedging transactions to manage the risk, assessing the effectiveness of risk management activities, and qualifying for and applying cash flow hedge accounting.

The illustrations that follow assume that an entity, a financial institution, had the following expected future net cash flows and hedging positions outstanding in a specific currency, consisting of interest rate swaps, at the beginning of Period X0. The cash flows shown are expected to occur at the end of the period and, therefore, create a cash flow interest exposure in the following period as a result of the reinvestment or repricing of the cash inflows or the refinancing or repricing of the cash outflows.

The illustrations assume that the entity has an ongoing interest rate risk management programme. Schedule I shows the expected cash flows and hedging positions that existed at the beginning of Period X0. It is included here to provide a starting point in the analysis. It provides a basis for considering existing hedges in connection with the evaluation that occurs at the beginning of Period X1.

Schedule I End of period: expected cash flows and hedging positions							
Quarterly period	*X0*	*X1*	*X2*	*X3*	*X4*	*X5*	*…n*
(units)	*Rs.*	*Rs.*	*Rs.*	*Rs.*	*Rs.*	*Rs.*	*Rs.*
Expected net cash flows		1,100	1,500	1,200	1,400	1,500	x,xxx
Outstanding interest rate swaps:							
Receive-fixed, pay-variable (notional amounts)	2,000	2,000	2,000	1,200	1,200	1,200	x,xxx
Pay-fixed, receive-variable (notional amounts)	(1,000)	(1,000)	(1,000)	(500)	(500)	(500)	x,xxx
Net exposure after		100	500	500	700	800	x.xxx

outstanding swaps							

The schedule depicts five quarterly periods. The actual analysis would extend over a period of many years, represented by the notation '…n'. A financial institution that manages its interest rate risk on an entity-wide basis re-evaluates its cash flow exposures periodically. The frequency of the evaluation depends on the entity's risk management policy.

For the purposes of this illustration, the entity is re-evaluating its cash flow exposures at the end of Period X0. The first step in the process is the generation of forecast net cash flow exposures from existing interest-earning assets and interest-bearing liabilities, including the rollover of short-term assets and short-term liabilities. Schedule II below illustrates the forecast of net cash flow exposures. A common technique for assessing exposure to interest rates for risk management purposes is an interest rate sensitivity gap analysis showing the gap between interest rate-sensitive assets and interest rate-sensitive liabilities over different time intervals. Such an analysis could be used as a starting point for identifying cash flow exposures to interest rate risk for hedge accounting purposes.

Schedule II Forecast net cash flow and repricing exposures							
Quarterly period (units)	*Notes*	*X1 Rs.*	*X2 Rs.*	*X3 Rs.*	*X4 Rs.*	*X5 Rs.*	*…n Rs.*
CASH INFLOW AND REPRICING EXPOSURES - from assets							
Principal and interest payments:							
Long-term fixed rate	(1)	2,400	3,000	3,000	1,000	1,200	x,xxx
Short-term (roll over)	(1)(2)	1,575	1,579	1,582	1,586	1,591	x,xxx
Variable rate – principal payments	(1)	2,000	1,000	–	500	500	x,xxx
Variable rate – estimated interest	(2)	125	110	105	114	118	x,xxx
Total expected cash inflows		*6,100*	*5,689*	*4,687*	*3,200*	*3,409*	*x,xxx*
Variable rate asset balances	(3)	8,000	7,000	7,000	6,500	6,000	x,xxx
Cash inflows and repricings	(4)	***14,100***	***`12,689***	***11,687***	***9,700***	***9,409***	***x,xxx***
CASH OUTFLOW AND REPRICING EXPOSURES - from liabilities							
Principal and interest payments:							
Long-term fixed rate	(1)	2,100	400	500	500	301	x,xxx
Short-term (roll over)	(1)(2)	735	737	738	740	742	x,xxx
Variable rate – principal payments	(1)	–	–	2,000	–	1,000	x,xxx
Variable rate – estimated interest	(2)	100	110	120	98	109	x,xxx
Total expected cash outflows		*2,935*	*1,247*	*3,358*	*1,338*	*2,152*	*x,xxx*
Variable rate liability balances	(3)	8,000	8,000	6,000	6,000	5,000	x,xxx

Cash outflows and repricings	(4)	***10,935***	***9,247***	***9,358***	***7,338***	***7,152***	***x,xxx***
NET EXPOSURES	(5)	*3,165*	*3,442*	*2,329*	*2,362*	*2,257*	*x,xxx*

(1) The cash flows are estimated using contractual terms and assumptions based on management's intentions and market factors. It is assumed that short-term assets and liabilities will continue to be rolled over in succeeding periods. Assumptions about prepayments and defaults and the withdrawal of deposits are based on market and historical data. It is assumed that principal and interest inflows and outflows will be reinvested and refinanced, respectively, at the end of each period at the then current market interest rates and share the benchmark interest rate risk to which they are exposed.

