# Supplementary Study Paper relevant for Final (old) Course Students appearing in May, 2010 Examinations

# Paper 1: Advanced Accounting

## CHAPTER 1- UNIT 2 ACCOUNTING STANDARDS

### ACCOUNTING STANDARDS

AS 1 to AS 32 (excluding AS 8) are applicable for May, 2010 Examinations*. The text of Accounting Standards AS 30 Financial Instruments: Recognition and Measurement [including Limited Revisions to AS 2, AS 11 (revised 2003), AS 21, AS 23, AS 26, AS 27, AS 28 and AS 29]; AS 31 and AS 32 [including Limited Revision to Accounting Standard (AS) 19 Leases] is available on Institute's website. Students desirous of downloading these standards are advised to use the following link:

http://www.icai.org/post.html?post_id=474

An overview of AS 30, AS 31 and AS 32 is given below for the benefit of students.

### AS 30 FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

#### Introduction

Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement, issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years. This Accounting Standard will become mandatory in respect of accounting periods commencing on or after 1-4-2011 for all commercial, industrial and business entities except to a Small and Medium-sized Entity (SME), 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) Is not a bank (including co-operative bank), financial institution or any entity carrying on insurance business;

(iii) Its turnover (excluding other income) does not exceed rupees 50 crore in the immediately preceding accounting year;

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

(v) 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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*Official Announcements and Notifications (in relation to syllabus) issued till 31st October, 2009 will be applicable for May, 2010 examination.

From the date of this Standard becoming mandatory for the concerned entities, the following stand withdrawn:

(i) Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date, to the extent it deals with contingencies3.

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

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

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

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

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

(iii) Guidance Note on Accounting for Securitisation.

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

## Objective

The objective of this Standard is to establish the principles for recognising and measuring

a) financial assets,

b) financial liabilities and

c) some contracts to buy or sell non-financial items.

## Scope

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

(a) those interests in subsidiaries, associates and joint ventures that are accounted for under AS 21, Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements, AS 23, Accounting for Investments in Associates, or AS 27, Financial Reporting of Interests in Joint ventures

However, entities should apply this Standard to an interest in a subsidiary, associate or joint venture that according to AS 21, AS 23 or AS 27 is accounted for under this Standard. Entities should also apply this Standard to derivatives on an interest in a subsidiary, associate or joint venture unless the derivative meets the definition of an equity instrument of the entity in AS 31, Financial Instruments: Presentation

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

   (i) lease receivables recognised by a lessor are subject to the derecognition and impairment provisions of this Standard

   (ii) finance lease payables recognised by a lessee are subject to the derecognition provisions of this Standard and

   (iii) derivatives that are embedded in leases are subject to the embedded derivatives provisions of this Standard .

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

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

(e) The issues are:-

  (i) rights and obligations arising under an insurance contract as defined in the Accounting Standard on Insurance Contracts other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract in paragraph or

  (ii) a contract that is within the scope of Accounting Standard on Insurance Contracts because it contains a discretionary participation feature. However, this Standard applies to a derivative that is embedded in a contract within the scope of Accounting Standard on Insurance Contract if the derivative is not itself a contract within the scope of that Standard. Moreover, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may choose to apply either this Standard or Accounting Standard on Insurance Contracts to such financial guarantee contracts. The issuer may make that choice contract by contract, but the choice made for each contract is irrevocable.

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

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

### Definitions

A derivative is a financial instrument or other contract within the scope of this Standard with all three of the following characteristics:

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

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

(c) it is settled at a future date.

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

### Definitions relating to Recognition and Measurement

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

The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability.

De-recognition is the removal of a previously recognised financial asset or financial liability from an entity's balance sheet.

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

### Definitions Relating to Hedge Accounting

A hedging instrument is

(a) a designated derivative or

(b) for a hedge of the risk of changes in foreign currency exchange rates only, a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item

A hedged item is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged. Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

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

A forecast transaction is an uncommitted but anticipated future transaction.

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

### Categories of Financial Instruments

The four categories are:

a) Held for Trading

b) Held to maturity

c) Loans & Recievable

c) Available for sale

Held for trading: A financial asset or financial liability is classified as held for trading if it is:

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

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

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

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity other than:

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

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

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

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than: (a) those that the entity intends to sell immediately or in the near term, which should be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss; (b) those that the entity upon initial recognition designates as available for sale; or (c) those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which should be classified as available for sale.

Available-for-sale financial assets are those non-derivative financial assets that are designated as available for sale or are not classified as

(a) loans and receivables,

(b) held-to-maturity investments, or

(c) financial assets at fair value through profit or loss.

Embedded Derivatives

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

A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.

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

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

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

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

If an embedded derivative is separated, the host contract should be accounted for under this Standard if it is a financial instrument, and in accordance with other appropriate Standards if it is not a financial instrument.

This Standard does not address whether an embedded derivative should be presented separately on the face of the financial statements.

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

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

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

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

If an entity is unable to determine reliably the fair value of an embedded derivative on the basis of its terms and conditions (for example, because the embedded derivative is based on an unquoted equity instrument), the fair value of the embedded derivative is the difference between the fair value of the hybrid (combined) instrument and the fair value of the host contract, if those can be determined under this Standard.

Example: A lease contract contains a provision that rentals increase each year by 10%. Is there an embedded derivative in this contract?

Answer: No. There is no embedded derivative since lease rental does not depend on any underling basis.

Example: X Co. entered with Y Co. to sell coal over a period of two year. The coal price will be determined as per the increase in electricity prices. Is there an embedded derivative?

Answer: Yes, there is embedded derivative because cash flow of the contract or settlement price is dependent on underlying electricity price.

## Recognition

### Initial Recognition

An entity should recognise a financial asset or a financial liability on its balance sheet when, and only when, the entity becomes a party to the contractual provisions of the instrument. When a financial asset or financial liability is recognised initially, an entity should measure it as follows:

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

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

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

### De-recognition of a Financial Asset

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

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

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

  (b) it transfers the financial asset as set out in paragraphs B and C and the transfer qualifies for derecognition in accordance with paragraph D.

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

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

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

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

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

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

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

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

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

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

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

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

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

## Regular Way Purchase or Sale of a Financial Asset

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

The trade date is the date that an entity commits itself to purchase or sell an asset. Trade date accounting refers to (a) the recognition of an asset to be received and the liability to pay for it on the trade date, and (b) derecognition of an asset that is sold, recognition of any gain or loss on disposal and the recognition of a receivable from the buyer for payment on the trade date.

The settlement date is the date on which an asset is delivered to or by an entity.

Settlement date accounting refers to (a) the recognition of an asset on the day it is received by the entity, and (b) the derecognition of an asset and recognition of any gain or loss on disposal on the day that it is delivered by the entity. When settlement date accounting is applied, an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset.

Hedging relationships are of three types:

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

(b) cash flow hedge: a hedge of the exposure to variability in cash flows that

    (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and

    (ii) could affect profit or loss.

(c) hedge of a net investment in a foreign operation as defined in AS 11.

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

A hedging relationship qualifies for hedge accounting only if, all of the following conditions are met.

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

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

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

(d) The effectiveness of the hedge can be reliably measured, i.e., the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured.

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

## Fair Value Hedges

A fair value hedge should be accounted for as follows:

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

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

## Cash Flow Hedges

A cash flow hedge should be accounted for as follows:

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

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

## Hedges of a Net Investment

Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment , should be accounted for similarly to cash flow hedges:

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

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

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

## Hedge Accounting

As required by the Standard, <u>on the date of this Standard becoming mandatory</u>, an entity should:

(a) measure all derivatives at fair value; and

(b) eliminate all deferred losses and gains, if any, arising on derivatives that under the previous accounting policy of the entity were reported as assets or liabilities.

Any resulting gain or loss (as adjusted by any related tax expense/ benefit) should be adjusted against opening balance of revenue reserves and surplus.

On the date of this Standard becoming mandatory, an entity should not reflect in its financial statements a hedging relationship of a type that does not qualify for hedge accounting under this Standard (for example, hedging relationships where the hedging instrument is a cash instrument or

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* For a hedge to be effective, para A129 of AS 30 requires that it should be within the range of 80 to125%.

written option; where the hedged item is a net position; or where the hedge covers interest risk in a held-to-maturity investment).

However, if an entity designated a net position as a hedged item under its previous accounting policy, it may designate an individual item within that net position as a hedged item under Accounting Standards, provided that it does so on the date of this Standard becoming mandatory.

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

Example: Omega Ltd. has entered into hedging relationship. At the year end the entity assesses the fair value of the hedged item and hedging instrument and the gains and losses arise as follows:

Hedged Item – gain of Rs.1,000

Hedged instrument – loss of Rs.1,200

The effectiveness of the hedge has been calculated as:

Rs.1,200/1,000 = 120%. The hedge is assessed as highly effective as it is between 80 to 125%.

## Embedded Derivatives

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

## Miscellaneous Illustrations:

### Illustration 1

On February1. 2008 Omega Ltd enters in to a contract with Beta Ltd. to receive the fair value of 1000 Omega's own equity shares outstanding as of 31.1.2009 in exchange for payment of Rs.1,04,000 in cash i.e., Rs.104 per share on 31.1.2009. The contract will be settled in net cash-

(i) fair value of forward on 1.2.2008 - Nil

(ii) fair value of forward 31.12.2008 Rs.6,300

(iii) fair value of forward 31.1.2009 Rs.2,000.

Give journal entries on the basis that the net amount is settled in cash. Omega Ltd closes its books on 31st December.

