Accounting Standard (AS) 31

Financial Instruments: Presentation

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Financial Instruments: Presentation

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Accounting Standard (AS) 31

Financial Instruments: Presentation

*(This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective and the Preface to the Statements of Accounting Standards [1].)*

Accounting Standard (AS) 31, *Financial Instruments: Presentation*, issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years. This Accounting Standard will become mandatory[2] in respect of accounting periods commencing on or after 1-4-2011 for all commercial, industrial and business entities except to a Small and Medium-sized Entity, as defined below:

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

(ii) which is not a bank (including co-operative bank), financial institution or any entity carrying on insurance business;

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

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

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

For the above purpose, an entity would qualify as a Small and Medium-sized Entity, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

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

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

Where, in respect of an entity there is a statutory requirement for presenting any financial instrument in a particular manner as liability or equity and/ or for presenting interest, dividend, losses and gains relating to a financial instrument in a particular manner as income/ expense or as distribution of profits, the entity should present that instrument and/ or interest, dividend, losses and gains relating to the instrument in accordance with the requirements of the statute governing the entity. Untill the relevant statute is amended, the entity presenting that instrument and/ or interest, dividend, losses and gains relating to the instrument in accordance with the requirements thereof will be considered to be complying with this Accounting Standard, in view of paragraph 4.1 of the *Preface to the Statements of Accounting Standards* which recognises that where a requirement of an Accounting Standard is different from the applicable law, the law prevails[3].

The following is the text of the Accounting Standard.

Objective

1. The objective of this Standard is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset.

2. The principles in this Standard complement the principles for recognising and measuring financial assets and financial liabilities in Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement* and for disclosing information about them in Accounting Standard (AS) 32, *Financial Instruments: Disclosures*[4].

[3] To illustrate, as per paragraph 35(a) of the Standard, a preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, is a financial liability. However, at present, Schedule VI to the Companies Act, 1956, *inter alia*, requires that all preference shares should be disclosed as a part of the 'Share Capital'. Untill Schedule VI is amended, a company classifying the preference shares as share capital will be considered to be complying with this Accounting Standard even in a case where as per this Standard the preference shares are to be shown as a liability. In the latter case, as a corollary to this, dividend on such preference shares treated as a distribution to holders thereof and not as an expense will also be considered as a compliance with this Accounting Standard. Similarly, in case of a co-operative entity those requirements of paragraphs 40 to 47 and Appendix B to the Standard would not apply which are contrary to the law governing such an entity.

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

Scope

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

(a) those interests in subsidiaries, associates and joint ventures that are accounted for in accordance with AS 21, Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements, AS 23, Accounting for Investments in Associates, or AS 27, Financial Reporting of Interests in Joint Ventures. However, in some cases, AS 21, AS 23 or AS 27 permits or requires an entity to account for an interest in a subsidiary, associate or joint venture using Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement[5]; in those cases, entities should apply the disclosure requirements in AS 21, AS 23 or AS 27 in addition to those in this Standard. Entities should also apply this Standard to all derivatives linked to interests in subsidiaries, associates or joint ventures.

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

(c) contracts for contingent consideration in a business combination[6]. This exemption applies only to the acquirer.

(d) insurance contracts as defined in the Accounting Standard on Insurance Contracts[7]. However, this Standard applies to derivatives that are embedded in insurance contracts if Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement requires the entity to account for them separately. Moreover, an issuer should apply this Standard to financial guarantee contracts if the issuer applies AS 30 in recognising and measuring the contracts, but should apply the Accounting Standard on Insurance Contracts if the issuer elects, in accordance with the Accounting Standard on Insurance Contracts, to apply that Standard in recognising and measuring them.

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[5] It may be noted that AS 21, AS 23 and AS 27, at present, make reference to Accounting Standard (AS) 13, *Accounting for Investments*, with regard to the accounting for an investment in a subsidiary, associate and joint venture, respectively. On Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*, becoming mandatory, AS 13 would stand withdrawn except to the extent it relates to accounting for investment properties. In other words, accounting for investments in a subsidiary, associate and joint venture would no longer be covered by AS 13. Keeping this in view, with the issuance of the proposed AS 30, Limited Revisions have been made to AS 21, AS 23 and AS 27 to replace the references to AS 13 with those to AS 30. Pursuant to these Limited Revisions, the titles of AS 21 and AS 23 are also modified.

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

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

[7] A separate Accounting Standard on *Insurance Contracts* will specify the requirements relating to insurance contracts.

(e) financial instruments that are within the scope of the Accounting Standard on Insurance Contracts[8] because they contain a discretionary participation feature. The issuer of these instruments is exempt from applying to these features paragraphs 32-67 of this Standard regarding the distinction between financial liabilities and equity instruments. However, these instruments are subject to all other requirements of this Standard. Furthermore, this Standard applies to derivatives that are embedded in these instruments (see Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement).

(f) financial instruments, contracts and obligations under share-based payment transactions[9] except for

(i) contracts within the scope of paragraphs 4-6 of this Standard, to which this Standard applies.

(ii) paragraphs 68, 69 and 70 of this Standard, which should be applied to treasury shares, purchased, sold, issued or cancelled in connection with employee share option plans, employees share purchase plans, and all other share-based payment arrangements.

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

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

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

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

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

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[8] See footnote 7.

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

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

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

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

Definitions

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

7.1 A <u>financial instrument</u> is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

7.2 A <u>financial asset</u> is any asset that is:

(a) cash;

(b) an equity instrument of another entity;

(c) a contractual right:

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

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

(d) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

7.3 A <u>financial liability</u> is any liability that is:

(a) a contractual obligation:

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

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

(b) a contract that will or may be settled in the entity's own equity instruments and is

(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity 's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

7.4 An <u>equity instrument</u> is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

7.5 <u>Fair value</u> is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

8. The following terms are defined in paragraph 8 of Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement* and are used in this Standard with the meaning specified in AS 30.

- amortised cost of a financial asset or financial liability
- available-for-sale financial assets
- derecognition
- derivative
- effective interest method
- financial asset or financial liability at fair value through profit or loss
- financial guarantee contract
- firm commitment
- forecast transaction
- hedge effectiveness
- hedged item
- hedging instrument
- held-to-maturity investments

- loans and receivables
- regular way purchase or sale
- transaction costs.

9. In this Standard, ‘contract’ and ‘contractual’ refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.

10. In this Standard, ‘entity’ includes individuals, partnerships, incorporated bodies, trusts and government agencies.

Financial Assets and Financial Liabilities

11. Currency (cash) is a financial asset because it represents the medium of exchange and is therefore the basis on which all transactions are measured and recognised in financial statements. A deposit of cash with a bank or similar financial institution is a financial asset because it represents the contractual right of the depositor to obtain cash from the institution or to draw a cheque or similar instrument against the balance in favour of a creditor in payment of a financial liability.

12. Common examples of financial assets representing a contractual right to receive cash in the future and corresponding financial liabilities representing a contractual obligation to deliver cash in the future are:

(a) trade accounts receivable and payable;

(b) bills receivable and payable;

(c) loans receivable and payable;

(d) bonds receivable and payable; and

(e) deposits and advances.

In each case, one party’s contractual right to receive (or obligation to pay) cash is matched by the other party’s corresponding obligation to pay (or right to receive).

13. Another type of financial instrument is one for which the economic benefit to be received or given up is a financial asset other than cash. For example, a promissory note payable in government bonds gives the holder the contractual right to receive and the issuer the contractual obligation to deliver government bonds, not cash. The bonds are financial assets because they represent obligations of the issuing government to pay cash. The promissory note is, therefore, a financial asset of the promissory note holder and a financial liability of the promissory note issuer.

14. ‘Perpetual’ debt instruments normally provide the holder with the contractual right to receive payments on account of interest at fixed dates extending into the indefinite future, either with no right to receive a return of principal or a right to a return of principal under terms that make it very unlikely or very far in the future. For example, an entity may issue a financial

instrument requiring it to make annual payments in perpetuity equal to a stated interest rate of 8 per cent applied to a stated par or principal amount of Rs. 1,000. Assuming 8 per cent to be the market rate of interest for the instrument when issued, the issuer assumes a contractual obligation to make a stream of future interest payments having a fair value (present value) of Rs. 1,000 on initial recognition. The holder and issuer of the instrument have a financial asset and a financial liability, respectively.