(2) Forward interest rates obtained from Schedule VI are used to forecast interest payments on variable rate financial instruments and expected rollovers of short-term assets and liabilities. All forecast cash flows are associated with the specific time periods (3 months, 6 months, 9 months and 12 months) in which they are expected to occur. For completeness, the interest cash flows resulting from reinvestments, refinancings and repricings are included in the schedule and shown gross even though only the net margin may actually be reinvested. Some entities may choose to disregard the forecast interest cash flows for risk management purposes because they may be used to absorb operating costs and any remaining amounts would not be significant enough to affect risk management decisions.

(3) The cash flow forecast is adjusted to include the variable rate asset and liability balances in each period in which such variable rate asset and liability balances are repriced. The principal amounts of these assets and liabilities are not actually being paid and, therefore, do not generate a cash flow. However, since interest is computed on the principal amounts for each period based on the then current market interest rate, such principal amounts expose the entity to the same interest rate risk as if they were cash flows being reinvested or refinanced.

(4) The forecast cash flow and repricing exposures that are identified in each period represent the principal amounts of cash inflows that will be reinvested or repriced and cash outflows that will be refinanced or repriced at the market interest rates that are in effect when those forecast transactions occur.

(5) The net cash flow and repricing exposure is the difference between the cash inflow and repricing exposures from assets and the cash outflow and repricing exposures from liabilities. In the illustration, the entity is exposed to interest rate declines because the exposure from assets exceeds the exposure from liabilities and the excess (ie the net amount) will be reinvested or repriced at the current market rate and there is no offsetting refinancing or repricing of outflows.

Note that some banks regard some portion of their non-interest bearing demand deposits as economically equivalent to long-term debt. However, these deposits do not create a cash flow exposure to interest rates and would therefore be excluded from this analysis for accounting purposes.

Schedule II *Forecast net cash flow and repricing exposures* provides no more than a starting point for assessing cash flow exposure to interest rates and for adjusting hedging positions. The complete analysis includes outstanding hedging positions and is shown in Schedule III *Analysis of expected net exposures and hedging positions*. It compares the forecast net cash flow exposures for each period (developed in Schedule II) with existing hedging positions (obtained from Schedule I), and provides a basis for considering whether adjustment of the hedging relationship should be made.

Schedule III Analysis of expected net exposures and hedging positions						
Quarterly period (units)	*X1 Rs.*	*X2 Rs.*	*X3 Rs.*	*X4 Rs.*	*X5 Rs.*	*…n Rs.*
Net cash flow and repricing exposures (Schedule II)	3,165	3,442	2,329	2,362	2,257	x,xxx
Pre-existing swaps outstanding:						
Receive-fixed, pay-variable (notional amounts)	2,000	2,000	1,200	1,200	1,200	x,xxx
Pay-fixed, receive-variable (notional amounts)	(1,000)	(1,000)	(500)	(500)	(500)	x,xxx
Net exposure after pre-existing swaps	*2,165*	*2,442*	*1,629*	*1,662*	*1,557*	*x,xxx*
Transactions to adjust outstanding hedging positions:						
Receive-fixed, pay variable swap 1 (notional amount, 10-years)	2,000	2,000	2,000	2,000	2,000	x,xxx
Pay-fixed, receive-variable swap 2 (notional amount, 3-years)			(1,000)	(1,000)	(1,000)	x,xxx
Swaps …X						x,xxx
Unhedged cash flow and repricing exposure	*165*	*442*	*629*	*662*	*557*	*x,xxx*

The notional amounts of the interest rate swaps that are outstanding at the analysis date are included in each of the periods in which the interest rate swaps are outstanding to illustrate the impact of the outstanding interest rate swaps on the identified cash flow exposures. The notional amounts of the outstanding interest rate swaps are included in each period because interest is computed on the notional amounts each period, and the variable rate components of the outstanding swaps are repriced to the current market rate quarterly. The notional amounts create an exposure to interest rates that in part is similar to the principal balances of variable rate assets and variable rate liabilities.