### Answer

(a) 1.2.2008

No entry is required because the fair value of derivatives is zero and no cash is paid or received

(b) 31.12.2008

| | | | |
|---|---|---|---|
| Forward Asset | Dr. | 6,300 | |
| To Gain | | | 6,300 |

| | | | | |
|---|---|---|---|---|
| (c ) | 31.1.2009 | | | |
| | Loss | Dr. | 4,300 | |
| | To Forward Asset | | | 4,300 |
| (d) | Cash | Dr. | 2,000 | |
| | To Forward asset | | | 2,000 |

### Illustration 2

X Ltd. is a subsidiary of Y Ltd. It holds 9% Rs.100 5-year debentures of Y Ltd. and designated them as held to maturity as per AS 30 "Financial Instruments: Recognition and Measurement". Can X Ltd. designate this financial asset as hedging instrument for managing foreign currency risk?

### Answer

Para 82 of AS 30 states that for hedge accounting purposes only instruments that involve a party external to the reporting entity can be designated as hedging instrument. Therefore, debenture issued by the parent company cannot be designated as hedging instrument for the purpose of consolidated financial statements of the group. However, it can be designated as hedging instrument for separate financial statements of X Ltd.

## AS 31 FINANCIAL INSTRUMENTS: PRESENTATION

### Introduction

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 in respect of accounting periods commencing on or after 1-4-2011 for all commercial, industrial and business entities except to a Small and Medium-sized Entity, as defined below:

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

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

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

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

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

For the above purpose, an entity would qualify as a Small and Medium-sized Entity, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period. Where, in respect of an entity there is a statutory requirement for presenting any financial instrument in a particular manner as liability or equity and/ or for presenting interest, dividend, losses and gains relating to a financial instrument in a particular manner as income/ expense or as distribution of profits, the entity should present that instrument and/ or interest, dividend,losses and gains relating to the instrument in accordance with the requirements of the statute governing the entity.

## Objective

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.

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

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; 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.

d) insurance contracts as defined in the Accounting Standard on Insurance Contracts. 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.

e) financial instruments that are within the scope of the Accounting Standard on Insurance Contracts because they contain a discretionary participation feature.

f) financial instruments, contracts and obligations under share-based payment transactions except for 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.

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.

## Definitions

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

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| A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. |
| A financial asset is any asset that is:<br>(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.

A **financial liability** is any liability that is:

(a) a contractual obligation:

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

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

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

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

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity 's own equity instruments.

An **equity instrument** is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

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

## Financial Assets and Financial Liabilities

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. 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).

## Equity Instruments

Examples of equity instruments include

a. non-puttable equity shares,

b. some types of preference shares 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. 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.

## Derivative Financial Instruments

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. 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.

## Presentation

## Liabilities and Equity

a) 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.

b) No Contractual Obligation to Deliver Cash or another Financial Asset

## Settlement Options

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.

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.

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.

### Treasury shares

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.

### Interest, Dividends, Losses and Gains

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.

### Offsetting a Financial Asset and a Financial Liability

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

### Illustration

X Ltd. has entered into a contract by which it has the option to sell its identified Property, Plant and Equipment (PPE) to Y Ltd. for Rs.100 million after 3 years whereas its current market price is Rs.180 million. Is the put option of X Ltd. a financial instrument? Explain.

### Answer

It is necessary to evaluate the past practice of X Ltd. If X Ltd. has the past practice of settling net, then it becomes a financial instrument. If X Ltd. Intends to sell the identified PPE and settle by delivery and there is no past practice of settling net, then the contract should not be accounted for as derivative under AS 30 and AS 31.

# AS 32 Financial Instruments: Disclosures

## Introduction

Accounting Standard (AS) 32, Financial Instruments: Disclosures, issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years. This Accounting Standard will become mandatory 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:

a) 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;

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

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

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

e) 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.

## Objective and Scope

The objective of this Standard is to require entities to provide disclosures in their financial statements that enable users to evaluate:

a) the significance of financial instruments for the entity's financial position and performance; and

b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.

The principles in this Accounting Standard complement the principles for recognising, measuring and presenting financial assets and financial liabilities in Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement and Accounting Standard (AS) 31, Financial Instruments: presentation.

AS 32 should be applied by all entities to all types of financial instruments, except:

a) those interests in subsidiaries, associates and joint ventures that are accounted for in accordance with AS 21, Consolidated Financial Statements and Accounting for Investment in Subsidiaries in Separate Financial Statements, AS 23, Accounting for Investments in Associates3, 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; in those cases, entities should apply the disclosure requirements in AS 21, AS 23 or AS 27 in addition to those in this Accounting Standard. Entities should also apply this Accounting Standard to all derivatives linked to interests in subsidiaries, associates or joint ventures unless the derivative meets the definition of an equity instrument in AS 31.

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

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

d) insurance contracts as defined in Accounting Standard on Insurance contracts.

e) financial instruments, contracts and obligations under share-based payment Transactions.

This Accounting Standard applies to recognised and unrecognised financial instruments. Recognised financial instruments include financial assets and financial liabilities that are within the scope of AS 30. Unrecognized financial instruments include some financial instruments that, although outside the scope of AS 30, are within the scope of this Accounting Standard (such as some loan commitments).

Disclosure for different classes of financial instruments

When this Accounting Standard requires disclosures by class of financial instrument, an entity should group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. An entity should provide sufficient information to permit reconciliation to the line items presented in the balance sheet.

Significance of financial instruments for financial position and performance

An entity should disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance.

<u>Balance sheet</u>

Categories of financial assets and financial liabilities

The carrying amounts of each of the following categories, as defined in AS 30, should be disclosed either on the face of the balance sheet or in the notes:

(a) financial assets at fair value through profit or loss, showing separately

(i) those designated as such upon initial recognition and

(ii) those classified as held for trading in accordance with AS 30;

(b) held-to-maturity investments;

(c) loans and receivables;

(d) available-for-sale financial assets;

(e) financial liabilities at fair value through profit or loss, showing separately

(i) those designated as such upon initial recognition and

(ii) those classified as held for trading in accordance with AS 30; and

(f) financial liabilities measured at amortised cost.

Financial assets or financial liabilities at fair value through profit or loss

If the entity has designated a loan or receivable (or group of loans or receivables) as at fair value through profit or loss, it should disclose:

a) the maximum exposure to credit risk at the reporting date.

b) the amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk.

c) the amount of change, during the period and cumulatively, in the fair value of the loan or receivable (or group of loans or receivables) that is attributable to changes in the credit risk of the financial asset determined either:

   (i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or

   (ii) using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset.Changes in market conditions that give rise to market risk include changes in an observed (benchmark) interest rate, commodity price, foreign exchange rate or index of prices or rates.

d) the amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the loan or receivable was designated.

If the entity has designated a financial liability as at fair value through profit or loss in accordance with AS 30, it should disclose:

a) the amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability determined either:

   (i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or

   (ii) using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the liability. Changes in market conditions that give rise to market risk include changes in a benchmark interest rate, the price of another entity's financial instrument, a commodity price, a foreign exchange rate or an index of prices or rates. For contracts that include a unit-linking feature, changes in market conditions include changes in the performance of the related internal or external investment fund.

b) the difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

### Disclosures

The entity should disclose:

(a) the methods used to comply

(b) if the entity believes that the disclosure it has given to comply and it does not faithfully represent the change in the fair value of the financial asset or financial liability attributable to changes in its credit risk, the reasons for reaching this conclusion and the factors it believes are relevant.

### Reclassification

If the entity has reclassified a financial asset as one measured:

(a) at cost or amortised cost, rather than at fair value; or

(b) at fair value, rather than at cost or amortised cost,

It should disclose the amount reclassified into and out of each category and the reason for that reclassification.

## Derecognition

An entity may have transferred financial assets in such a way that part or all of the financial assets do not qualify for derecognition. The entity should disclose for each class of such financial assets:

a) the nature of the assets;

b) the nature of the risks and rewards of ownership to which the entity remains exposed;

c) when the entity continues to recognise all of the assets, the carrying amounts of the assets and of the associated liabilities; and

d) when the entity continues to recognise the assets to the extent of its continuing involvement, the total carrying amount of the original assets, the amount of the assets that the entity continues to recognise, and the carrying amount of the associated liabilities.

## Collateral

An entity should disclose:

a) the carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities, including amounts that have been reclassified in accordance with paragraphs 37(a) of AS 30; and

b) the terms and conditions relating to its pledge.

When an entity holds collateral (of financial or non-financial assets) and is permitted to sell or repledge the collateral in the absence of default by the owner of the collateral, it should disclose:

a) the fair value of the collateral held;

b) the fair value of any such collateral sold or repledged, and whether the entity has an obligation to return it; and

c) the terms and conditions associated with its use of the collateral.

## Allowance account for credit losses

When financial assets are impaired by credit losses and the entity records the impairment in a separate account (e.g. an allowance account used to record individual impairments or a similar account used to record a collective impairment of assets) rather than directly reducing the carrying amount of the asset, it should disclose a reconciliation of changes in that account during the period for each class of financial assets.

## Compound financial instruments with multiple embedded derivatives

If an entity has issued an instrument that contains both a liability and an equity Component and the instrument has multiple embedded derivatives whose values are interdependent (such as a callable convertible debt instrument), it should disclose the existence of those features.

## Defaults and breaches

For loans payable recognised at the reporting date, an entity should disclose:

a) details of any defaults during the period of principal, interest, sinking fund, or redemption terms of those loans payable;

b) the carrying amount of the loans payable in default at the reporting date; and

c) whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue.

If, during the period, there were breaches of loan agreement terms, an entity should disclose the same information if those breaches permitted the lender to demand accelerated repayment (unless the breaches were remedied, or the terms of the loan were renegotiated, on or before the reporting date).

### Statement of profit and loss and equity

### Items of income, expense, gains or losses

An entity should disclose the following items of income, expense, gains or losses either on the face of the financial statements or in the notes:

(a) net gains or net losses on:

   (i) financial assets or financial liabilities at fair value through profit or loss, showing separately those on financial assets or financial liabilities designated as such upon initial recognition, and those on financial assets or financial liabilities that are classified as held for trading in accordance with AS 30;

   (ii) available-for-sale financial assets, showing separately the amount of gain or loss recognised directly in equity during the period and the amount removed from equity and recognised in the statement of profit and loss for the period;

   (iii) held-to-maturity investments;

   (iv) loans and receivables; and

   (v) financial liabilities measured at amortised cost.