15. A contractual right or contractual obligation to receive, deliver or exchange financial instruments is itself a financial instrument. A chain of contractual rights or contractual obligations meets the definition of a financial instrument if it will ultimately lead to the receipt or payment of cash or to the acquisition or issue of an equity instrument.

16. The ability to exercise a contractual right or the requirement to satisfy a contractual obligation may be absolute, or it may be contingent on the occurrence of a future event. For example, a financial guarantee is a contractual right of the lender to receive cash from the guarantor, and a corresponding contractual obligation of the guarantor to pay the lender, if the borrower defaults. The contractual right and obligation exist because of a past transaction or event (assumption of the guarantee), even though the lender's ability to exercise its right and the requirement for the guarantor to perform under its obligation are both contingent on a future act of default by the borrower. A contingent right and obligation meet the definition of a financial asset and a financial liability, even though such assets and liabilities are not always recognised in the financial statements. Some of the contingents rights and obligations may be insurance contracts within the scope of the Accounting Standard on *Insurance Contracts*[10].

17. Under AS 19, *Leases*, a finance lease is regarded as primarily an entitlement of the lessor to receive, and an obligation of the lessee to pay, a stream of payments that are substantially the same as blended payments of principal and interest under a loan agreement. The lessor accounts for its investment in the amount receivable under the lease contract rather than the leased asset itself. An operating lease, on the other hand, is regarded as primarily an uncompleted contract committing the lessor to provide the use of an asset in future periods in exchange for consideration similar to a fee for a service. The lessor continues to account for the leased asset itself rather than any amount receivable in the future under the contract. Accordingly, a finance lease is regarded as a financial instrument and an operating lease is not regarded as a financial instrument (except as regards individual payments currently due and payable).

18. Physical assets (such as inventories, property, plant and equipment), leased assets and intangible assets (such as patents and trademarks) are not financial assets. Control of such physical and intangible assets creates an opportunity to generate an inflow of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset.

19. Assets (such as prepaid expenses) for which the future economic benefit is the receipt of goods or services, rather than the right to receive cash or another financial asset, are not financial assets. Similarly, items such as deferred revenue and most warranty obligations are not financial

[10] See footnote 7.

liabilities because the outflow of economic benefits associated with them is the delivery of goods and services rather than a contractual obligation to pay cash or another financial asset.

20. Liabilities or assets that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial liabilities or financial assets. Accounting for income taxes is dealt with in AS 22, *Accounting for Taxes on Income*.

Equity Instruments

21. Examples of equity instruments include non-puttable equity shares, some types of preference shares (see paragraphs 38 and 39) and warrants or written call options that allow the holder to subscribe for or purchase a fixed number of non-puttable equity shares in the issuing entity in exchange for a fixed amount of cash or another financial asset. An obligation of an entity to issue or purchase a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument of the entity. However, if such a contract contains an obligation for the entity to pay cash or another financial asset, it also gives rise to a liability for the present value of the redemption amount (see paragraph 52(a)). An issuer of non-puttable equity shares assumes a liability when it formally acts to make a distribution and becomes legally obligated to the shareholders to do so. This may be the case following the declaration of a dividend or when the entity is being wound up and any assets remaining after the satisfaction of liabilities become distributable to shareholders.

22. A purchased call option or other similar contract acquired by an entity that gives it the right to reacquire a fixed number of its own equity instruments in exchange for delivering a fixed amount of cash or another financial asset is not a financial asset of the entity. Instead, any consideration paid for such a contract is deducted from equity.

Derivative Financial Instruments

23. Financial instruments include primary instruments (such as receivables, payables and equity instruments) and derivative financial instruments (such as financial options, futures and forwards, interest rate swaps and currency swaps). Derivative financial instruments meet the definition of a financial instrument and, accordingly, are within the scope of this Standard.

24. Derivative financial instruments create rights and obligations that have the effect of transferring between the parties to the instrument one or more of the financial risks inherent in an underlying primary financial instrument. On inception, derivative financial instruments give one party a contractual right to exchange financial assets or financial liabilities with another party under conditions that are potentially favourable, or a contractual obligation to exchange financial assets or financial liabilities with another party under conditions that are potentially unfavourable. However, they generally[11] do not result in a transfer of the underlying primary

[11] This is true of most, but not all derivatives, e.g. in some cross-currency interest rate swaps principal is exchanged on inception (and re-exchanged on maturity).

financial instrument on inception of the contract, nor does such a transfer necessarily take place on maturity of the contract. Some instruments embody both a right and an obligation to make an exchange. Because the terms of the exchange are determined on inception of the derivative instrument, as prices in financial markets change those terms may become either favourable or unfavourable.

25. A put or call option to exchange financial assets or financial liabilities (i.e. financial instruments other than an entity's own equity instruments) gives the holder a right to obtain potential future economic benefits associated with changes in the fair value of the financial instrument underlying the contract. Conversely, the writer of an option assumes an obligation to forgo potential future economic benefits or bear potential losses of economic benefits associated with changes in the fair value of the underlying financial instrument. The contractual right of the holder and obligation of the writer meet the definition of a financial asset and a financial liability, respectively. The financial instrument underlying an option contract may be any financial asset, including shares in other entities and interest-bearing instruments. An option may require the writer to issue a debt instrument, rather than transfer a financial asset, but the instrument underlying the option would constitute a financial asset of the holder if the option were exercised. The option-holder's right to exchange the financial asset under potentially favourable conditions and the writer's obligation to exchange the financial asset under potentially unfavourable conditions are distinct from the underlying financial asset to be exchanged upon exercise of the option. The nature of the holder's right and of the writer's obligation are not affected by the likelihood that the option will be exercised.

26. Another example of a derivative financial instrument is a forward contract to be settled in six months' time in which one party (the purchaser) promises to deliver Rs. 1,000,000 cash in exchange for Rs. 1,000,000 face amount of fixed rate government bonds, and the other party (the seller) promises to deliver Rs. 1,000,000 face amount of fixed rate government bonds in exchange for Rs. 1,000,000 cash. During the six months, both parties have a contractual right and a contractual obligation to exchange financial instruments. If the market price of the government bonds rises above Rs. 1,000,000, the conditions will be favourable to the purchaser and unfavourable to the seller; if the market price falls below Rs. 1,000,000, the effect will be the opposite. The purchaser has a contractual right (a financial asset) similar to the right under a call option held and a contractual obligation (a financial liability) similar to the obligation under a put option written; the seller has a contractual right (a financial asset) similar to the right under a put option held and a contractual obligation (a financial liability) similar to the obligation under a call option written. As with options, these contractual rights and obligations constitute financial assets and financial liabilities separate and distinct from the underlying financial instruments (the bonds and cash to be exchanged). Both parties to a forward contract have an obligation to perform at the agreed time, whereas performance under an option contract occurs only if and when the holder of the option chooses to exercise it.

27. Many other types of derivative instruments embody a right or obligation to make a future exchange, including interest rate and currency swaps, interest rate caps, collars and floors, loan commitments[12], and letters of credit. An interest rate swap contract may be viewed as a variation

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

of a forward contract in which the parties agree to make a series of future exchanges of cash amounts, one amount calculated with reference to a floating interest rate and the other with reference to a fixed interest rate. Futures contracts are another variation of forward contracts, differing primarily in that the contracts are standardised and traded on an exchange.

Contracts to Buy or Sell Non-Financial Items

28. Contracts to buy or sell non-financial items do not meet the definition of a financial instrument because the contractual right of one party to receive a non-financial asset or service and the corresponding obligation of the other party do not establish a present right or obligation of either party to receive, deliver or exchange a financial asset. For example, contracts that provide for settlement only by the receipt or delivery of a non-financial item (e.g. an option, futures or forward contract on silver) are not financial instruments. Many commodity contracts are of this type. Some are standardised in form and traded on organised markets in much the same fashion as some derivative financial instruments. For example, a commodity futures contract may be bought and sold readily for cash because it is listed for trading on an exchange and may change hands many times. However, the parties buying and selling the contract are, in effect, trading the underlying commodity. The ability to buy or sell a commodity contract for cash, the ease with which it may be bought or sold and the possibility of negotiating a cash settlement of the obligation to receive or deliver the commodity do not alter the fundamental character of the contract in a way that creates a financial instrument. Nevertheless, some contracts to buy or sell non-financial items that can be settled net or by exchanging financial instruments, or in which the non-financial item is readily convertible to cash, are within the scope of the Standard as if they were financial instruments (see paragraph 4).