The exposure that remains after considering the existing positions is then evaluated to determine the extent to which adjustments of existing hedging positions are necessary. The bottom portion of Schedule III shows the beginning of Period X1 using interest rate swap transactions to reduce the net exposures further to within the tolerance levels established under the entity's risk management policy.

Note that in the illustration, the cash flow exposure is not entirely eliminated. Many financial institutions do not fully eliminate risk but rather reduce it to within some tolerable limit.

Various types of derivative instruments could be used to manage the cash flow exposure to interest rate risk identified in the schedule of forecast net cash flows (Schedule II). However, for the purpose of the illustration, it is assumed that interest rate swaps are used for all hedging activities. It is also assumed that in periods in which interest rate swaps should be reduced, rather than terminating some of the outstanding interest rate swap positions, a new swap with the opposite return characteristics is added to the portfolio.

In the illustration in Schedule III above, swap 1, a receive-fixed, pay-variable swap, is used to reduce the net exposure in Periods X1 and X2. Since it is a 10-year swap, it also reduces exposures identified in other future periods not shown. However, it has the effect of creating an over-hedged position in Periods X3–X5. Swap 2, a forward starting pay-fixed, receive-variable interest rate swap, is used to reduce the notional amount of the outstanding receive-fixed, pay-variable interest rate swaps in Periods X3–X5 and thereby reduce the over-hedged positions.

It also is noted that in many situations, no adjustment or only a single adjustment of the outstanding hedging position is necessary to bring the exposure to within an acceptable limit. However, when the entity's risk management policy specifies a very low tolerance of risk a greater number of adjustments to the hedging positions over the forecast period would be needed to further reduce any remaining risk.

To the extent that some of the interest rate swaps fully offset other interest rate swaps that have been entered into for hedging purposes, it is not necessary to include them in a designated hedging relationship for hedge accounting purposes. These offsetting positions can be combined, de-designated as hedging instruments, if necessary, and reclassified for accounting purposes from the hedging portfolio to the trading portfolio. This procedure limits the extent to which the gross swaps must continue to be designated and tracked in a hedging relationship for accounting purposes. For the purposes of this illustration it is assumed that Rs.500 of the pay-fixed, receive-variable interest rate swaps fully offset Rs.500 of the receive-fixed, pay-variable interest rate swaps at the beginning of Period X1 and for Periods X1–X5, and are de-designated as hedging instruments and reclassified to the trading account.

After reflecting these offsetting positions, the remaining gross interest rate swap positions from Schedule III are shown in Schedule IV as follows.

Schedule IV Interest rate swaps designated as hedges						
Quarterly period (units)	*X1 Rs.*	*X2 Rs.*	*X3 Rs.*	*X4 Rs.*	*X5 Rs.*	*…n Rs.*
Receive-fixed, pay-variable (notional amounts)	3,500	3,500	2,700	2,700	2,700	x,xxx
Pay-fixed, receive-variable (notional amounts)	(500)	(500)	(1,000)	(1,000)	(1,000)	x,xxx
Net outstanding swaps positions	*3,000*	*3,000*	*1,700*	*1,700*	*1,700*	x,xxx

For the purposes of the illustrations, it is assumed that swap 2, entered into at the beginning of Period X1, only partially offsets another swap being accounted for as a hedge and therefore continues to be designated as a hedging instrument.

Hedge accounting considerations

Illustrating the designation of the hedging relationship

The discussion and illustrations thus far have focused primarily on economic and risk management considerations relating to the identification of risk in future periods and the adjustment of that risk using interest rate swaps. These activities form the basis for designating a hedging relationship for accounting purposes.

The examples in Ind AS 39 focus primarily on hedging relationships involving a single hedged item and a single hedging instrument, but there is little discussion and guidance on portfolio hedging relationships for cash flow hedges when risk is being managed centrally. In this illustration, the general principles are applied to hedging relationships involving a component of risk in a portfolio having multiple risks from multiple transactions or positions.