(b) total interest income and total interest expense (calculated using the effective interest method) for financial assets or financial liabilities that are not at fair value through profit or loss;

### Nature and extent of risks arising from financial instruments

An entity should disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the reporting date.

### Qualitative disclosures and Quantitative disclosures

For each type of risk arising from financial instruments, an entity should disclose:

(a) the exposures to risk and how they arise;

(b) its objectives, policies and processes for managing the risk and the methods used to measure the risk; and

(c) any changes in (a) or (b) from the previous period.

For each type of risk arising from financial instruments, an entity should disclose:

(a) summary quantitative data about its exposure to that risk at the reporting date. This disclosure should be based on the information provided internally to key management personnel of the entity (as defined in AS 18 Related Party Disclosures), for example the entity's board of directors or chief executive officer.

(b) the disclosures to the extent not provided in (a), unless the risk is not material for a discussion of materiality.

(c) Concentrations of risk if not apparent from (a) and (b)

If the quantitative data disclosed as at the reporting date are unrepresentative of an entity's exposure to risk during the period, an entity should provide further information that is representative.

### Credit risk

An entity should disclose by class of financial instrument:

(a) the amount that best represents its maximum exposure to credit risk at the reporting date without taking account of any collateral held or other credit enhancements (eg netting agreements that do not qualify for offset in accordance with AS 31);

(b) in respect of the amount disclosed in (a), a description of collateral held as security and other credit enhancement;

(c) information about the credit quality of financial assets that are neither past due nor impaired; and

(d) the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated.

### Liquidity risk

An entity should disclose:

(a) a maturity analysis for financial liabilities that shows the remaining contractual maturities; and

(b) a description of how it manages the liquidity risk inherent in (a).

### Sensitivity analysis

The entity should disclose:

(a) a sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date;

(b) the methods and assumptions used in preparing the sensitivity analysis; and

(c) changes from the previous period in the methods and assumptions used, and the reasons for such changes.

If an entity prepares a sensitivity analysis, such as value-at-risk, that reflects interdependencies between risk variables (eg interest rates and exchange rates) and uses it to manage financial risks, it may use that sensitivity analysis in place of the analysis.

The entity should also disclose:

(a) an explanation of the method used in preparing such a sensitivity analysis, and of the main parameters and assumptions underlying the data provided; and

(b) an explanation of the objective of the method used and of limitations that may result in the information not fully reflecting the fair value of the assets and liabilities involved.

### Other market risk disclosures

When the sensitivity analyses disclosed in above or they are unrepresentative of a risk inherent in a financial instrument (for example because the year-end exposure does not reflect the exposure during the year), the entity should disclose that fact and the reason it believes the sensitivity analyses are unrepresentative.

<u>Reference: The students are advised to refer the full text of AS 30, AS 31 and AS 32.</u>

# RELEVANT ANNOUNCEMENTS AND NOTIFICATIONS

## Companies (Accounting Standards) Amendment Rules, 2009 – Amendments in Annexure

### NOTIFICATION NO. G.S.R.225 (E)

### DATED 31-3-2009

In exercise of the powers conferred by clause (a) of sub-section (1) of section 642 read with sub-section (1) of section 21A and sub-section (3C) of section 211 of the Companies Act, 1956 (1 of 1956), the Central Government in consultation with the National Advisory Committee on Accounting Standards, hereby makes the following rules to amended the Companies (Accounting Standards) Rules, 2006, namely:-

1. (1) These rules may be called the Companies (Accounting Standards) Amendment Rules, 2009.

   (2) They shall come into force on the date of their publication in the Official Gazette.

2. In the Companies (Accounting Standard) Rules, 2006, in the Annexure, under the heading "B. ACCOUNTING STANDARDS", in the sub-heading "Accounting Standard (AS) 11" relating to "The Effects of Changes in Foreign Exchange Rates", after paragraph 45, the following shall be inserted, namely:-

"46. In respect of accounting periods commencing on or after 7th December, 2006 and ending on or before 31st March, 2011, at the option of the enterprise (such option to be irrevocable and to be exercised retrospectively for such accounting period, from the date this transitional provision comes into force or the first date on which the concerned foreign currency monetary item is acquired, whichever is later and applied to all such foreign currency monetary items), exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, insofar as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long-term asset/liability but not beyond 31st March, 2011, by recognition as income or expense in each of such periods, with the exception of exchange differences dealt with in accordance with paragraph 15. For the purposes of exercise of this option, an asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of 12 months or more at the date of origination of the asset or liability. Any difference pertaining to accounting periods which commenced on or after 7th December, 2006, previously recognized in the profit and loss account before the exercise of the option shall be reversed insofar as it relates to the acquisition of a depreciable capital asset by addition or deduction from the cost of the asset and in other cases by transfer to "Foreign Currency Monetary Item Translation Difference Account" in both cases, by debit or credit, as the case may be, to the general reserve. If the option stated in this paragraph is exercised, disclosure shall be made of the fact of such exercise of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized."

## Announcement

## Accounting for Derivatives

1. Certain issues have been raised with regard to the foreign currency derivative exposures of various corporates that are not being fully accounted for. These exposures may translate into heavy losses due to fluctuations in the foreign exchange rates. The matter was considered by the Council of the ICAI at its

meeting held on March 27-29, 2008. The Council decided to clarify the best practice treatment to be followed for all derivatives, which is contained in the following paragraphs.

2. It may be noted that although the ICAI has issued AS 30, Financial Instruments: Recognition and Measurement, which contains accounting for derivatives, it becomes recommendatory from 1.04.2009 and mandatory from 1.04.2011. In this scenario, the Council expressed the view that since the aforesaid Standard contains appropriate accounting for derivatives, the same can

be followed by the entities, as the earlier adoption of a standard is always encouraged.

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

4. The entity needs to disclose the policy followed with regard to accounting for derivatives in its financial statements. In case AS 30 is followed by the entity, a disclosure of the amounts recognized in the financial statements should be made. In case AS 30 is not followed, the losses provided for as suggested in paragraph 3 above should be separately disclosed by the entity.

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

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

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

## ANNOUNCEMENT

## Deferment of Applicability of Accounting Standard (AS) 15, Employee Benefits (revised 2005)

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

## ANNOUNCEMENT

## Option to an entity to adopt alternative treatment allowed by way of Amendment to the Transitional Provisions of Accounting Standard (AS) 15, Employee Benefits (revised 2005)

An amendment by way of limited revision to Accounting Standard (AS) 15, Employee Benefits (revised 2005), has been made with a view to provide, inter alia, an option to an entity to charge additional liability arising upon the first application of the Standard as an expense over a period up to five years with a disclosure of un-recognised amount. The Council of the Institute of Chartered Accountants of India has decided to give a one time option to the entities which have followed the treatment prescribed under the

Transitional Provisions prior to the above-stated amendment to adopt the alternative treatment, allowed by way of the said amendment, from the date the Transitional Provision was so applied. An entity is, however, allowed to exercise this option only during the first accounting year commencing on or after 7th December, 2006. In case an entity chooses to adopt the option, the earlier accounting treatment followed in this respect should be reversed.

## ACCOUNTING STANDARD INTERPRETATIONS (ASI)

The latest list of applicable ASIs is given as follows:

| No. | Related AS | Topic |
|---|---|---|
| 1 | 16 | Interpretation of the term 'substantial period' |
| 3 | 22 | Computation of deferred tax during tax holiday u/s 80-IA and 80-IB (Revised) |
| 4 | 22 | Computation of deferred tax in respect of losses under the head Capital Gains |
| 5 | 22 | Computation of deferred tax during tax holiday u/s 10A and 10B |
| 6 | 22 | Computation of current and deferred tax subject to MAT u/s 115JB |
| 7 | 22 | Disclosure of deferred tax assets/liabilities in balance sheet |
| 8 | 21, 23, 27 | Interpretation of the term 'near future' |
| 9 | 22 | Interpretation of the term 'virtual certainty' |
| 10 | 16 | Computation of exchange difference to be treated as borrowing cost |
| 12 | 20 | Applicability of AS 20 to unlisted companies |
| 13 | 18 | Aggregation of related party disclosures |
| 14 | 9 | Manner of disclosure of excise duty |
| 15 | 21 | Notes to the Consolidated Financial Statements (CFS) |
| 16 | 23 | Treatment in CFS: Dividend proposed by an associate |
| 17 | 23 | Treatment in CFS: Changes in equity not included in P & L A/c |
| 18 | 23 | Consideration of potential equity to ascertain whether the investee is an associate |
| 19 | 18 | Interpretation of the term 'intermediary' |

| | | |
|---|---|---|
| 20 | 17 | Disclosure of segment information in certain cases (Revised) |
| 21 | 18 | Non-executive directors; whether related parties |
| 22 | 17 | Interest expenses; whether to treat as segment expenses |
| 23 | 18 | Remuneration paid to key management personnel; whether related party transaction |
| 24 | 21 | Subsidiaries having two parents |
| 25 | 21 | Shares held as stock-in-trade |
| 26 | 21 | Consolidation of current and deferred tax |
| 27 | 25 | Applicability of AS 25 |
| 28 | 21, 27 | Disclosure of post-acquisition reserves in Consolidated Financial Statements |
| 29 | 7 | Turnover in case of contractors |

Note: ASI 2 and ASI 11 have been withdrawn by the ICAI.