29. A contract that involves the receipt or delivery of physical assets does not give rise to a financial asset of one party and a financial liability of the other party unless any corresponding payment is deferred past the date on which the physical assets are transferred. Such is the case with the purchase or sale of goods on trade credit.

30. Some contracts are commodity-linked, but do not involve settlement through the physical receipt or delivery of a commodity. They specify settlement through cash payments that are determined according to a formula in the contract, rather than through payment of fixed amounts. For example, the principal amount of a bond may be calculated by applying the market price of oil prevailing at the maturity of the bond to a fixed quantity of oil. The principal is indexed by reference to a commodity price, but is settled only in cash. Such a contract constitutes a financial instrument.

31. The definition of a financial instrument also encompasses a contract that gives rise to a non-financial asset or non-financial liability in addition to a financial asset or financial liability. Such financial instruments often give one party an option to exchange a financial asset for a non-financial asset. For example, an oil-linked bond may give the holder the right to receive a stream of fixed periodic interest payments and a fixed amount of cash on maturity, with the option to exchange the principal amount for a fixed quantity of oil. The desirability of exercising this option will vary from time to time depending on the fair value of oil relative to the exchange ratio of cash for oil (the exchange price) inherent in the bond. The intentions of the bondholder

concerning the exercise of the option do not affect the substance of the component assets. The financial asset of the holder and the financial liability of the issuer make the bond a financial instrument, regardless of the other types of assets and liabilities also created.

Presentation

Liabilities and Equity

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

33. When an issuer applies the definitions in paragraph 7 to determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if, both conditions (a) and (b) below are met.

(a) The instrument includes no contractual obligation:

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

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.

(b) If the instrument will or may be settled in the issuer's own equity instruments, it is

(i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or

(ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. For this purpose the issuer's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the issuer's own equity instruments.

A contractual obligation, including one arising from a derivative financial instrument that will or may result in the future receipt or delivery of the issuer's own equity instruments, but does not meet conditions (a) and (b) above, is not an equity instrument.

No Contractual Obligation to Deliver Cash or Another Financial Asset (paragraph 33(a))

34. A critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of one party to the financial instrument (the issuer) either to deliver cash or another financial asset to the other party (the holder) or to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer. Although the holder of an equity instrument may be entitled to receive a pro rata share of any dividends or other distributions of equity, the issuer does not have a contractual obligation

to make such distributions because it cannot be required to deliver cash or another financial asset to another party.

35. The substance of a financial instrument, rather than its legal form, governs its classification on the entity's balance sheet. Substance and legal form are commonly consistent, but not always. Some financial instruments take the legal form of equity but are liabilities in substance and others may combine features associated with equity instruments and features associated with financial liabilities. For example:

(a) a preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, is a financial liability.

(b) a financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability. This is so even when the amount of cash or other financial assets is determined on the basis of an index or other item that has the potential to increase or decrease, or when the legal form of the puttable instrument gives the holder a right to a residual interest in the assets of an issuer. The existence of an option for the holder to put the instrument back to the issuer for cash or another financial asset means that the puttable instrument meets the definition of a financial liability. For example, open-ended mutual funds, unit trusts and some co-operative entities may provide their unitholders or members with a right to redeem their interests in the issuer at any time for cash equal to their proportionate share of the asset value of the issuer. However, classification as a financial liability does not preclude the use of descriptors such as 'net asset value attributable to unitholders' and 'change in net asset value attributable to unitholders' on the face of the financial statements of an entity that has no equity capital (such as some mutual funds and unit trusts, see Illustrative Example 1 of Appendix A) or the use of additional disclosure to show that total members' interests comprise items such as reserves that meet the definition of equity and puttable instruments that do not (see Illustrative Example 2 of Appendix A).

36. If an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability. For example:

(a) a restriction on the ability of an entity to satisfy a contractual obligation, such as lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, does not negate the entity's contractual obligation or the holder's contractual right under the instrument.

(b) a contractual obligation that is conditional on a counterparty exercising its right to redeem is a financial liability because the entity does not have the unconditional right to avoid delivering cash or another financial asset.

37. A financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may establish an obligation indirectly through its terms and conditions. For example:

(a) a financial instrument may contain a non-financial obligation that must be settled if, and only if, the entity fails to make distributions or to redeem the instrument. If the entity can avoid a transfer of cash or another financial asset only by settling the non-financial obligation, the financial instrument is a financial liability.

(b) a financial instrument is a financial liability if it provides that on settlement the entity will deliver either:

(i) cash or another financial asset; or

(ii) its own shares whose value is determined to exceed substantially the value of the cash or other financial asset.

Although the entity does not have an explicit contractual obligation to deliver cash or another financial asset, the value of the share settlement alternative is such that the entity will settle in cash. In any event, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option (see paragraph 53).

38. Preference shares may be issued with various rights. In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability. For example, a preference share that provides for redemption on a specific date or at the option of the holder contains a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share. The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves, does not negate the obligation. An option of the issuer to redeem the shares for cash does not satisfy the definition of a financial liability because the issuer does not have a present obligation to transfer financial assets to the shareholders. In this case, redemption of the shares is solely at the discretion of the issuer. An obligation may arise, however, when the issuer of the shares exercises its option, usually by formally notifying the shareholders of an intention to redeem the shares.

39. When preference shares are non-redeemable, the appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument. When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments. The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:

(a) a history of making distributions;

(b) an intention to make distributions in the future;

(c) a possible negative impact on the price of equity shares of the issuer if distributions are not made (because of restrictions on paying dividends on the equity shares if dividends are not paid on the preference shares);

(d) the amount of the issuer's reserves;

(e) an issuer's expectation of a profit or loss for a period; or

(f) an ability or inability of the issuer to influence the amount of its profit or loss for the period.

40. The contractual right of the holder of a financial instrument (including members' shares in co-operative entities) to request redemption does not, in itself, require that financial instrument to be classified as a financial liability. Rather, the entity must consider all of the terms and conditions of the financial instrument in determining its classification as a financial liability or equity. Those terms and conditions include relevant laws, regulations and the governing rules or bye-laws of the entity in effect at the date of classification, but not expected future amendments to those laws, regulations or bye-laws.

41. Members' shares in co-operative entities that would be classified as equity if the members did not have a right to request redemption are equity if either of the conditions described in paragraphs 42 and 43 is present. Demand deposits, including current accounts, deposit accounts and similar contracts that arise when members act as customers are financial liabilities of the entity.

42. Members' shares are equity if the entity has an unconditional right to refuse redemption of the members' shares.

43. Law, regulation or the governing rules or bye-laws of the entity can impose various types of prohibitions on the redemption of members' shares, *e.g.*, unconditional prohibitions or prohibitions based on liquidity criteria. If redemption is unconditionally prohibited by law, regulation or the governing rules or bye-laws of the entity, members' shares are equity. However, provisions in law, regulation or the governing rules or bye-laws of the entity that prohibit redemption only if conditions — such as liquidity constraints — are met (or are not met) do not result in members' shares being equity.

44. An unconditional prohibition may be absolute, in that all redemptions are prohibited. An unconditional prohibition may be partial, in that it prohibits redemption of members' shares if redemption would cause the number of members' shares or amount of paid-up capital from members' shares to fall below a specified level. Members' shares in excess of the prohibition against redemption are liabilities, unless the entity has the unconditional right to refuse redemption as described in paragraph 42. In some cases, the number of shares or the amount of paid-up capital subject to a redemption prohibition may change from time to time. Such a change in the redemption prohibition leads to a transfer between financial liabilities and equity. In such a case, the entity should disclose separately the amount, timing and reason for the transfer.

45. Equity is the residual interest in the assets after deducting all liabilities. Therefore, at initial recognition, the entity should measure the equity component in the member's shares at the

residual amount after deducting from the total amount of the shares as a whole the value separately determined for its financial liabilities for redemption. The entity measures its financial liability for redemption at fair value. In the case of members' shares with a redemption feature, the fair value of the financial liability for redemption is measured at no less than the maximum amount payable under the redemption provisions of its governing bye-laws or applicable law discounted from the first date that the amount could be required to be paid (see Example 3 of Appendix B).