Although designation is necessary to achieve hedge accounting, the way in which the designation is described also affects the extent to which the hedging relationship is judged to be effective for accounting purposes and the extent to which the entity's existing system for managing risk will be required to be modified to track hedging activities for accounting purposes. Accordingly, an entity may wish to designate the hedging relationship in a manner that avoids unnecessary systems changes by taking advantage of the information already generated by the risk management system and avoids unnecessary bookkeeping and tracking. In designating hedging relationships, the entity may also consider the extent to which ineffectiveness is expected to be recognised for accounting purposes under alternative designations.

The designation of the hedging relationship needs to specify various matters. These are illustrated and discussed here from the perspective of the hedge of the interest rate risk associated with the cash inflows, but the guidance can also be applied to the hedge of the risk associated with the cash outflows. It is fairly obvious that only a portion of the gross exposures relating to the cash inflows is being hedged by the interest rate swaps. Schedule V *The general hedging relationship* illustrates the designation of the portion of the gross reinvestment risk exposures identified in Schedule II as being hedged by the interest rate swaps.

Schedule V The general hedging relationship						
Quarterly period	*X1*	*X2*	*X3*	*X4*	*X5*	*…n*
(units)	*Rs.*	*Rs.*	*Rs.*	*Rs.*	*Rs.*	*Rs.*
Cash inflow repricing exposure (Schedule II)	14,100	12,689	11,687	9,700	9,409	x,xxx
Receive-fixed, pay-variable swaps (Schedule IV)	3,500	3,500	2,700	2,700	2,700	x,xxx
Hedged exposure percentage	*24.8%*	*27.6%*	*23.1%*	*27.8%*	*28.7%*	*xx.x%*

The hedged exposure percentage is computed as the ratio of the notional amount of the receive-fixed, pay-variable swaps that are outstanding divided by the gross exposure. Note that in Schedule V there are sufficient levels of forecast reinvestments in each

period to offset more than the notional amount of the receive-fixed, pay-variable swaps and satisfy the accounting requirement that the forecast transaction is highly probable.

It is not as obvious, however, how the interest rate swaps are specifically related to the cash flow interest risks designated as being hedged and how the interest rate swaps are effective in reducing that risk. The more specific designation is illustrated in Schedule VI *The specific hedging relationship* below. It provides a meaningful way of depicting the more complicated narrative designation of the hedge by focusing on the hedging objective to eliminate the cash flow variability associated with future changes in interest rates and to obtain an interest rate equal to the fixed rate inherent in the term structure of interest rates that exists at the commencement of the hedge.

The expected interest from the reinvestment of the cash inflows and repricings of the assets is computed by multiplying the gross amounts exposed by the forward rate for the period. For example, the gross exposure for Period X2 of Rs.14,100 is multiplied by the forward rate for Periods X2–X5 of 5.50 per cent, 6.00 per cent, 6.50 per cent and 7.25 per cent, respectively, to compute the expected interest for those quarterly periods based on the current term structure of interest rates. The hedged expected interest is computed by multiplying the expected interest for the applicable three-month period by the hedged exposure percentage.

Schedule VI The specific hedging relationship						
Quarterly period		*X1*	*X2*	*X3*	*X4*	*X5*	*…n*
Spot rates		5.00%	5.25%	5.50%	5.75%	6.05%	x.xx%
Forward rates[30]		5.00%	5.50%	6.00%	6.50%	7.25%	x.xx%
Cash flow exposures and expected interest amounts							
Repricing period	Time to forecast transaction	Gross amounts exposed	Expected interest				
			Rs.	Rs.	Rs.	Rs.	Rs.
2	3 months	14,100	**194**	212	229	256	
3	6 months	12,689		**190**	206	230	Xxx
4	9 months	11,687			**190**	212	Xxx
5	12 months	9,700				**176**	Xxx
6	15 months	9,409					**Xxx**
Hedged percentage (Schedule V) in the previous period		24.8%	27.6%		23.1%	27.8%	xx.x %
Hedged expected interest		48	52		44	49	xx

It does not matter whether the gross amount exposed is reinvested in long-term fixed rate debt or variable rate debt, or in short-term debt that is rolled over in each

[30] The forward interest rates are computed from the spot interest rates and rounded for the purposes of the presentation. Computations that are based on the forward interest rates are made based on the actual computed forward rate and then rounded for the purposes of the presentation.

subsequent period. The exposure to changes in the forward interest rate is the same. For example, if the Rs.14,100 is reinvested at a fixed rate at the beginning of Period X2 for six months, it will be reinvested at 5.75 per cent. The expected interest is based on the forward interest rates for Period X2 of 5.50 per cent and for Period X3 of 6.00 per cent, equal to a blended rate of 5.75 per cent $(1.055 \times 1.060)^{0.5}$, which is the Period X2 spot rate for the next six months.