Students desirous of downloading these Accounting Standards Interpretations are advised to use the following link:

http://www.icai.org/post.html?post_id=498&c_id=143

## CHAPTER 1- UNIT 4 GUIDANCE NOTES

The following is the list of guidance notes on accounting aspects applicable for May, 2010 Examinations:

1. Guidance Note on Treatment of Reserve Created on Revaluation of Fixed Assets.
2. Guidance Note on Accrual Basis of Accounting.
3. Guidance Note on Accounting Treatment for Excise Duty.
4. Guidance Note on Accounting for Depreciation in Companies.
5. Guidance Note on Availability of Revaluation Reserve for Issue of Bonus shares.
6. Guidance Note on Accounting Treatment for MODVAT/CENVAT.
7. Guidance Note on Accounting for Corporate Dividend Tax.
8. Guidance Note on Accounting for Employee Share-based Payments.
9. Guidance Note on Accounting for Fringe Benefits Tax.
10. Guidance Note on Accounting for Credit Available in respect of Minimum Alternate Tax under the Income Tax Act, 1961.
11. Guidance Note on Measurement of Income Tax for Interim Financial Reporting in the context of AS 25

Note: Official Announcements and Notifications (in relation to syllabus) issued till 31st October, 2009 will be applicable for May, 2010 examination.

Note: For the full text of the Guidance Notes, students are advised to refer the Compendium of Guidance Notes (2006) issued by the ICAI. The Guidance Note on Measurement of Income Tax Expense for Interim Financial Reporting in the Context of AS 25 is not available in the Compendium of Guidance Notes. Therefore, the text of this Guidance Note is given for the benefit of students.

## GN(A) 24 (Issued 2006)

## GUIDANCE NOTE ON MEASUREMENT OF INCOME TAX EXPENSE FOR INTERIM FINANCIAL REPORTING IN THE CONTEXT OF AS 25

(The following is the text of the Guidance Note on Measurement of Income-tax Expense for Interim Financial Reporting in the context of AS 25, issued by the Council of the Institute of Chartered Accountants of India.)

1. Accounting Standard (AS) 25, 'Interim Financial Reporting', issued by the Council of the Institute of Chartered Accountants of India (ICAI), prescribes the minimum content of an interim financial report and the principles for recognition and measurement in complete or condensed financial statements for an interim period. AS 25 became mandatory in respect of accounting periods commencing on or after 1st April, 2002. In accordance with the Accounting Standards Interpretation (ASI) 27, 'Applicability of AS 25 to Interim Financial Results', the recognition and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in the interim financial results presented under Clause 41 of the Listing Agreement entered into between stock exchanges and the listed enterprises. This Guidance Note deals with the measurement of income tax expense for the purpose of inclusion in the interim financial reports.

2. The general principles for recognition and measurement have been laid down in AS 25 as below:

   "27. An enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an enterprise's reporting (annual, half-yearly, or quarterly) should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis.

   28. Requiring that an enterprise apply the same accounting policies in its interim financial statements as in its annual financial statements may seem to suggest that interim period measurements are made as if each interim period stands alone as an independent reporting period. However, by providing that the frequency of an enterprise's reporting should not affect the measurement of its annual results, paragraph 27 acknowledges that an interim period is a part of a financial year. Year-to-date measurements may involve changes in estimates of amounts reported in prior interim periods of the current financial year. But the principles for recognising assets, liabilities, income, and expenses for interim periods are the same as in annual financial statements."

3. Paragraph 29(c) of AS 25 illustrates the application of the general principles for recognition and measurement of tax expense in interim periods, as below:

   "29…..

   (c) income tax expense is recognized in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year. Amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual income tax rate changes."

4. Appendix 3 to AS 25 illustrates the general recognition and measurement principles for the preparation of interim financial reports. Paragraphs 8 to 16 of the Appendix provide guidance on the computation of income-tax expense for the interim period, which are reproduced in Appendix A to this Guidance Note for ready reference. Paragraph 8 of the Appendix states as below:

   "8. Interim period income tax expense is accrued using the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate applied to the pre-tax income of the interim period."

5. The various steps involved in the measurement of income tax expense for the purpose of interim financial reports are as below:

   (i) An enterprise will first have to estimate its annual accounting income. For this purpose, an enterprise would have to take into account all probable events and transactions that are expected to occur during the financial year. Such an estimate would involve, e.g., estimating on prudent basis, the depreciation on expected expenditure on acquisition of fixed assets, profits from sale of fixed assets/investments, etc. Such future events and transactions should be taken into account only if there is a reasonable certainty that the same would take place during the financial year.

   (ii) The enterprise should next estimate its tax liability for the financial year. For this purpose, the enterprise will have to estimate taxable income for the year. By applying the enacted or the substantively enacted tax rate on the taxable income, an estimate of the current tax for the year is arrived at. The estimates of tax liability would have to be based on the estimated deductions, allowances, etc., that would be available to the enterprise, provided there is a reasonable certainty for the same. The enterprise would also have to estimate the deferred tax assets/liabilities by applying the principles of Accounting Standard (AS) 22, 'Accounting for Taxes on Income', issued by the Institute of Chartered Accountants of India. Special considerations may have to be applied in certain cases as below:

      (a) Where brought forward losses exist from the previous financial year (when deferred tax asset was not recognised on considerations of prudence as per AS 22): In such a situation, for estimating the current tax liability, the brought forward losses would have to be deducted from the estimated annual accounting income as explained in paragraph 16 of Appendix 3 to AS 25 (reproduced in Appendix A to this Guidance Note). Since such carried forward losses will get set-off during the year, these would not have any tax consequence in future periods.

      (b) Where brought forward losses exist (when deferred tax asset was recognised on the considerations of prudence as per AS 22): In such a situation, current tax would be computed in the same manner as explained in (a) above. However, in the determination of deferred tax, the tax expense arising from the reversal of the deferred tax asset recognised previously, to the extent of reversal of deferred tax asset in the current year, would also be considered.

   (iii) The enterprise would now have to calculate the weighted average annual effective tax rate. This tax rate would be determined by dividing the estimated tax expense as arrived at step (ii) above by the estimated annual accounting income as arrived at step (i) above. Where different tax rates are applicable to different portions of the estimated annual accounting income, e.g., normal tax rate and a different tax rate for capital gains, the weighted average annual effective tax rate would have to be calculated separately for such portions of estimated annual accounting income.

(iv) The weighted average annual effective tax rate arrived at step (iii) would be applied to the accounting income for the interim period for determining the income tax expense to be recognised in the interim financial reports.

6. Accounting for interim period income-tax expense as suggested above is based on the approach prescribed in AS 25 that the interim period is part of the whole accounting year (often referred to as the 'integral approach') and, therefore, the said expense should be worked out on the basis of the estimated weighted average annual effective income-tax rate. According to this approach, the said rate is determined on the basis of the taxable income for the whole year, and applied to the accounting income for the interim period in order to determine the amount of tax expense for that interim period. This is in contrast to accounting for certain other expenses such as depreciation which is based on the approach prescribed in AS 25 that the interim period should be considered on stand-alone basis (often referred to as the 'discrete approach') because expenses such as depreciation are worked out on the basis of the period for which a fixed asset was available for use. The aforesaid treatments are, however, consistent with the requirement contained in paragraph 27 of AS 25 that an enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements.

7. Appendix B contains examples of computing weighted average annual effective tax rate.

## APPENDIX A

### Extracts From Appendix 3 to Accounting Standard (AS) 25, Interim Financial Reporting

### Measuring Income Tax Expense for Interim Period

8. Interim period income tax expense is accrued using the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate applied to the pre-tax income of the interim period.

9. This is consistent with the basic concept set out in paragraph 27 that the same accounting recognition and measurement principles should be applied in an interim financial report as are applied in annual financial statements. Income taxes are assessed on an annual basis. Therefore, interim period income tax expense is calculated by applying, to an interim period's pre-tax income, the tax rate that would be applicable to expected total annual earnings, that is, the estimated average effective annual income tax rate. That estimated average annual income tax rate would reflect the tax rate structure expected to be applicable to the full year's earnings including enacted or substantively enacted changes in the income tax rates scheduled to take effect later in the financial year. The estimated average annual income tax rate would be re-estimated on a year-to-date basis, consistent with paragraph 27 of this Statement. Paragraph 16(d) requires disclosure of a significant change in estimate.

10. To the extent practicable, a separate estimated average annual effective income tax rate is determined for each governing taxation law and applied individually to the interim period pre-tax income under such laws. Similarly, if different income tax rates apply to different categories of income (such as capital gains or income earned in particular industries), to the extent practicable a separate rate is applied to each individual category of interim period pre-tax income. While that degree of precision is desirable, it may not be achievable in all cases, and a weighted average of rates across such governing taxation laws or across categories of income is used if it is a reasonable approximation of the effect of using more specific rates.

11. As illustration, an enterprise reports quarterly, earns Rs. 150 lakhs pre-tax profit in the first quarter but expects to incur losses of Rs 50 lakhs in each of the three remaining quarters (thus having zero income for the year), and is governed by taxation laws according to which its estimated average annual income tax rate

is expected to be 35 per cent. The following table shows the amount of income tax expense that is reported in each quarter:

(Amount in Rs. lakhs)

| | 1st Quarter | 2nd Quarter | 3rd Quarter | 4th Quarter | Annual |
|---|---|---|---|---|---|
| Tax Expense | 52.5 | (17.5) | (17.5) | (17.5) | 0 |

### Difference in Financial Reporting Year and Tax Year

12. If the financial reporting year and the income tax year differ, income tax expense for the interim periods of that financial reporting year is measured using separate weighted average estimated effective tax rates for each of the income tax years applied to the portion of pre-tax income earned in each of those income tax years.

13. To illustrate, an enterprise's financial reporting year ends 30 September and it reports quarterly. Its year as per taxation laws ends 31 March. For the financial year that begins 1 October, Year 1 ends 30 September of Year 2, the enterprise earns Rs 100 lakhs pre-tax each quarter. The estimated weighted average annual income tax rate is 30 per cent in Year 1 and 40 per cent in Year 2.