46. As required by paragraph 71, distributions to holders of equity instruments (net of any income tax benefits) are recognised directly in the revenue reserves and surplus. Interest, dividends and other returns relating to financial instruments classified as financial liabilities are expenses, regardless of whether those amounts paid are legally characterised as dividends, interest or otherwise.

47. Appendix B, which is an integral part of the Standard, illustrates the application of paragraphs 40 to 46.

Settlement in the Entity's Own Equity Instruments (paragraph 33(b))

48. A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. An entity may have a contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instruments to be received or delivered equals the amount of the contractual right or obligation. Such a contractual right or obligation may be for a fixed amount or an amount that fluctuates in part or in full in response to changes in a variable other than the market price of the entity's own equity instruments (e.g. an interest rate, a commodity price or a financial instrument price). Two examples are (a) a contract to deliver as many of the entity's own equity instruments as are equal in value to Rs.100, and (b) a contract to deliver as many of the entity's own equity instruments as are equal in value to the value of 100 grams of gold. Such a contract is a financial liability of the entity even though the entity must or can settle it by delivering its own equity instruments. It is not an equity instrument because the entity uses a variable number of its own equity instruments as a means to settle the contract. Accordingly, the contract does not evidence a residual interest in the entity's assets after deducting all of its liabilities.

49. A contract that will be settled by the entity (receiving or) delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument. For example, an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond is an equity instrument. Changes in the fair value of a contract arising from variations in market interest rates that do not affect the amount of cash or other financial assets to be paid or received, or the number of equity instruments to be received or delivered, on settlement of the contract do not preclude the contract from being an equity instrument. Any consideration received (such as the premium received for a written option or warrant on the entity's own shares) is added directly to equity in an appropriate account. Any consideration paid (such as the premium paid for a purchased option) is deducted directly from an appropriate equity account. Changes in the fair value of an equity instrument are not recognised in the financial statements.

50. A contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability for the present value of the redemption amount (for example, for the present value of the forward repurchase price, option exercise price or other redemption amount). This is the case even if the contract itself is an equity instrument. One example is an entity's obligation under a forward contract to purchase its own equity instruments for cash. When the financial liability is recognised initially under AS 30, its fair value (the present value of the redemption amount) is reclassified from equity. Subsequently, the financial liability is measured in accordance with AS 30. If the contract expires without delivery, the carrying amount of the financial liability is reclassified to equity. An entity's contractual obligation to purchase its own equity instruments gives rise to a financial liability for the present value of the redemption amount even if the obligation to purchase is conditional on the counterparty exercising a right to redeem (eg a written put option that gives the counterparty the right to sell an entity's own equity instruments to the entity for a fixed price).

51. A contract that will be settled by the entity delivering or receiving a fixed number of its own equity instruments in exchange for a variable amount of cash or another financial asset is a financial asset or financial liability. An example is a contract for the entity to deliver 100 of its own equity instruments in return for an amount of cash calculated to equal the value of 100 grams of gold.

52. The following examples illustrate how to classify different types of contracts on an entity's own equity instruments:

(a) A contract that will be settled by the entity receiving or delivering a fixed number of its own shares for no future consideration, or exchanging a fixed number of its own shares for a fixed amount of cash or another financial asset, is an equity instrument. Accordingly, any consideration received or paid for such a contract is added directly to or deducted directly from equity. One example is an issued share option that gives the counterparty a right to buy a fixed number of the entity 's shares for a fixed amount of cash. However, if the contract requires the entity to purchase (redeem) its own shares for cash or another financial asset at a fixed or determinable date or on demand, the entity also recognises a financial liability for the present value of the redemption amount. One example is an entity' s obligation under a forward contract to repurchase a fixed number of its own shares for a fixed amount of cash.

(b) An entity' s obligation to purchase its own shares for cash gives rise to a financial liability for the present value of the redemption amount even if the number of shares that the entity is obliged to repurchase is not fixed or if the obligation is conditional on the counterparty exercising a right to redeem. One example of a conditional obligation is an issued option that requires the entity to repurchase its own shares for cash if the counterparty exercises the option.

(c) A contract that will be settled in cash or another financial asset is a financial asset or financial liability even if the amount of cash or another financial asset that will be received or delivered is based on changes in the market price of the entity's own equity. One example is a net cash-settled share option.

(d) A contract that will be settled in a variable number of the entity's own shares whose value equals a fixed amount or an amount based on changes in an underlying variable (eg a commodity price) is a financial asset or a financial liability. An example is a written option to buy gold that, if exercised, is settled net in the entity's own instruments by the entity delivering as many of those instruments as are equal to the value of the option contract. Such a contract is a financial asset or financial liability even if the underlying variable is the entity's own share price rather than gold. Similarly, a contract that will be settled in a fixed number of the entity's own shares, but the rights attaching to those shares will be varied so that the settlement value equals a fixed amount or an amount based on changes in an underlying variable, is a financial asset or a financial liability.

Contingent Settlement Provisions

53. A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, or the issuer's future revenues, net income or debt-to-equity ratio). The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer unless:

(a) the part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not genuine; or

(b) the issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer.

54. Paragraph 53 requires that if a part of a contingent settlement provision that could require settlement in cash or another financial asset (or in another way that would result in the instrument being a financial liability) is not genuine, the settlement provision does not affect the classification of a financial instrument. Thus, a contract that requires settlement in cash or a variable number of the entity's own shares only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur is an equity instrument. Similarly, settlement in a fixed number of an entity's own shares may be contractually precluded in circumstances that are outside the control of the entity, but if these circumstances have no genuine possibility of occurring, classification as an equity instrument is appropriate.

Settlement Options

55. When a derivative financial instrument gives one party a choice over how it is settled (eg the issuer or the holder can choose settlement net in cash or by exchanging shares for cash), it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument.

56. An example of a derivative financial instrument with a settlement option that is a financial liability is a share option that the issuer can decide to settle net in cash or by exchanging its own shares for cash. Similarly, some contracts to buy or sell a non-financial item in exchange for the entity' s own equity instruments are within the scope of this Standard because they can be settled either by delivery of the non-financial item or net in cash or another financial instrument (see paragraphs 4-6). Such contracts are financial assets or financial liabilities and not equity instruments.

Treatment in Consolidated Financial Statements

57. In consolidated financial statements, an entity presents minority interests - i.e. the interests of other parties in the equity and income of its subsidiaries in accordance with AS 1 (revised)[13], *Presentation of Financial Statements*, and AS 21, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements*[14]. When classifying a financial instrument (or a component of it) in consolidated financial statements, an entity considers all terms and conditions agreed between members of the group and the holders of the instrument in determining whether the group as a whole has an obligation to deliver cash or another financial asset in respect of the instrument or to settle it in a manner that results in liability classification. When a subsidiary in a group issues a financial instrument and a parent or other group entity agrees additional terms directly with the holders of the instrument (e.g. a guarantee), the group may not have discretion over distributions or redemption. Although the subsidiary may appropriately classify the instrument without regard to these additional terms in its individual financial statements, the effect of other agreements between members of the group and the holders of the instrument is considered in order to ensure that consolidated financial statements reflect the contracts and transactions entered into by the group as a whole. To the extent that there is such an obligation or settlement provision, the instrument (or the component of it that is subject to the obligation) is classified as a financial liability in consolidated financial statements.

[13] AS 1 is presently under revision.

[14] A limited revision has been made to AS 21 with the issuance of the Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*. Pursuant to the limited revision, the title of AS 21 is also modified.

Compound Financial Instruments

(see also Illustrative Examples 3-6 of Appendix A)

58. The issuer of a non-derivative financial instrument should evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components should be classified separately as financial liabilities or equity instruments in accordance with paragraph 32.

59. Paragraph 58 applies only to issuers of non-derivative compound financial instruments. Paragraph 58 does not deal with compound financial instruments from the perspective of holders. Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement* deals with the separation of embedded derivatives from the perspective of holders of compound financial instruments that contain debt and equity features.

60. An entity recognises separately the components of a financial instrument that (a) creates a financial liability of the entity and (b) grants an option to the holder of the instrument to convert it into an equity instrument of the entity. For example, a debenture or similar instrument convertible by the holder into a fixed number of equity shares of the entity is a compound financial instrument. From the perspective of the entity, such an instrument comprises two components: a financial liability (a contractual arrangement to deliver cash or another financial asset) and an equity instrument (a call option granting the holder the right, for a specified period of time, to convert it into a fixed number of equity shares of the entity). The economic effect of issuing such an instrument is substantially the same as issuing simultaneously a debt instrument with an early settlement provision and warrants to purchase equity shares, or issuing a debt instrument with detachable share purchase warrants. Accordingly, in all cases, the entity presents the liability and equity components separately on its balance sheet.