However, only the expected interest from the reinvestment of the cash inflows or repricing of the gross amount for the first three-month period after the forecast transaction occurs is designated as being hedged. The expected interest being hedged is represented by the shaded cells. The exposure for the subsequent periods is not hedged. In the example, the portion of the interest rate exposure being hedged is the forward rate of 5.50 per cent for Period X2. In order to assess hedge effectiveness and compute actual hedge ineffectiveness on an ongoing basis, the entity may use the information on hedged interest cash inflows in Schedule VI and compare it with updated estimates of expected interest cash inflows (for example, in a table that looks like Schedule II). As long as expected interest cash inflows exceed hedged interest cash inflows, the entity may compare the cumulative change in the fair value of the hedged cash inflows with the cumulative change in the fair value of the hedging instrument to compute actual hedge effectiveness. If there are insufficient expected interest cash inflows, there will be ineffectiveness. It is measured by comparing the cumulative change in the fair value of the expected interest cash flows to the extent they are less than the hedged cash flows with the cumulative change in the fair value of the hedging instrument.

Describing the designation of the hedging relationship

As mentioned previously, there are various matters that should be specified in the designation of the hedging relationship that complicate the description of the designation but are necessary to limit ineffectiveness to be recognised for accounting purposes and to avoid unnecessary systems changes and bookkeeping. The example that follows describes the designation more fully and identifies additional aspects of the designation not apparent from the previous illustrations.

Example designation

Hedging objective

The hedging objective is to eliminate the risk of interest rate fluctuations over the hedging period, which is the life of the interest rate swap, and in effect obtain a fixed interest rate during this period that is equal to the fixed interest rate on the interest rate swap.

Type of hedge

Cash flow hedge.

Hedging instrument

The receive-fixed, pay-variable swaps are designated as the hedging instrument. They hedge the cash flow exposure to interest rate risk.

Each repricing of the swap hedges a three-month portion of the interest cash inflows that results from:

- the forecast reinvestment or repricing of the principal amounts shown in Schedule V.
- unrelated investments or repricings that occur after the repricing dates on the swap over its life and involve different borrowers or lenders.

The hedged item—General

The hedged item is a portion of the gross interest cash inflows that will result from the reinvestment or repricing of the cash flows identified in Schedule V and are expected to occur within the periods shown on such schedule. The portion of the interest cash inflow that is being hedged has three components:

the principal component giving rise to the interest cash inflow and the period in which it occurs,

the interest rate component, and

the time component or period covered by the hedge.

The hedged item—The principal component

The portion of the interest cash inflows being hedged is the amount that results from the first portion of the principal amounts being invested or repriced in each period:

that is equal to the sum of the notional amounts of the received-fixed, pay-variable interest rate swaps that are designated as hedging instruments and outstanding in the period of the reinvestment or repricing, and

that corresponds to the first principal amounts of cash flow exposures that are invested or repriced at or after the repricing dates of the interest rate swaps.

The hedged item—The interest rate component

The portion of the interest rate change that is being hedged is the change in both of the following:

the credit component of the interest rate being paid on the principal amount invested or repriced that is equal to the credit risk inherent in the interest rate swap. It is that portion of the interest rate on the investment that is equal to the interest index of the interest rate swap, such as MIBOR, and

the yield curve component of the interest rate that is equal to the repricing period on the interest rate swap designated as the hedging instrument.

The hedged item—The hedged period

The period of the exposure to interest rate changes on the portion of the cash flow exposures being hedged is:

the period from the designation date to the repricing date of the interest rate swap that occurs within the quarterly period in which, but not before, the forecast transactions occur, and

its effects for the period after the forecast transactions occur equal to the repricing interval of the interest rate swap.