(Amount in Rs. lakhs)

| | Quarter Ending 31 Dec. Year 1 | Quarter Ending 31 Mar. Year 1 | Quarter Ending 30 June Year 2 | Quarter Ending 30 Sep. Year 2 | Year Ending 30 Sep. Year 2 |
|---|---|---|---|---|---|
| Tax Expense | 30 | 30 | 40 | 40 | 140 |

### Tax Deductions/Exemptions

14. Tax statutes may provide deductions/exemptions in computation of income for determining tax payable. Anticipated tax benefits of this type for the full year are generally reflected in computing the estimated annual effective income tax rate, because these deductions/exemptions are calculated on an annual basis under the usual provisions of tax statutes. On the other hand, tax benefits that relate to a one-time event are recognised in computing income tax expense in that interim period, in the same way that special tax rates applicable to particular categories of income are not blended into a single effective annual tax rate.

### Tax Loss Carry forwards

15. A deferred tax asset should be recognised in respect of carry forward tax losses to the extent that it is virtually certain, supported by convincing evidence, that future taxable income will be available against which the deferred tax assets can be realised. The criteria are to be applied at the end of each interim

period and, if they are met, the effect of the tax loss carry forward is reflected in the computation of the estimated average annual effective income tax rate.

16. To illustrate, an enterprise that reports quarterly has an operating loss carryforward of Rs 100 lakhs for income tax purposes at the start of the current financial year for which a deferred tax asset has not been recognised. The enterprise earns Rs 100 lakhs in the first quarter of the current year and expects to earn Rs 100 lakhs in each of the three remaining quarters. Excluding the loss carryforward, the estimated average annual income tax rate is expected to be 40 per cent. The estimated payment of the annual tax on Rs. 400 lakhs of earnings for the current year would be Rs. 120 lakhs {(Rs. 400 lakhs - Rs. 100 lakhs) x 40%}. Considering the loss carryforward, the estimated average annual effective income tax rate would be 30% {(Rs. 120 lakhs/Rs. 400 lakhs) x 100}. This average annual effective income tax rate would be applied to earnings of each quarter. Accordingly, tax expense would be as follows:

(Amount in Rs. lakhs)

| | 1st Quarter | 2nd Quarter | 3rd Quarter | 4th Quarter | Annual |
|---|---|---|---|---|---|
| Tax Expense | 30.00 | 30.00 | 30.00 | 30.00 | 120.00 |

Appendix B

Examples of Computation of Weighted Average Annual Effective Tax Rate

Example 1: When deferred tax asset was not recognised for carried forward losses from earlier accounting periods.

| | QUARTER I | QUARTER II | QUARTER III | QUARTER IV | Total |
|---|---|---|---|---|---|
| | Rs. | Rs. | Rs. | Rs. | Rs. |
| Estimated Pre-tax Income (after considering estimated depreciation on the probable acquisition of fixed assets during the year) | (25) | 175 | (25) | 50 | 175 |
| Carried forward losses from earlier accounting periods, the deferred tax asset in respect of which was not recognised as it did not meet the requirements of prudence laid down in AS 22. During this year, in view of the | | | | | (25) |

| | | | | | |
|---|---|---|---|---|---|
| expected taxable income, this loss is expected to be set off thereagainst. Therefore, it will not have any tax effect on future periods. | | | | | |
| Additional estimated depreciation as per tax laws as compared to the accounting depreciation after considering depreciation on probable capital expenditure on acquisition of fixed assets during the year. | | | | | (50) |
| Estimated taxable income on which tax payable. | | | | | 100 |
| Applicable tax rate (say) | | | | | 30% |
| Estimated current tax expense for the year. | | | | | 30 |
| Estimated deferred tax expense for the year (50x30/100) | | | | | 15 |
| Weighted Average Annual Effective Tax Rate (current tax) | | | | | $\frac{30}{175}$ x100=17.14% |
| Weighted Average Annual Effective Tax Rate (deferred tax)_ | | | | | $\frac{15}{175}$ x 100 =8.57% |
| Tax expense for the interim period<br>Current tax<br>Deferred tax<br>Total | (4.29)<br>(2.14)<br>(6.43) | 30<br>15<br>45 | (4.29)<br>(2.14)<br>(6.43) | 8.57<br>4.29<br>12.86 | 29.99<br>15.01<br>45.00 |

(a) The above calculation needs to be done for every interim period for which recognition and measurement of tax expense is required.

(b) It is presumed that there are no other differences between accounting income and taxable income.

Example 2: When deferred tax asset was recognised for carried forward losses from earlier accounting periods.

| | QUARTER I | QUARTER II | QUARTER III | QUARTER IV | Total |
|---|---|---|---|---|---|
| | Rs. | Rs. | Rs. | Rs. | Rs. |
| Estimated Pre-tax Income (after considering estimated depreciation on the probable acquisition of fixed assets during the year) | (25) | 175 | (25) | 50 | 175 |
| Carried forward losses from earlier accounting periods, the deferred tax asset in respect of which was recognised on the basis of considerations of AS 22. During this year, in view of the expected taxable income, this loss is expected to be set off thereagainst. This will result in reversal of the deferred tax asset in the current year. | | | | | (25) |
| Additional estimated depreciation as per tax laws as compared to the accounting depreciation after considering depreciation on probable capital expenditure on acquisition of fixed assets during the year. | | | | | (50) |
| Estimated taxable income on which tax payable. | | | | | 100 |
| Applicable tax rate (say) | | | | | 30% |
| Estimated current tax expense for the year. | | | | | 30 |
| Estimated deferred tax expense for the year:<br>(i) Defered tax liability on account of timing difference in depreciation (50x30/100) 15 | | | | | 22.5 |

| | | | | | |
|---|---|---|---|---|---|
| (ii) Reversal of deferred tax asset<br>(25x30/100) 7.5 | | | | | |
| Weighted Average Annual Effective Tax Rate (Current tax) | | | | | $\frac{30}{175}$ x100=17.14% |
| Weighted Average Annual Effective Tax Rate (Deferred tax) | | | | | $\frac{22.5}{175}$ x100=12.86% |
| Tax expense for the interim period<br>Current tax<br>Deferred tax<br>Total | (4.29)<br>(3.21)<br>(7.50) | 30.0<br>22.5<br>52.5 | (4.29)<br>(3.21)<br>(7.50) | 8.57<br>6.43<br>15.00 | 29.99<br>22.51<br>52.50 |

(a) The above calculation needs to be done for every interim period for which recognition and measurement of tax expense is required.

(b) It is presumed that there are no other differences between accounting income and taxable income.

Example 3: When progressive rates of tax are applicable

Under the Indian tax system, the tax rates for corporates and firms are not progressive (i.e., based on levels of income), but are flat rates. Therefore, the tax rate to be applied in the interim period would be the normal rate applicable to the entity. However, the calculation of weighted average annual effective tax rate can be illustrated as below where the tax rates are progressive:

Estimated annual income Rs.1 lakh

Assumed Tax Rates:

On first Rs. 40,000 30%

On the balance income 40%

Tax expense: 30% of Rs. 40,000 + 40% of Rs. 60,000 = Rs. 36,000

Weighted average annual effective tax rate $= \frac{36,000}{1,00,000} \times 100 = 36\%$

Supposing the estimated income of each quarter is Rs. 25,000, the tax expense of Rs. 9,000 (36% of Rs. 25,000) would be recognised in each of the quarterly financial reports.

Example 4:When different rates of tax are applicable to different portions of the estimated annual accounting income (refer para5(iii))

Estimated annual income Rs. 1 lakh

(inclusive of Estimated Capital Gains (earned in Quarter II) Rs. 20,000

Assumed Tax Rates:

| | |
|---|---|
| On Capital Gains | 10% |
| On other income: | |
| First Rs. 40,000 | 30% |
| Balance income | 40% |

Assuming there is no difference between the estimated taxable income and the estimated accounting income,

Tax Expense:

On Capital Gains portion of annual income:

| | |
|---|---|
| 10% of Rs. 20,000 | Rs. 2,000 |
| On other income: 30% of Rs. 40,000 + 40% of Rs.40,000 | Rs.28,000 |
| Total: | Rs.30,000 |

Weighted Average Annual Effective Tax Rate:

On Capital Gains portion of annual income: $\frac{2,000}{20,000} \times 100 = 10\%$

On other income: $\frac{28,000}{80,000} \times 100 = 35\%$

Supposing the estimated income of each quarter is Rs.25,000, when income of Rs.25,000 for 2nd Quarter includes capital gains of Rs.20,000, the tax expense for each quarter will be calculated as below:

| | | Income | Tax Expense | | |
|---|---|---|---|---|---|
| Quarter I: | | Rs. 25,000 | 35% of Rs. 25,000 = | Rs. 8,750 | |
| Quarter II: | Capital Gains: | Rs. 20,000 | 10% of Rs. 20,000 = | Rs. 2,000 | |
| | Other: | Rs. 5,000 | 35% of Rs. 5,000 = | Rs. 1,750 | Rs.12,500 |
| Quarter III: | | Rs. 25,000 | 35% of Rs. 25,000 = | | Rs. 8,750 |
| Quarter IV: | | Rs. 25,000 | 35% of Rs. 25,000 = | | Rs. 8,750 |
| Total tax expense for the year | | | | | Rs. 30,000 |

## CHAPTER 6 - UNIT 8 ACCOUNTING FOR FINANCIAL INSTRUMENTS

Recently, the Institute of Chartered Accountants of India came out with the Accounting Standards 30, 31, 32 for recognition, measurement, presentation and disclosures of financial instruments. The unit on Financial Instruments has, therefore, been revised in line with these standards. Students are advised to read the same in place of the given unit in the existing Final Course (existing) Study Material.