61. Classification of the liability and equity components of a convertible instrument is not revised as a result of a change in the likelihood that a conversion option will be exercised, even when exercise of the option may appear to have become economically advantageous to some holders. Holders may not always act in the way that might be expected because, for example, the tax consequences resulting from conversion may differ among holders. Furthermore, the likelihood of conversion will change from time to time. The entity's contractual obligation to make future payments remains outstanding until it is extinguished through conversion, maturity of the instrument or some other transaction.

62. Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement* deals with the measurement of financial assets and financial liabilities. Equity instruments are instruments that evidence a residual interest in the assets of an entity after deducting all of its liabilities. Therefore, when the initial carrying amount of a compound financial instrument is allocated to its equity and liability components, the equity component is assigned the residual amount after deducting from the fair value of the instrument as a whole the amount separately determined for the liability component. The value of any derivative features (such as a call option) embedded in the compound financial instrument other than the equity component (such as an equity conversion option) is included in the liability component. The sum of the carrying amounts assigned to the liability and equity components on initial recognition is always equal to

the fair value that would be ascribed to the instrument as a whole. No gain or loss arises from initially recognising the components of the instrument separately.

63. A common form of compound financial instrument is a debt instrument with an embedded conversion option, such as a debenture convertible into equity shares of the issuer, and without any other embedded derivative features. Paragraph 58 requires the issuer of such a financial instrument to present the liability component and the equity component separately on the balance sheet, as follows:

(a) The issuer's obligation to make scheduled payments of interest and principal is a financial liability that exists as long as the instrument is not converted. Accordingly, the issuer of a debenture convertible into equity shares first determines the carrying amount of the liability component by measuring the fair value of a similar liability (including any embedded non-equity derivative features) that does not have an associated equity component. Thus, on initial recognition, the fair value of the liability component is the present value of the contractually determined stream of future cash flows discounted at the rate of interest applied at that time by the market to instruments of comparable credit status and providing substantially the same cash flows, on the same terms, but without the conversion option.

(b) The equity instrument is an embedded option to convert the liability into equity of the issuer. The fair value of the option comprises its time value and its intrinsic value, if any. This option has value on initial recognition even when it is out of the money. The carrying amount of the equity instrument represented by such option is determined by deducting the fair value of the financial liability from the fair value of the compound financial instrument as a whole.

64. On conversion of a convertible instrument at maturity, the entity derecognises the liability component and recognises it as equity. The original equity component remains as equity (although it may be transferred from one line item within equity to another). There is no gain or loss on conversion at maturity.

65. When an entity extinguishes a convertible instrument before maturity through an early redemption or repurchase in which the original conversion privileges are unchanged, the entity allocates the consideration paid and any transaction costs for the repurchase or redemption to the liability and equity components of the instrument at the date of the transaction. The method used in allocating the consideration paid and transaction costs to the separate components is consistent with that used in the original allocation to the separate components of the proceeds received by the entity when the convertible instrument was issued, in accordance with paragraphs 58-63.

66. Once the allocation of the consideration is made, any resulting gain or loss is treated in accordance with accounting principles applicable to the related component, as follows:

(a) the amount of gain or loss relating to the liability component is recognised in the statement of profit and loss; and

(b) the amount of consideration relating to the equity component is adjusted in equity against the original equity component and the balance, if any, against the reserves and surplus.

67. An entity may amend the terms of a convertible instrument to induce early conversion, for example by offering a more favourable conversion ratio or paying other additional consideration in the event of conversion before a specified date. The difference, at the date the terms are amended, between the fair value of the consideration the holder receives on conversion of the instrument under the revised terms and the fair value of the consideration the holder would have received under the original terms is recognised as a loss in the statement of profit and loss.

Treasury shares

68. If an entity reacquires its own equity instruments, those instruments ('treasury shares') should be deducted from equity. No gain or loss should be recognised in statement of profit and loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. Such treasury shares may be acquired and held by the entity or by other members of the consolidated group. Consideration paid or received should be recognised directly in equity.

69. The amount of treasury shares held is disclosed separately either on the face of the balance sheet or in the notes, in accordance with AS 1[15] (Revised), *Presentation of Financial Statements*. An entity provides disclosure in accordance with AS 18, *Related Party Disclosures*, if the entity reacquires its own equity instruments from related parties.

70. An entity's own equity instruments are not recognised as a financial asset regardless of the reason for which they are reacquired. Paragraph 68 requires an entity that reacquires its own equity instruments to deduct those equity instruments from equity. However, when an entity holds its own equity on behalf of others, eg, a financial institution holding its own equity on behalf of a client, there is an agency relationship and as a result those holdings are not included in the entity's balance sheet.

Interest, Dividends, Losses and Gains

71. ***Interest, dividends, losses and gains relating to a financial instrument or a component of financial instrument that is a financial liability should be recognised as income or expense in the statement of profit and loss. Distributions to holders of an equity instrument should be debited by the entity directly to an appropriate equity account, net of any related income tax benefit. Transaction costs of an equity transaction should be accounted for as a deduction from equity net of any related income tax benefit.***

72. The classification of a financial instrument as a financial liability or an equity instrument determines whether interest, dividends, losses and gains relating to that instrument are recognised as expense or income in the statement of profit and loss or are recognised directly in

[15] See footnote 13.

the revenue reserves and surplus. Thus, dividend payments on shares wholly recognised as liabilities are recognised as expenses in the same way as interest on a bond/ debenture. Similarly, gains and losses associated with redemptions or refinancings of financial liabilities are recognised in the statement of profit and loss, whereas redemptions or refinancings of equity instruments are recognised as changes in equity. Changes in the fair value of an equity instrument are not recognised in the financial statements.

73. An entity typically incurs various costs in issuing or acquiring its own equity instruments. Those costs might include regulatory fees, amounts paid to legal, accounting and other professional advisers, printing costs and stamp duties. The transaction costs (net of any related income tax benefit) of an equity transaction are recognised directly in the appropriate equity account to the extent they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided. The costs of an equity transaction that is abandoned are recognised as an expense.

74. Transaction costs that relate to the issue of a compound financial instrument are allocated to the liability and equity components of the instrument in proportion to the allocation of proceeds. Transaction costs that relate jointly to more than one transaction are allocated to those transactions using a basis of allocation that is rational and consistent with similar transactions.

75. The amount of transaction costs recognised in the revenue reserves and surplus is disclosed separately under AS 1 (revised)[16].

76. The following example illustrates the application of paragraph 71 to a compound financial instrument. Assume that a non-cumulative preference share is mandatorily redeemable for cash in five years, but that dividends are payable at the discretion of the entity before the redemption date. Such an instrument is a compound financial instrument, with the liability component being the present value of the redemption amount. The unwinding of the discount on this component is recognised in statement of profit and loss and classified as interest expense. Any dividends paid relate to the equity component and, accordingly, are recognised directly in the revenue reserves and surplus. A similar treatment would apply if the redemption was not mandatory but at the option of the holder, or if the share was mandatorily convertible into a variable number of equity shares calculated to equal a fixed amount or an amount based on changes in an underlying variable (e.g., commodity). However, if any unpaid dividends are added to the redemption amount, the entire instrument is a liability. In such a case, any dividends are classified as interest expense.

77. Dividends classified as an expense are presented in the statement of profit and loss as a separate item. In addition to the requirements of this Standard, disclosure of interest and dividends is subject to the requirements of AS 1 (revised)[17] and Accounting Standard (AS) 32, *Financial Instruments: Disclosures*[18].

78. Gains and losses related to changes in the carrying amount of a financial liability are recognised as income or expense in the statement of profit and loss even when they relate to an

[16] See footnote 13.

[17] See footnote 13.

[18] See footnote 4.

instrument that includes a right to the residual interest in the assets of the entity in exchange for cash or another financial asset (see paragraph 35(b)). Under AS 1 (revised)[19], the entity presents any gain or loss arising from remeasurement of such an instrument separately on the face of the statement of profit and loss when it is relevant in explaining the entity's performance.