It is important to recognise that the swaps are not hedging the cash flow risk for a single investment over its entire life. The swaps are designated as hedging the cash flow risk from different principal investments and repricings that are made in each repricing period of the swaps over their entire term. The swaps hedge only the interest accruals that occur in the first period following the reinvestment. They are hedging the cash flow impact resulting from a change in interest rates that occurs up to the repricing of the swap. The exposure to changes in rates for the period from the repricing of the swap to the date of the hedged reinvestment of cash inflows or repricing of variable rate assets is not hedged. When the swap is repriced, the interest rate on the swap is fixed until the next repricing date and the accrual of the net swap settlements is determined. Any changes in interest rates after that date that affect the amount of the interest cash inflow are no longer hedged for accounting purposes.

Designation objectives

Systems considerations

Many of the tracking and bookkeeping requirements are eliminated by designating each repricing of an interest rate swap as hedging the cash flow risk from forecast reinvestments of cash inflows and repricings of variable rate assets for only a portion of the lives of the related assets. Much tracking and bookkeeping would be necessary if the swaps were instead designated as hedging the cash flow risk from forecast principal investments and repricings of variable rate assets over the entire lives of these assets.

This type of designation avoids keeping track of gains and losses recognised in other comprehensive income after the forecast transactions occur (Ind AS 39.97 and Ind AS 39.98) because the portion of the cash flow risk being hedged is that portion that will be reclassified from equity to profit or loss in the period immediately following the forecast transactions that corresponds with the periodic net cash settlements on the swap. If the hedge were to cover the entire life of the assets being acquired, it would be necessary to associate a specific interest rate swap with the asset being acquired. If a forecast transaction is the acquisition of a fixed rate instrument, the fair value of the swap that hedged that transaction would be reclassified from equity to profit or loss to adjust the interest income on the asset when the interest income is recognised. The swap would then have to be terminated or redesignated in another hedging relationship. If a forecast transaction is the acquisition of a variable rate asset, the swap would continue in the hedging relationship but it would have to be tracked back to the asset acquired so that any fair value amounts on the swap recognised in other comprehensive income could be reclassified from equity to profit or loss upon the subsequent sale of the asset.

It also avoids the necessity of associating with variable rate assets any portion of the fair value of the swaps that is recognised in other comprehensive income. Accordingly, there is no portion of the fair value of the swap that is recognised in other comprehensive income that should be reclassified from equity to profit or loss when a forecast transaction occurs or upon the sale of a variable rate asset.

This type of designation also permits flexibility in deciding how to reinvest cash flows when they occur. Since the hedged risk relates only to a single period that corresponds

with the repricing period of the interest rate swap designated as the hedging instrument, it is not necessary to determine at the designation date whether the cash flows will be reinvested in fixed rate or variable rate assets or to specify at the date of designation the life of the asset to be acquired.

Effectiveness considerations

Ineffectiveness is greatly reduced by designating a specific portion of the cash flow exposure as being hedged.

- Ineffectiveness due to credit differences between the interest rate swap and hedged forecast cash flow is eliminated by designating the cash flow risk being hedged as the risk attributable to changes in the interest rates that correspond with the rates inherent in the swap, such as the AA rate curve. This type of designation prevents changes resulting from changes in credit spreads from being considered as ineffectiveness.
- Ineffectiveness due to duration differences between the interest rate swap and hedged forecast cash flow is eliminated by designating the interest rate risk being hedged as the risk relating to changes in the portion of the yield curve that corresponds with the period in which the variable rate leg of the interest rate swap is repriced.
- Ineffectiveness due to interest rate changes that occur between the repricing date of the interest rate swap and the date of the forecast transactions is eliminated by simply not hedging that period of time. The period from the repricing of the swap and the occurrence of the forecast transactions in the period immediately following the repricing of the swap is left unhedged. Therefore, the difference in dates does not result in ineffectiveness.

Accounting considerations

The ability to qualify for hedge accounting using the methodology described here is founded on provisions in Ind AS 39 and on interpretations of its requirements. Some of those are described in the answer to Question F.6.2 *Hedge accounting considerations when interest rate risk is managed on a net basis*. Some additional and supporting provisions and interpretations are identified below.

Hedging a portion of the risk exposure

The ability to identify and hedge only a portion of the cash flow risk exposure resulting from the reinvestment of cash flows or repricing of variable rate instruments is found in Ind AS 39.81 as interpreted in the answers to Questions F.6.2 Issue (k) and F.2.17 *Partial term hedging*.