REVISED UNIT

## 1. Introduction

During the last few years, a number of new financial instruments have assumed significance in the Indian economy. With rapid globalization, this trend is likely to accelerate in future. Derivatives are a kind of financial instruments whose values change in response to the change in specified interest rates, security prices, commodity prices, index of prices or rates, or similar variables. Typical examples of derivatives are futures and forward contracts, swaps and option contracts. Recently, the Institute of Chartered Accountants of India came out with the Accounting Standards 30, 31, 32 for recognition, measurement , presentation and disclosures of financial instruments.

## 2. Categories of Financial Instruments

The four categories are:

a) Held for Trading

b) Held to maturity

c) Loans & Recievable

c) Available for sale

Held for trading: A financial asset or financial liability is classified as held for trading if it is:

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

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

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

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity other than:

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

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

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

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than: (a) those that the entity intends to sell immediately or in the near term, which should be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss; (b) those that the entity upon initial recognition designates as available for sale; or (c) those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which should be classified as available for sale.

Available-for-sale financial assets are those non-derivative financial assets that are designated as available for sale or are not classified as

(a) loans and receivables,

(b) held-to-maturity investments, or

(c) financial assets at fair value through profit or loss.

### 2.1 Derivatives

Derivatives are financial instruments that drive their value from changes in benchmark based on stock prices, interest rates, mortgage rates, currency rates, commodity prices or some other agreed upon base. The method of accounting for derivatives would depend on the standard issued by the ICAI and pronouncements of other regulatory bodies such as the Securities and Exchange Board of India. However, the main issues relating to its accounting are its recognition, classification, impairment and de-recognition.

According to Para 8 of AS 30, A derivative is a financial instrument or other contract within the scope of this Standard with all three of the following characteristics:

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

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

(c) it is settled at a future date.

### 2.2 Hedge Accounting

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

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

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

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

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

A proportion of the entire hedging instrument, such as 50 per cent of the notional amount, may be designated as the hedging instrument in a hedging relationship. However, a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding. A single hedging instrument may be designated as a hedge of more than one type of risk provided that (a) the risks hedged can be identified clearly; (b) the effectiveness of the hedge can be demonstrated; and (c) it is possible to ensure that there is specific designation of the hedging instrument and different risk positions.

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

A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation. The hedged item can be (a) a single asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation, (b) a group of assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations with similar risk characteristics or (c) in a portfolio hedge of interest rate risk only, a portion of the portfolio of financial assets or financial liabilities that share the risk being hedged. Unlike loans and receivables, a held-to-maturity investment cannot be a hedged item with respect to interest-rate risk or prepayment risk because designation of an investment as held-to-maturity requires an intention to hold the investment until maturity without regard to changes in the fair value or cash flows of such an investment attributable to changes in interest rates. However, a held-to-maturity investment can be a hedged item with respect to risks from changes in foreign currency exchange rates and credit risk.

For hedge accounting purposes, only assets, liabilities, firm commitments or highly probable forecast transactions that involve a party external to the entity can be designated as hedged items. It follows that hedge accounting can be applied to transactions between entities or segments in the same group only in the individual or separate financial statements of those entities or segments and not in the consolidated financial statements of the group. As an exception, the foreign currency risk of an intragroup monetary item (e.g., a payable/receivable between two subsidiaries) may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation in accordance with Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates. In accordance with AS 11, foreign exchange rate gains and losses on intra-group monetary item are not fully eliminated on consolidation when the intra-group monetary item is transacted between two group entities that have different functional currencies[1]. In addition, the foreign currency risk of a highly probable forecast intra-group transaction may qualify as a hedged item in consolidated financial statements provided that the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss.

If the hedged item is a financial asset or financial liability, it may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value (such as one or more selected contractual cash flows or portions of them or a percentage of the fair value) provided that effectiveness can be measured. For example, an identifiable and separately measurable portion of the interest rate exposure of an interest-bearing asset or interest-bearing liability may be designated as the hedged risk (such as a risk-free interest rate or benchmark interest rate component of the total interest rate exposure of a hedged financial instrument). In a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only in such a hedge), the portion hedged may be designated in terms of an amount of a currency (e.g. an amount of rupees, dollars, euro, pounds or rand) rather than as individual assets (or liabilities). Although the portfolio may, for risk management purposes, include assets and liabilities, the amount designated is an amount of assets or an amount of

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

liabilities. Designation of a net amount including assets and liabilities is not permitted. The entity may hedge a portion of the interest rate risk associated with this designated amount. For example, in the case of a hedge of a portfolio containing prepayable assets, the entity may hedge the change in fair value that is attributable to a change in the hedged interest rate on the basis of expected, rather than contractual, repricing dates. When the portion hedged is based on expected repricing dates, the effect that changes in the hedged interest rate have on those expected repricing dates should be included when determining the change in the fair value of the hedged item. Consequently, if a portfolio that contains prepayable items is hedged with a non-prepayable derivative, ineffectiveness arises if the dates on which items in the hedged portfolio are expected to prepay are revised, or actual prepayment dates differ from those expected.

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

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

Hedging relationships are of three types:

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

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

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

A hedging relationship qualifies for hedge accounting under AS 30 if, and only if, all of the following conditions are met.

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

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

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

(d) The effectiveness of the hedge can be reliably measured, i.e., the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured.

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

Fair Value Hedges

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

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

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

Cash Flow Hedges

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

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

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

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

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

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

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

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

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

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

Hedges of a Net Investment

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

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

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

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

2.3. Forwards and Options: A forward contract is basically a contractual arrangement in which one party buys and other party sells designated currency at a forward rate mutually agreed upon on the date of contract for delivery at designated future date. Accordingly, 'An enterprise may enter into a forward contract or other financial instrument that is in substance a forward exchange contract to establish the amount of reporting currency required or available at settlement date of a transaction. The difference between the forward rate and the exchange rate at the date of transaction should be recognised as income or expense over the life of the contract, except in respect of liabilities incurred for acquiring fixed assets, in which case, such difference should be adjusted in carrying amount of the respective fixed assets.

For example, suppose XYZ Ltd. needs $3,00,000 on May 1, 2009 for repayment of loan installment and interest. As on December 1, 2008, it appears to the company that the dollar may be dearer as compared to the exchange rate prevailing on that date, say $1 = Rs. 43.50. Accordingly, XYZ Ltd. may enter into a forward contract with a banker for $3,00,000. The forward rate may be higher or lower than the spot rate prevailing on the date of the forward contract. Let us assume forward rate as on December 1, 2008 was $ 1 = Rs. 44 as against the spot rate of Rs. 43.50. As on the future date, i.e., May 1, 2009, the banker will pay XYZ Ltd. $ 3,00,000 at Rs. 44 irrespective of the spot rate as on that date. Let us assume that the Spot rate as on that date is $ 1 = Rs. 44.80.

In the given example XYZ Ltd. gained Rs. 2,40,000 by entering into the forward contract.

| | |
|---|---|
| Payment to be made as per forward contract | |
| (US $3,00,000 × Rs. 44) | Rs. 1,32,00,000 |
| Amount payable had the forward | |
| contract not been in place | |
| (US $3,00,000 × Rs. 44.80) | Rs. 1,34,40,000 |
| Gain arising out of the forward | |
| exchange contract | Rs. 2,40,000 |

Currency options provide the corporate treasurer another tool for hedging foreign exchange risk arising out of the firm's operations. Unlike forward contract options allowing the hedger to gain from favourable exchange rate movements, Currency options are frequently suggested as an appropriate hedging tool because one can remove downside risk without limiting the upside potential. Options can be put option or a call option. A put option is a contract that specifies the currency that the holder has the right to sell. A call option is a contract that specifies the currency that the holder has the right to sell. This can better be explained with the help of an illustration.

In late February, an American Importer anticipates a Yen payment of JPY 100 million to a Japanese supplier sometime in late May. The current USD/JPY spot rate is 0.007739 (which implies that JPY/USD rate of 129.22). A June Yen call option on the Philadelphia Exchange with the strike price of $0.0078 per yen is available for a premium of 0.0108 cents per yen or $ 0.000108 per yen. A contract is for JPY 6.25 million. Premium per contact is therefore : $ 0.000108 × 6250000 = $ 675. The firm decides to purchase 16 calls for a total premium of $ 10800. In addition, there is a brokerage fee of $ 20 per contract. Thus, total expenses in buying the options is $ 11120. The firm has, in effect, ensured that its buying rate for yen will not exceed - $ 0.0078 + $ (11120/100000000) = $ 0.0079112 per yen. The yen depreciates to $ 0.0075 per yen in late may when the payment becomes due. The firm will not exercise the option. It can sell 16 calls in the market, provided the resale value exceeds the brokerage commission it will have to pay. Therefore, price per yen is $ 0.075 + 0.0001125 $. If Yen appreciates, then the firm will exercise option.

## 2.4 Stock Index Futures

Stock index futures are instruments where the underlying variable is a stock index future. Both the Bombay Stock Exchange and the National Stock Exchange have introduced index futures in June, 2000 and permit trading on the Sensex Futures and the Nifty Futures respectively. AS 13 on Accounting for Investments deals with accounting of shares, debenture and other securities. Accounting Standard (AS) 13, Accounting for Investments, stands withdrawn from the date AS 30 becomes applicable, except to the extent it relates to accounting for investment properties.

## 2.5 Embedded Derivatives

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

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

(a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract (see Appendix A paragraphs A50 and A53 of AS 30);

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

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

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

Notwithstanding paragraph 10 of AS 30, if a contract contains one or more embedded derivatives, an entity may designate the entire hybrid (combined) contract as a financial asset or financial liability at fair value through profit or loss unless:

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

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

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

If an entity is unable to determine reliably the fair value of an embedded derivative on the basis of its terms and conditions (for example, because the embedded derivative is based on an unquoted equity instrument), the fair value of the embedded derivative is the difference between the fair value of the hybrid (combined) instrument and the fair value of the host contract, if those can be determined under this Standard. If the entity is unable to determine the fair value of the embedded derivative using this method, paragraph 12 of AS 30 applies and the hybrid (combined) instrument is designated as at fair value through profit or loss.