Offsetting a Financial Asset and a Financial Liability

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

(a) currently has a legally enforceable right to set off the recognised amounts; and

(b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

In accounting for a transfer of a financial asset that does not qualify for derecognition, the entity should not offset the transferred asset and the associated liability (see Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement).

80. This Standard requires the presentation of financial assets and financial liabilities on a net basis when doing so reflects an entity's expected future cash flows from settling two or more separate financial instruments. When an entity has the right to receive or pay a single net amount and intends to do so, it has, in effect, only a single financial asset or financial liability. In other circumstances, financial assets and financial liabilities are presented separately from each other consistently with their characteristics as resources or obligations of the entity.

81. Offsetting a recognised financial asset and a recognised financial liability and presenting the net amount differs from the derecognition of a financial asset or a financial liability. Although offsetting does not give rise to recognition of a gain or loss, the derecognition of a financial instrument not only results in the removal of the previously recognised item from the balance sheet but also may result in recognition of a gain or loss.

82. A right of set-off is a debtor's legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor. In unusual circumstances, a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor provided that there is an agreement between the three parties that clearly establishes the debtor's right of set-off. Because the right of set-off is a legal right, the conditions supporting the right may vary from one legal jurisdiction to another and the laws applicable to the relationships between the parties need to be considered.

83. The existence of an enforceable right to set off a financial asset and a financial liability affects the rights and obligations associated with a financial asset and a financial liability and may affect an entity's exposure to credit and liquidity risk. However, the existence of the right, by itself, is not a sufficient basis for offsetting. In the absence of an intention to exercise the right or to settle simultaneously, the amount and timing of an entity's future cash flows are not

[19] See footnote 13.

affected. When an entity intends to exercise the right or to settle simultaneously, presentation of the asset and liability on a net basis reflects more appropriately the amounts and timing of the expected future cash flows, as well as the risks to which those cash flows are exposed. An intention by one or both parties to settle on a net basis without the legal right to do so is not sufficient to justify offsetting because the rights and obligations associated with the individual financial asset and financial liability remain unaltered.

84. An entity's intentions with respect to settlement of particular assets and liabilities may be influenced by its normal business practices, the requirements of the financial markets and other circumstances that may limit the ability to settle net or to settle simultaneously. When an entity has a right of set-off, but does not intend to settle net or to realise the asset and settle the liability simultaneously, the effect of the right on the entity's credit risk exposure is disclosed in accordance with Accounting Standard (AS) 32, *Financial Instruments: Disclosures*[20].

85. Simultaneous settlement of two financial instruments may occur through, for example, the operation of a clearing house in an organised financial market or a face-to-face exchange. In these circumstances the cash flows are, in effect, equivalent to a single net amount and there is no exposure to credit or liquidity risk. In other circumstances, an entity may settle two instruments by receiving and paying separate amounts, becoming exposed to credit risk for the full amount of the asset or liquidity risk for the full amount of the liability. Such risk exposures may be significant even though relatively brief. Accordingly, realisation of a financial asset and settlement of a financial liability are treated as simultaneous only when the transactions occur at the same moment.

86. The conditions set out in paragraph 79 are generally not satisfied and offsetting is usually inappropriate when:

(a) several different financial instruments are used to emulate the features of a single financial instrument (a 'synthetic instrument');

(b) financial assets and financial liabilities arise from financial instruments having the same primary risk exposure (for example, assets and liabilities within a portfolio of forward contracts or other derivative instruments) but involve different counterparties;

(c) financial or other assets are pledged as collateral for non-recourse financial liabilities;

(d) financial assets are set aside in trust by a debtor for the purpose of discharging an obligation without those assets having been accepted by the creditor in settlement of the obligation (for example, a sinking fund arrangement); or

(e) obligations incurred as a result of events giving rise to losses are expected to be recovered from a third party by virtue of a claim made under an insurance contract.

87. To offset a financial asset and a financial liability, an entity must have a currently enforceable legal right to set off the recognised amounts. An entity may have a conditional right

[20]See footnote 4.

to set off recognised amounts. An entity that undertakes a number of financial instrument transactions with a single counterparty may enter into a 'master netting arrangement' with that counterparty. Such an agreement provides for a single net settlement of all financial instruments covered by the agreement in the event of default on, or termination of, any one contract. These arrangements are commonly used by financial institutions to provide protection against loss in the event of bankruptcy or other circumstances that result in a counterparty being unable to meet its obligations. A master netting arrangement commonly creates a right of set-off that becomes enforceable and affects the realisation or settlement of individual financial assets and financial liabilities only following a specified event of default or in other circumstances not expected to arise in the normal course of business. A master netting arrangement does not provide a basis for offsetting unless both of the criteria in paragraph 79 are satisfied. When financial assets and financial liabilities subject to a master netting arrangement are not offset, the effect of the arrangement on an entity's exposure to credit risk is disclosed in accordance with Accounting Standard (AS) 32, *Financial Instruments: Disclosures*[21].

88. The Standard does not provide special treatment for so-called 'synthetic instruments', which are groups of separate financial instruments acquired and held to emulate the characteristics of another instrument. For example, a floating rate long-term debt combined with an interest rate swap that involves receiving floating payments and making fixed payments synthesises a fixed rate long-term debt. Each of the individual financial instruments that together constitute a 'synthetic instrument' represents a contractual right or obligation with its own terms and conditions and each may be transferred or settled separately. Each financial instrument is exposed to risks that may differ from the risks to which other financial instruments are exposed. Accordingly, when one financial instrument in a 'synthetic instrument' is an asset and another is a liability, they are not offset and presented on an entity's balance sheet on a net basis unless they meet the criteria for offsetting in paragraph 79.

[21] See footnote 4.

Appendix A

Illustrative Examples

These examples accompany, but are not part of the Accounting Standard (AS) 31, *Financial Instruments: Presentation*.

Entities such as Mutual Funds and Co-operatives whose Share Capital is not Equity as defined in AS 31

Example 1: Entities with no equity

A1. The following example illustrates a statement of profit and loss and balance sheet format that may be used by entities such as mutual funds that do not have equity as defined in AS 31. Other formats are possible.

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

	20x5-20x6	*20x4-20x5*
	Rs.	Rs.
Revenue	2,956	1,718
Expenses (appropriately classified)	(644)	(614)
Profit from operating activities	2,312	1,104
Finance costs -distributions to unitholders	(47)	(47)
- other finance costs	(50)	(50)
Change in net assets attributable to unitholders	2,215	1,007

Balance sheet at 31 March 20x6

		20x5-20x6		*20x4-20x5*
	Rs.	Rs	Rs	Rs
ASSETS				
Non-current assets (appropriately classified)	91,374		78,484	
Total non-current assets		91,374		78,484
Current assets (appropriately classified)	1,422		1,769	
Total current assets		1,422		1,769
Total assets		92,796		80,253

LIABILITIES				
Current liabilities (appropriately classified)	647		66	
Total current liabilities		(647)		(66)
Non-current liabilities excluding net assets attributable to unitholders (appropriately classified)	280		136	
		(280)		(136)
Net assets attributable to unitholders		91,869		80,051

Example 2: Entities with some equity

A2. The following example illustrates a statement of profit and loss and balance sheet format that may be used by entities whose share capital is not equity as defined in AS 31, because the entity has an obligation to repay the share capital on demand. Other formats are possible.

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

	20x5-20x6	***20x4-20x5***
	Rs.	Rs.
Revenue	472	498
Expenses (appropriately classified)	(367)	(396)
Profit from operating activities	105	102
Finance costs – distributions to members	(50)	(50)
– other finance costs	(4)	(4)
Change in net assets attributable to members	51	48

Balance sheet at 31 March 20x6

		20x5-20x6		***20x4-20x5***
	Rs.	Rs.	Rs.	Rs.
ASSETS				
Non-current assets (appropriately classified)	908		830	
Total non-current assets		908		830
Current assets (appropriately classified)	383		350	
Total current assets		383		350

Total assets		1,291		1,180
LIABILITIES				
Current liabilities (appropriately classified)	372		338	
Share capital repayable on demand	202		161	
Total current liabilities		(574)		(499)
Total assets less current liabilities		717		681
Non-current liabilities (appropriately classified)	187		196	
		187		196
RESERVES[22]				
Reserves e.g. revaluation reserve, retained earnings etc	530		485	
		530		485
		717		681
MEMORANDUM NOTE - TOTAL MEMBERS' INTERESTS				
Share capital repayable on demand		202		161
Reserves		530		485
		732		646

Accounting for Compound Financial Instruments

Example 3: Separation of a compound financial instrument on initial recognition

A3. Paragraph 58 describes how the components of a compound financial instrument are separated by the entity on initial recognition. The following example illustrates how such a separation is made.