Hedging multiple risks with a single instrument

The ability to designate a single interest rate swap as a hedge of the cash flow exposure to interest rates resulting from various reinvestments of cash inflows or repricings of variable rate assets that occur over the life of the swap is founded on Ind AS 39.76 as interpreted in the answer to Question F.1.12 *Hedges of more than one type of risk*.

Hedging similar risks in a portfolio

The ability to specify the forecast transaction being hedged as a portion of the cash flow exposure to interest rates for a portion of the duration of the investment that gives rise to the interest payment without specifying at the designation date the expected life of the instrument and whether it pays a fixed or variable rate is founded on the answer to Question F.6.2 Issue (I), which specifies that the items in the portfolio do not necessarily have to have the same overall exposure to risk, providing they share the same risk for which they are designated as being hedged.

Hedge terminations

The ability to de-designate the forecast transaction (the cash flow exposure on an investment or repricing that will occur after the repricing date of the swap) as being hedged is provided for in Ind AS 39.101 dealing with hedge terminations. While a portion of the forecast transaction is no longer being hedged, the interest rate swap is not de-designated, and it continues to be a hedging instrument for the remaining transactions in the series that have not occurred. For example, assume that an interest rate swap having a remaining life of one year has been designated as hedging a series of three quarterly reinvestments of cash flows. The next forecast cash flow reinvestment occurs in three months. When the interest rate swap is repriced in three months at the then current variable rate, the fixed rate and the variable rate on the interest rate swap become known and no longer provide hedge protection for the next three months. If the next forecast transaction does not occur until three months and ten days, the ten-day period that remains after the repricing of the interest rate swap is not hedged.

F.6.4 Hedge accounting: premium or discount on forward exchange contract

A forward exchange contract is designated as a hedging instrument, for example, in a hedge of a net investment in a foreign operation. Is it permitted to amortise the discount or premium on the forward exchange contract to profit or loss over the term of the contract?

No. The premium or discount on a forward exchange contract may not be amortised to profit or loss under Ind AS 39. Derivatives are always measured at fair value in the balance sheet. The gain or loss resulting from a change in the fair value of the forward exchange contract is always recognised in profit or loss unless the forward exchange contract is designated and effective as a hedging instrument in a cash flow hedge or in a hedge of a net investment in a foreign operation, in which case the effective portion of the gain or loss is recognised in other comprehensive income. In that case, the amounts recognised in other comprehensive income are reclassified from equity to profit or loss when the hedged future cash flows occur or on the disposal of the net investment, as appropriate. Under Ind AS 39.74(b), the interest element (time value) of the fair value of a forward may be excluded from the designated hedge relationship. In that case, changes in the interest element portion of the fair value of the forward exchange contract are recognised in profit or loss.

F.6.5 Ind AS 39 and Ind AS 21 Fair value hedge of asset measured at cost

If the future sale of a ship carried at historical cost is hedged against the exposure to currency risk by foreign currency borrowing, does Ind AS 39 require

the ship to be remeasured for changes in the exchange rate even though the basis of measurement for the asset is historical cost?

No. In a fair value hedge, the hedged item is remeasured. However, a foreign currency borrowing cannot be classified as a fair value hedge of a ship since a ship does not contain any separately measurable foreign currency risk. If the hedge accounting conditions inInd AS 39.88 are met, the foreign currency borrowing may be classified as a cash flow hedge of an anticipated sale in that foreign currency. In a cash flow hedge, the hedged item is not remeasured.

To illustrate: a shipping entity in Denmark has a US subsidiary that has the same functional currency (the Danish krone). The shipping entity measures its ships at historical cost less depreciation in the consolidated financial statements. In accordance withInd AS 21.23(b), the ships are recognised in Danish krone using the historical exchange rate. To hedge, fully or partly, the potential currency risk on the ships at disposal in US dollars, the shipping entity normally finances its purchases of ships with loans denominated in US dollars.

In this case, a US dollar borrowing (or a portion of it) may be designated as a cash flow hedge of the anticipated sale of the ship financed by the borrowing provided the sale is highly probable, for example, because it is expected to occur in the immediate future, and the amount of the sales proceeds designated as being hedged is equal to the amount of the foreign currency borrowing designated as the hedging instrument. The gains and losses on the currency borrowing that are determined to constitute an effective hedge of the anticipated sale are recognised in other comprehensive income in accordance with Ind AS 39.95(a).