An entity that applies this Standard for the first time should assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of the conditions that existed on the date it first became a party to the contract or on the date on which a reassessment is required by Appendix A paragraph A56 of AS 30, whichever is the later date.

## 3. Initial Recognition of Financial Instruments

An entity should recognise a financial asset or a financial liability on its balance sheet when, and only when, the entity becomes a party to the contractual provisions of the instrument. (See paragraphs 38-42 of AS 30 with respect to regular way purchases of financial assets.)

## 4. De-Recognition of Financial Assets and Liabilities

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

(a) Paragraphs 16-22 of AS 30 are applied to a part of a financial asset (or a part of a group of similar financial assets) if, and only if, the part being considered for derecognition meets one of the following three conditions.

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

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

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

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

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

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

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

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

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

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

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

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

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

An exchange between an existing borrower and lender of debt instruments with substantially different terms should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, should be recognised in the statement of profit and loss. If an entity repurchases a part of a financial liability, the entity allocates the previous carrying amount of the financial liability between the part that continues to be recognised and the part that is derecognised based on the relative fair values of those parts on the date of the repurchase. The difference between (a) the carrying amount allocated to the part derecognised and (b) the consideration paid, including any non-cash assets transferred or liabilities assumed, for the part derecognised is recognised in the statement of profit and loss.

5. Measurement

Initial Measurement of Financial Assets and Financial Liabilities

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

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

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

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

When an entity uses settlement date accounting for an asset that is subsequently measured at cost or amortised cost, the asset is recognised initially at its fair value on the trade date (see paragraphs 38–42 of AS 30). Often it will be obvious whether the effect of discounting of short-term receivables and payables would be material or immaterial and there would be no need to make detailed calculations. In other cases, it will be necessary to make detailed calculations.

Subsequent Measurement of Financial Assets

For the purpose of measuring a financial asset after initial recognition, this Standard classifies financial assets into the following four Categories defined in paragraphs 8.2 to 8.5 of AS 30:

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

(b) held-to-maturity investments;

(c) loans and receivables; and

(d) available-for-sale financial assets.

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

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

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

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

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

Subsequent Measurement of Financial Liabilities

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

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

(b) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies. Paragraphs 29 and 31 of AS 30 apply to the measurement of such financial liabilities.

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

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

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

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

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

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

    (ii) the amount initially recognised (see paragraphs 47-49 of AS 30) less, when appropriate, cumulative amortisation recognised, if any.

Financial liabilities that are designated as hedged items are subject to the hedge accounting requirements in paragraphs 99-113 of AS 30.

## 6. Reclassifications

An entity should not reclassify a financial instrument into or out of the fair value through profit or loss category while it is held or issued. If, as a result of a change in intention or ability, it is no longer appropriate to classify an investment as held to maturity, it should be reclassified as available for sale and remeasured at fair value, and the difference between its carrying amount and fair value should be accounted for in accordance with paragraph 61(b) of AS 30.

## 7. Impairment and Uncollectibility of Financial Assets

An entity should assess at each balance sheet date whether there is any objective evidence that a financial asset or group of financial assets is impaired. If any such evidence exists, the entity should apply paragraph 69 (for financial assets carried at amortised cost), paragraph 72-74 of AS 30 (for short-term receivables with no stated interest rate carried at original invoice amount), paragraph 75 of AS 30 (for financial assets carried at cost) or paragraph 76 of AS 30 (for available-for-sale financial assets) to determine the amount of any impairment loss.

## 8. Gains and Losses

A gain or loss arising from a change in the fair value of a financial asset or financial liability that is not part of a hedging relationship, should be recognised, as follows.

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

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

For financial assets and financial liabilities carried at amortised cost, a gain or loss is recognised in the statement of profit and loss when the financial asset or financial liability is derecognised or impaired, and through the amortisation process. However, for financial assets or financial liabilities that are hedged items the accounting for the gain or loss should follow paragraphs 99-113 of AS 30.

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

### Illustration 1

A Ltd. lent Rs. 20,000 for 8 years at 8% interest payable annually. At the time, the fair value of the loan at effective annual interest rate of 10.2% was Rs. 17,670. The borrower had the option to pre-pay the loan. After 3 years, when amortized cost of the loan was Rs. 18,100, the company transferred its right to receive principal to the extent of Rs. 90% and interest to the extent of 9.5% in favour of B Ltd. The consideration for the transaction was Rs. 16,700. The other particulars of the transaction were as below:

(a) Fair value of the loan at the time of transaction at effective interest rate of 10% was Rs. 18,484. A Ltd. retained the excess spread of 0.5% principal transferred.

(b) A Ltd. retained the right to receive collections of principal to the extent of Rs. 2,000 plus interest thereon. Defaults if any, are deductible from the company's claim on the principal, subject to maximum Rs. 2,000.

(c) The estimated fair value of the excess spread of 0.5% is Rs. 38.

(d) Collections from pre-payments are to be allocated between A Ltd. and the transferee proportionately in the ratio of 1:9.

Show the necessary computations to record the transfer.

### Solution

The company has transferred the significant prepayment risk but has retained control over the loan. It has also retained significant default risk, giving credit enhancement for the transferee. The continuing involvement approach in this case is appropriate.

### Allocation of carrying amount of loan

| Component of loan | Fair Value | Proportion | Carrying amount allocated |
|---|---|---|---|
| | Rs. | Rs. | Rs. |
| Part transferred | 16,636 | 90% | 16,290 |

| | | | |
|---|---|---|---|
| Part retained | 1,848 | 10% | 1,810 |
| | 18,484 | | 18,100 |

Gain from part transferred = Rs. 16,636 – Rs. 16,290 = Rs. 346

Carrying amount of part retained = Rs. 1,810

Fair value of part transferred = Rs. 16,636

Consideration received from transferee = Rs. 16,700

Value of credit enhancement = Rs. 16,700 – Rs. 16,636 = Rs. 64

Value of interest strip = Rs. 38

Value of income recognised in subsequent time periods on time proportion basis

= Rs. 64 + Rs. 38 = Rs. 102

In respect of principal not transferred, the company should recognize Rs. 2,000 as asset as well as liability (for the possibility of default) for continued involvement.

Value of liability for continued involvement

= Principal retained + Deferred Income = Rs. 2,000 + Rs. 102 = Rs. 2,102

### Illustration 2

At the beginning of year 1, an enterprise issued 20,000 convertible debentures with face value Rs. 100 per debenture, at par. The debentures have six-year term. The interest at annual rate of 9% is paid half-yearly. The bondholders have an option to convert half of the face value of debentures into 2 ordinary shares at the end of year 3. The bondholders not exercising the conversion option will be repaid at par to the extent of Rs. 50 per debenture at the end of year 3. The non-convertible portion will be repaid at 10% premium at the end of year 6. At the time of issue, the prevailing market interest rate for similar debt without conversion option was 10%. Compute value of embedded derivative.

Solution

| Half-year | Cash Flow Rs. 000 | DF (5%) | PV Rs. 000 |
|---|---|---|---|
| 1 – 6 | 90 | 5.076 | 456.84 |
| 7 – 12 | 45 | 3.787 | 170.41 |
| 12 | 1,100 | 0.557 | 612.70 |
| Value of host (Liability component) | | | 1,239.95 |
| Value of embedded derivative (Equity component) | | | 760.05 |
| Issue proceeds | | | 2,000.00 |

### Illustration 3

Certain callable convertible debentures are issued at Rs. 60. The value of similar debentures without call or equity conversion option is Rs. 57. The value of call as determined using Black and Scholes model for option pricing is Rs. 2.

Determine values of liability and equity component.

### Solution

A callable bond is one that gives the issuer a right to buy the bond from the bondholders at a specified price. This feature in effect is a call option written by the bondholder. The option premium (value of call) is payable by the issuer.

Liability component (disregarding the call) = Rs. 57

Value of call payable by issuer = Rs. 2

Liability component = Rs. 57 – Rs. 2 = Rs. 55

Equity component = Rs. 60 – Rs. 55 = Rs. 5

### Illustration 4

On 1 April, 2008 Delta Ltd. issued Rs.30,00,000, 6 % convertible debentures of face value of Rs. 100 per debenture at par. The debentures are redeemable at a premium of 10% on 31.03.12 or these may be converted into ordinary shares at the option of the holder, the interest rate for equivalent debentures without conversion rights would have been 10%. Being compound financial instrument, you are required to separate equity and debt portion as on 01.04.08. The present value of Re. 1 receivable at the end of the end of each year based on discount rates of 6% and 10% can be taken as:

| | 6% | 10% |
|---|---|---|
| End of year 1 | 0.94 | 0.91 |
| 2 | 0.89 | 0.83 |
| 3 | 0.84 | 0.75 |
| 4 | 0.79 | 0.68 |

### Answer

Computation of Equity and Debt Component of Convertible Debentures as on 1.4.08

| | Rs. |
|---|---|
| Present value of the principal repayable after four years | |
| [30,00,000 × 1.10 × 0.68 (10% Discount factor)] | 22,44,000 |
| Present value of Interest [1,80,000 x 3.17 (4 years cumulative 10% discount factor)] | 5,70,600 |
| Value of debt component | 28,14,600 |
| Value of equity component | 1,85,400 |
| Proceeds of the issue | 30,00,000 |

### Self-examination Questions

1. Define financial instruments in brief.
2. Write short Notes on:

(i) Embedded Derivatives.

(ii) Loss arising from a change in the fair value of a financial asset.

(iii) Available-for-sale financial assets.

3. How is the difference between forward rate and exchange rate recognized on the date of transaction in a forward contract?