A4. An entity issues 2,000 convertible debentures at the start of year 1. The debentures have a three-year term, and are issued at par with a face value of Rs. 1,000 per debenture, giving total proceeds of Rs. 2,000,000. Interest is payable annually in arrears at a nominal annual interest rate of 6 per cent. Each debenture is convertible at any time up to maturity into 250 equity shares. When the debentures are issued, the prevailing market interest rate for similar debt without conversion options is 9 per cent.

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

A5. The liability component is measured first, and the difference between the proceeds of the debenture issue and the fair value of the liability is assigned to the equity component. The present value of the liability component is calculated using a discount rate of 9 per cent, the market interest rate for similar debentures having no conversion rights, as shown below.

	Rs.
Present value of the principal - Rs. 2,000,000 payable at the end of three years	1,544,367
Present value of the interest – Rs. 120,000 payable annually in arrears for three years	303,755
Total liability component	1,848,122
Equity component (balancing figure)	151,878
Proceeds of the debenture issue	2,000,000

Example 4: Separation of a compound financial instrument with multiple embedded derivative features

A6. The following example illustrates the application of paragraph 62 to the separation of the liability and equity components of a compound financial instrument with multiple embedded derivative features.

A7. Assume that the proceeds received on the issue of a callable convertible debenture are Rs. 60. The value of a similar debenture without a call or equity conversion option is Rs. 57. Based on an option pricing model, it is determined that the value to the entity of the embedded call feature in a similar debenture without an equity conversion option is Rs. 2. In this case, the value allocated to the liability component under paragraph 62 is Rs. 55 (Rs. 57 – Rs. 2) and the value allocated to the equity component is Rs. 5 (Rs. 60 – Rs. 55).

Example 5: Repurchase of a convertible instrument

A8. The following example illustrates how an entity accounts for a repurchase of a convertible instrument. For simplicity, at inception, the face amount of the instrument is assumed to be equal to the aggregate carrying amount of its liability and equity components in the financial statements, i.e. no original issue premium or discount exists. Also, for simplicity, tax considerations have been omitted from the example.

A9. On 1 January 1999, Entity A issued a 10 per cent convertible debenture with a face value of Rs. 1,000 maturing on 31 December 2008. The debenture is convertible into equity shares of Entity A at a conversion price of Rs.25 per share. Interest is payable half-yearly in cash. At the date of issue, Entity A could have issued non-convertible debt with a ten-year term bearing a coupon interest rate of 11 per cent.

A10. In the financial statements of Entity A the carrying amount of the debenture was allocated on issue as follows:

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

A11. On 1 January 2004, the convertible debenture has a fair value of Rs. 1,700.

A12. Entity A makes a tender offer to the holder of the debenture to repurchase the debenture for Rs. 1,700, which the holder accepts. At the date of repurchase, Entity A could have issued non-convertible debt with a five-year term bearing a coupon interest rate of 8 per cent.

A13. The repurchase price is allocated as follows:

	Carrying Value	**Fair Value**	**Difference**
Liability component:	Rs.	Rs.	Rs.
Present value of 10 remaining half-yearly interest Payments of Rs. 50, discounted at 11% and 8%, Respectively	377	405	
Present value of Rs. 1,000 due in 5 years, discounted at 11% and 8%, compounded half-yearly, respectively	585	676	
	962	1,081	(119)
Equity component	60	619[23]	(559)
Total	1,022	1,700	(678)

A14. Entity A recognises the repurchase of the debenture as follows:

Dr	Liability component	Rs. 962	
Dr	Debt settlement expense (statement of profit and loss)	Rs. 119	
	Cr Cash		Rs. 1,081
	To recognise the repurchase of the liability component.		

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

Dr	Equity component	Rs. 60	
Dr.	Reserves and Surplus	Rs. 559	
	Cr Cash		Rs. 619
	To recognise the cash paid for the equity component.		

Example 6: Amendment of the terms of a convertible instrument to induce early conversion

A15. The following example illustrates how an entity accounts for the additional consideration paid when the terms of a convertible instrument are amended to induce early conversion.

A16. On 1 January 2005, Entity A issued a 10 per cent convertible debenture with a face value of Rs. 1,000 with the same terms as described in Example 5. On 1 January 2006, to induce the holder to convert the convertible debenture promptly, Entity A reduces the conversion price to Rs.20 if the debenture is converted before 1 March 2006 (i.e. within 60 days).

A17. Assume the market price of Entity A's equity shares on the date the terms are amended is Rs.40 per share. The fair value of the incremental consideration paid by Entity A is calculated as follows:

*Number of equity shares to be issued to debenture holders under **amended** conversion terms:*

Face amount	Rs. 1,000	
New conversion price	/Rs. 20	per share
Number of equity shares to be issued on conversion	50	shares

*Number of equity shares to be issued to debenture holders under **original** conversion terms:*

Face amount	Rs. 1,000	
Original conversion price	/Rs.25	per share
Number of equity shares issued upon conversion	40	shares
*Number of **incremental** equity shares issued upon conversion*	10	Shares

Value of incremental equity shares issued upon conversion

Rs.40 per share x 10 incremental shares	Rs.400

A18. The incremental consideration of Rs. 400 is recognised as a loss in the statement of profit and loss.

Appendix B

Examples of Application of Paragraphs 40-46

This appendix is an integral part of AS 31.

B1. This appendix sets out seven examples of the application of paragraphs 40-46. The examples do not constitute an exhaustive list; other fact patterns are possible. Each example assumes that there are no conditions other than those set out in the facts of the example that would require the financial instrument to be classified as a financial liability.

Unconditional Right to Refuse Redemption (Paragraph 42)

Example 1

Facts

B2. The governing bye-laws of the entity state that redemptions are made at the sole discretion of the entity. The bye-laws do not provide further elaboration or limitation on that discretion. In its history, the entity has never refused to redeem members' shares, although the governing board of the entity has the right to do so.

Classification

B3. The entity has the unconditional right to refuse redemption and the members' shares are equity. The Standard establishes principles for classification that are based on the terms of the financial instrument and notes that a history of, or intention to make, discretionary payments does not trigger liability classification. Paragraph 39 of the Standard states:

> "When preference shares are non-redeemable, the appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument. When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments. The classification of a preference share as an equity instrument or a financial liability is not affected by, for example:
>
> (a) a history of making distributions;
>
> (b) an intention to make distributions in the future;

(c) a possible negative impact on the price of equity shares of the issuer if distributions are not made (because of restrictions on paying dividends on the equity shares if dividends are not paid on the preference shares);

(d) the amount of the issuer's reserves;

(e) an issuer's expectation of a profit or loss for a period; or

(f) an ability or inability of the issuer to influence the amount of its profit or loss for the period."

Example 2

Facts

B4. The governing bye-laws of the entity state that redemptions are made at the sole discretion of the entity. However, the bye-laws further state that approval of a redemption request is automatic unless the entity is unable to make payments without violating regulations regarding liquidity or reserves.

Classification

B5. The entity does not have the unconditional right to refuse redemption and the members' shares are a financial liability. The restrictions described above are based on the entity's ability to settle its liability. They restrict redemptions only if the liquidity or reserve requirements are not met and then only until such time as they are met. Hence, they do not, under the principles established in the Standard, result in the classification of the financial instrument as equity. Paragraph 38 of the Standard states:

> "Preference shares may be issued with various rights. In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability. For example, a preference share that provides for redemption on a specific date or at the option of the holder is a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share. *The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves, does not negate the obligation.* [Emphasis added]"

Prohibitions Against Redemption (Paragraphs 43 and 44)

Example 3

Facts

B6. A co-operative entity has issued shares to its members at different dates and for different amounts in the past as follows:

(a) 1 January 20X1: 100,000 shares at Rs. 10 each (Rs. 1,000,000);

(b) 1 January 20X2: 100,000 shares at Rs. 20 each (a further Rs. 2,000,000, so that the total for shares issued is Rs. 3,000,000).