Section G Other

G.1 Disclosure of changes in fair value

Ind AS 39 requires financial assets classified as available for sale (AFS) and financial assets and financial liabilities at fair value through profit or loss to be remeasured to fair value. Unless a financial asset or a financial liability is designated as a cash flow hedging instrument, fair value changes for financial assets and financial liabilities at fair value through profit or loss are recognised in profit or loss, and fair value changes for AFS assets are recognised in other comprehensive income. What disclosures are required regarding the amounts of the fair value changes during a reporting period?

Ind AS 107.20 requires items of income, expense and gains and losses to be disclosed. This disclosure requirement encompasses items of income, expense and gains and losses that arise on remeasurement to fair value. Therefore, an entity provides disclosures of fair value changes, distinguishing between changes that are recognised in profit or loss and changes that are recognised in other comprehensive income. Further breakdown is provided of changes that relate to:

(a) AFS assets, showing separately the amount of gain or loss recognised in other comprehensive income during the period and the amount that was reclassified from equity to profit or loss for the period as a reclassification adjustment;

(b) financial assets or financial liabilities at fair value through profit or loss, showing separately those fair value changes on financial assets or financial liabilities (i) designated as such upon initial recognition and (ii) classified as held for trading in accordance withInd AS 39; and

(c) hedging instruments.

Ind AS 107 neither requires nor prohibits disclosure of components of the change in fair value by the way items are classified for internal purposes. For example, an entity may choose to disclose separately the change in fair value of those derivatives that in accordance with Ind AS 39 it categorises as held for trading, but the entity classifies as part of risk management activities outside the trading portfolio.

In addition,Ind AS 107.8 requires disclosure of the carrying amounts of financial assets or financial liabilities at fair value through profit or loss, showing separately: (i) those designated as such upon initial recognition and (ii) those held for trading in accordance withInd AS 39.

G.2 Ind AS 39 and Ind AS 7 Hedge accounting: statements of cash flows

How should cash flows arising from hedging instruments be classified in statements of cash flows?

Cash flows arising from hedging instruments are classified as operating, investing or financing activities, on the basis of the classification of the cash flows arising from the hedged item. While the terminology in Ind AS 7 has not been updated to reflectInd AS 39, the classification of cash flows arising from hedging instruments in the statement of cash flows should be consistent with the classification of these instruments as hedging instruments underInd AS 39.

Appendix 1

Comparison with IAS 39, *Financial Instruments: Measurement and Recognition*

Note: This appendix is not a part of the Indian Accounting Standard. The purpose of this Appendix is only to bring out the differences between Indian Accounting Standard (Ind AS) 39 and the corresponding International Accounting Standard (IAS) 39, Financial Instruments; Recognition and Measurement issued by the International Accounting Standards Board.

1 A provisio has been added to paragraph 48 of Ind AS 39 that in determining the fair value of the financial liabilities which upon initial recognition are designated at fair value through profit or loss, any change in fair value consequent to changes in the entity's own credit risk shall be ignored. IAS 39 requires all changes in fair values in such liabilities to be recognised in profit or loss.

2 IAS 39 does not change the requirements relating to employeebenefit plans that comply with IAS 26, Accounting and Reporting by Retirement Benefit Plans. Ind AS 39 does not mention so as IAS 26 is not relevant for companies

3 **The transitional provisions given in IAS 39 and IFRIC 6, IFRIC 16 and IFRIC 19 have not been given in Ind AS 39, since Accounting Standard corresponding to IFRS 1, *First-time Adoption of International Financial Reporting Standards,*** will deal with the same**.** The transitional provisions given in IAS 39 and IFRIC 6, IFRIC 16 and IFRIC 19 have not been given in Ind AS 39, since all transitional provisions related to Ind ASs, wherever considered appropriate have been included in Ind AS 101, *First-time Adoption of Indian Accounting Standards* corresponding to IFRS 1, *First-time Adoption of International Financial Reporting Standards*

4 Different terminology is used, as used in existing laws e.g., the term **'**balance sheet' is used instead of 'Statement of financial position' and 'Statement of profit and losses' is used instead of 'Statement of comprehensive income'.

5 The following paragraph numbers appear as 'Deleted 'in IAS 39. In order to maintain consistency with paragraph numbers of IAS 39, the paragraph numbers are retained in Ind AS 39 :

(i) paragraph 2(f)

(ii) paragraph 3

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