Shares are redeemable on demand at the amount for which they were issued.

B7. The governing bye-laws of the entity state that cumulative redemptions cannot exceed 20 per cent of the highest number of its members' shares ever outstanding. At 31 December 20X2, the entity has 200,000 of outstanding shares, which is the highest number of members' shares ever outstanding and no shares have been redeemed in the past. On 1 January 20X3, the entity amends its governing bye-laws and increases the permitted level of cumulative redemptions to 25 per cent of the highest number of its members' shares ever outstanding.

Classification

Before the governing bye-laws are amended

B8. Members' shares in excess of the prohibition against redemption are financial liabilities. The co-operative entity measures this financial liability at fair value at initial recognition. Because these shares are redeemable on demand, the co-operative entity determines the fair value of such financial liabilities as required by paragraph 55 of AS 30, which states: 'The fair value of a financial liability with a demand feature (*e.g.*, a demand deposit) is not less than the amount payable on demand…'. Accordingly, the co-operative entity classifies as financial liabilities the maximum amount payable on demand under the redemption provisions.

B9. On 1 January 20X1, the maximum amount payable under the redemption provisions is 20,000 shares at Rs. 10 each and, accordingly, the entity classifies Rs. 200,000 as financial liability and Rs. 800,000 as equity. However, on 1 January 20X2, because of the new issue of shares at Rs. 20, the maximum amount payable under the redemption provisions increases to 40,000 shares at Rs. 20 each. The issue of additional shares at Rs. 20 creates a new liability that is measured on initial recognition at fair value. The liability after these shares have been issued is 20 per cent of the total shares in issue (200,000), measured at Rs. 20, or Rs. 800,000. This requires recognition of an additional liability of Rs. 600,000. In this example no gain or loss is recognised. Accordingly, the entity now classifies Rs. 800,000 as financial liabilities and Rs. 2,200,000 as equity. This example assumes these amounts are not changed between 1 January 20X1 and 31 December 20X2.

After the governing bye-laws are amended

B10. Following the change in its governing bye-laws, the co-operative entity can now be required to redeem a maximum of 25 per cent of its outstanding shares or a maximum of 50,000 shares at Rs. 20 each. Accordingly, on 1 January 20X3, the co-operative entity classifies as financial liabilities an amount of Rs. 1,000,000 being the maximum amount payable on demand under the redemption provisions, as determined in accordance with paragraph 55 of AS 30. It, therefore, transfers on 1 January 20X3 from equity to financial liabilities an amount of Rs.

200,000, leaving Rs. 2,000,000 classified as equity. In this example, the entity does not recognise a gain or loss on the transfer.

Example 4

Facts

B11. Law governing the operations of co-operatives, or the terms of the governing bye-laws of the entity, prohibit an entity from redeeming members' shares if, by redeeming them, it would reduce paid-in capital from members' shares below 75 per cent of the highest amount of paid-in capital from members' shares. The highest amount for a particular co-operative is Rs. 1,000,000. At the balance sheet date, the balance of paid-in capital is Rs. 900,000.

Classification

B12. In this case, Rs. 750,000 would be classified as equity and Rs. 150,000 would be classified as financial liabilities. In addition to the paragraphs already cited, paragraph 35(b) of the Standard states in part:

> "…a financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability. This is so even when the amount of cash or other financial assets is determined on the basis of an index or other item that has the potential to increase or decrease, or when the legal form of the puttable instrument gives the holder a right to a residual interest in the assets of an issuer. The existence of an option for the holder to put the instrument back to the issuer for cash or another financial asset means that the puttable instrument meets the definition of a financial liability. …"

B13. The redemption prohibition described in this example is different from the restrictions described in paragraphs 36 and 38 of the Standard. Those restrictions are limitations on the ability of the entity to pay the amount due on a financial liability, *i.e.*, they prevent payment of the liability only if specified conditions are met. In contrast, this example describes an unconditional prohibition on redemptions beyond a specified amount, regardless of the entity's ability to redeem members' shares (*e.g.*, given its cash resources, profits or distributable reserves). In effect, the prohibition against redemption prevents the entity from incurring any financial liability to redeem more than a specified amount of paid-up capital. Therefore, the portion of shares subject to the redemption prohibition is not a financial liability. While each member's shares may be redeemable individually, a portion of the total shares outstanding is not redeemable in any circumstances other than liquidation of the entity.

Example 5

Facts

B14. The facts of this example are as stated in example 4. In addition, at the balance sheet date, liquidity requirements imposed in the jurisdiction prevent the entity from redeeming any

members' shares unless its holdings of cash and short-term investments are greater than a specified amount. The effect of these liquidity requirements at the balance sheet date is that the entity cannot pay more than Rs. 50,000 to redeem the members' shares.

Classification

B15. As in example 4, the entity classifies Rs. 750,000 as equity and Rs. 150,000 as a financial liability. This is because the amount classified as a liability is based on the entity's unconditional right to refuse redemption and not on conditional restrictions that prevent redemption only if liquidity or other conditions are not met and then only until such time as they are met. The provisions of paragraphs 36 and 38 of the Standard apply in this case.

Example 6

Facts

B16. The governing bye-laws of the entity prohibit it from redeeming members' shares, except to the extent of proceeds received from the issue of additional members' shares to new or existing members during the preceding three years. Proceeds from issuing members' shares must be applied to redeem shares for which members have requested redemption. During the three preceding years, the proceeds from issuing members' shares have been Rs. 12,000 and no member's shares have been redeemed.

Classification

B17. The entity classifies Rs. 12,000 of the members' shares as financial liabilities. Consistently with the conclusions described in example 4, members' shares subject to an unconditional prohibition against redemption are not financial liabilities. Such an unconditional prohibition applies to an amount equal to the proceeds of shares issued before the preceding three years, and accordingly, this amount is classified as equity. However, an amount equal to the proceeds from any shares issued in the preceding three years is not subject to an unconditional prohibition on redemption. Accordingly, proceeds from the issue of members' shares in the preceding three years give rise to financial liabilities until they are no longer available for redemption of members' shares. As a result the entity has a financial liability equal to the proceeds of shares issued during the three preceding years, net of any redemptions during that period.

Example 7

Facts

B18. The bye-laws governing the operations of a co-operative entity state that atleast 50 per cent of the entity's total 'outstanding liabilities' (a term defined in the byelaws to include members' share accounts) has to be in the form of members' paid-up capital. The effect of the bye-laws is that if all of a co-operative's outstanding liabilities are in the form of members'

shares, it is able to redeem them all. On 31 December 20X1, the entity has total outstanding liabilities of Rs. 200,000, of which Rs. 125,000 represent members' share accounts. The terms of the members' share accounts permit the holder to redeem them on demand and there are no limitations on redemption in the governing byelaws of the entity.

Classification

B19. In this example, members' shares are classified as financial liabilities. The redemption prohibition is similar to the restrictions described in paragraphs 36 and 38 of the Standard. The restriction is a conditional limitation on the ability of the entity to pay the amount due on a financial liability, *i.e.*, they prevent payment of the liability only if specified conditions are met. More specifically, the entity could be required to redeem the entire amount of members' shares (Rs. 125,000) if it repaid all of its other liabilities (Rs. 75,000). Consequently, the prohibition against redemption does not prevent the entity from incurring a financial liability to redeem more than a specified number of members' shares or amount of paid-in capital. It allows the entity only to defer redemption until a condition is met, i.e., the repayment of other liabilities. Members' shares in this example are not subject to an unconditional prohibition against redemption and are therefore classified as financial liabilities.

Appendix C

Comparison with IAS 32, *Financial Instruments: Presentation*

Note: This Appendix is not a part of Accounting Standard (AS) 31, Financial Instruments: Presentation. The purpose of this appendix is only to bring out the major differences between AS 31 and the corresponding International Accounting Standard (IAS) 32.

Comparison with IAS 32, *Financial Instruments: Presentation*

The Accounting Standard is based on International Accounting Standard (IAS) 32, *Financial Instruments: Presentation* and incorporates IFRIC 2, *Members' Shares in Co-operative Entities and Similar Instruments* (Re. IAS 32, *Financial Instruments: Presentation*), issued by the International Financial Reporting Interpretation Committee (IFRIC) of the International Accounting Standards Board (IASB). There is no major difference between AS 31, and IAS 32 and IFRIC 2.