4. On March 30, 2006, fair value per ordinary share of A Ltd. was Rs. 45. On this dare, B Ltd. committed to buy 10,000 of these shares at fair value. B Ltd. paid the price and accepted delivery of these shares on April 3, 2006. B Ltd. closed its annual accounts on March 31, 2006. Fair value of A Ltd. shares was Rs. 45.40 on March 31, 2006 and Rs. 45.30 on April 3, 2006.

Show journal entries in the books of B Ltd. in respect of above in the following three cases:

(a) B Ltd. classifies its investments in A Ltd. as 'financial asset held-to-maturity'

(b) B Ltd. classifies its investments in A Ltd. as 'financial asset available for sale'

5. A Ltd. borrows Rs. 10 lakh from B Ltd. under the following terms:

(a) The loan will carry 5% annual rate of interest, payable at the end of each year.

(b) A Ltd. will make immediate payment of an origination fee of Rs. 70,000 to B Ltd.

(c) The principal will be repaid in two instalments, Rs. 4 lakh at the end of year 3 and Rs. 6 lakh at the end of year 5.

Show the Loan Account in books of B Ltd.

# CHAPTER 8 IAS, US GAAP AND STANDARDS IN INDIA

This chapter has been revised corresponding to the latest changes in the area of IAS, IFRS, US GAAP and Indian Accounting Standards. Students are advised to go through the revised chapter instead of the chapter given in the Final Course (existing) Study Material.

## 1. INTRODUCTION

In today's complex economic environment, the measurement and presentation of financial information is critical as far as allocation of economic resources is concerned. Accounting was created as a mean of measuring and reporting upon such economic activity. Throughout the world, various accounting bodies are engaged in the task of formulating and implementing accounting policies and practices to show true and fair view of the financial statements, which are the basis of decision-making.

Accounting as a language of business communicates the financial results of an enterprise to various interested parties by means of financial statements exhibiting true and fair view of its state of affairs as also of the working results. Like any other language, accounting has its own set of rules, which have been developed by accounting bodies. These rules cannot be absolutely rigid like those of the physical sciences. These rules, accordingly, do provide a reasonable degree of flexibility in line with the economic environment, social needs, legal requirements and technological developments. This however, does not imply that accounting principles and practices can be applied arbitrarily. Accounting principles have to operate within the bounds of rationality. This could, perhaps, be considered as a genesis for setting the accounting standards.

Accounting Standards (ASs) are written policy documents issued by expert accounting body or by government or other regulatory body covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions in the financial statements. The ostensible purpose of the standard setting bodies is to promote the dissemination of timely and useful financial information to investors and certain other parties having an interest in the company's economic performance. The Accounting Standards reduce the accounting alternatives in the preparation of financial statements within the bounds of rationality, thereby ensuring comparability of financial statements of different enterprises. The Accounting Standards deal with the issues of (i) recognition of events and transactions in the financial statements, (ii) measurement of these transactions and events, (iii) presentation of these transactions and events in the financial statements in a manner that is meaningful and understandable to the reader, and (iv) the disclosure requirements which should be there to enable the public at large and the stakeholders and the potential investors in particular, to get an insight into what these financial statements are trying to reflect and thereby facilitating them to take prudent and informed business decisions.

Accounting Standards standardize diverse accounting policies with a view to eliminate, to the maximum possible extent, (i) the non-comparability of financial statements and thereby improving the reliability of financial statements, and (ii) to provide a set of standard accounting policies, valuation norms and disclosure requirements.

The last decade has witnessed a sea change in the global economic scenario. The emergence of transnational corporations in search of money, not only for fuelling growth, but to sustain on going activities has necessitated raising of capital from all parts of the world, cutting across frontiers. Each country has its own set of rules and regulations for accounting and financial reporting. Therefore, when an enterprise decides to raise capital from the markets other than the country in which it is located, the rules and regulations of that other country will apply and this in turn will require that the enterprise is in a position to understand the differences between the rules governing financial reporting in the foreign country as compared to its own country of origin. Therefore translation and re-instatements are of utmost importance in a world that is rapidly globalising in all ways. In themselves also, the accounting standards and principle need to be robust so that the larger society develops degree of confidence in the financial statements, which are put forward by organizations.

## 2. INTERNATIONAL ACCOUNTING STANDARD BOARD

With a view of achieving these objectives, the London based group namely the International Accounting Standards Committee (IASC), responsible for developing International Accounting Standards, was established in June, 1973. It is presently known as International Accounting Standards Board, The IASC comprises the professional accountancy bodies of over 75 countries (including the Institute of Chartered Accountants of India). Primarily, the IASC was established, in the public interest, to formulate and publish, International Accounting Standards to be followed in the presentation of audited financial statements. International Accounting Standards were issued to promote acceptance and observance of International Accounting Standards worldwide. The members of IASC have undertaken a responsibility to support the standards promulgated by IASC and to propagate those standards in their respective countries.

Between 1973 and 2001, the International Accounting Standards Committee (IASC) released International Accounting Standards. Between 1997 and 1999, the IASC restructured their organization, which resulted in formation of International Accounting Standards Board (IASB). These changes came into effect on 1st April, 2001. Subsequently, IASB issued statements about current and future standards: IASB publishes its Standards in a series of pronouncements called International Financial, Reporting Standards (IFRS). However, IASB has not rejected the standards issued by the ISAC. Those pronouncements continue to be designated as "International Accounting Standards" (IAS). The IASB approved IASB Resolution on IASC Standards at their meeting in April, 2001, in which it confirmed the status of all IASC Standards and SIC Interpretations in effect as on 1st April, 2001.

## 3. INTERNATIONAL FINANCIAL REPORTING STANDARDS

IASs were issued between 1973 and 2001 by Board of the International Accounting Standards Committee (IASC). In April 2001 the IASB adopted all IASs and continued the development, calling new standards IFRSs.

Although IASs are no longer produced, they are still in effect unless replaced by an IFRS, whether in its entirety or part of.

International Financial Reporting Standards in a broad sense comprise:

- Framework for the Preparation and Presentation of Financial Statements—stating basic principles and grounds of IFRS
- IAS—standards issued before 2001
- IFRS—standards issued after 2001
- SIC—interpretations of accounting standards, giving specific guidance on unclear issues
- IFRIC—newer interpretations, issued after 2001

IASs and IFRSs can be classified into following categories.

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| PRESENTATION | |
| IFRS 1 | First-Time Adoption of IFRS |
| IAS 1 | Presentation of Financial Statements |
| IAS 7 | Cash Flow Statements |
| IAS 8 | Accounting Policies, Changes in Accounting Estimates, and Errors |
| BALANCE SHEET AND INCOME STATEMENT | |
| IFRS 2 | Share-Based payment |
| IFRS 4 | Insurance Contracts |
| IAS 2 | Inventories |
| IAS 11 | Construction Contracts |
| IAS 12 | Income Taxes |
| IAS 16 | Property, Plant, and Equipment |
| IAS 17 | Leases |
| IAS 18 | Revenue |
| IAS 19 | Employee Benefits |
| IAS 20 | Accounting for Government Grants and Disclosure of Government Assistance |
| IAS 21 | The Effects of Changes in Foreign Exchange Rates |
| IAS 23 | Borrowing Costs |
| IAS 36 | Impairment of Assets |
| IAS 37 | Provisions, Contingent Liabilities, and Contingent Assets |
| IAS 38 | Intangible Assets |
| IAS 39 | Financial Instruments: Recognition and Measurement |
| IAS 40 | Investment Property |
| IAS 41 | Agriculture |

GROUP STATEMENTS

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| IFRS 3 | Business Combinations |
| IAS 27 | Consolidated and Separate Financial Statements |
| IAS 28 | Investments in Associates |
| IAS 31 | Interests in Joint ventures |

DISCLOSURE

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| IFRS 5 | Non-current Assets Held for Sale and Discontinued Operations |
| IFRS 6 | Exploration for and Evaluation of Mineral Resources |
| IFRS 7 | Financial Instruments: Disclosures |
| IFRS 8 | Operating Segments |
| IAS 10 | Events After the Balance Sheet Date |
| IAS 24 | Related-Party Disclosures |
| IAS 26 | Accounting and Reporting by Retirement Benefit Plans |
| IAS 29 | Financial Reporting in Hyperinflationary Economies |
| IAS 32 | Financial Instruments: Presentation |
| IAS 33 | Earnings per Share |
| IAS 34 | Interim Financial Reporting |

Note: IFRS 9 Financial Instruments Classification and Measurement was issued In Nov.2009. This will be effective for annual periods beginning on or after 1$^{st}$ Jan., 2013.

4. US GAAPS

GAAP refers to accounting policies and procedures that are widely used in practice. Unlike India where accounting has its basis in law, US GAAP has evolved to be a collection of pronouncements issued by particular accounting organisation. US GAAPs are the accounting rules used to prepare financial statements for publicly traded companies and many private companies in the United States. Generally accepted accounting principles for local and state governments operates under a different set of assumptions, principles, and constraints, as determined by the Governmental Accounting Standards Board (GASB).

In the United States, as well as in other countries practicing under the English common law system, the government does not set accounting standards, in the belief that the private sector has better knowledge and resources. The Securities and Exchange Commission (SEC) has the ultimate authority to set US accounting and financial reporting standards for public (listed) companies. The SEC has delegated this responsibility to the private sector led by the Financial Accounting Standards Board (FASB). Other private sector bodies including the American Institute of Certified Public Accountants (AICPA) and the FASB's Emerging Issues Task Force (EITF) also establish authoritative accounting standards in the United States. Interpretations of the Financial Accounting Standard Board (FIN) also provide implementation and interpretation guidance. The SEC has the statutory authority to establish GAAP for filings made with it. While allowing most of the standard settings to be done in the private sector, the SEC is still very active in both its oversight responsibility as well as establishing guidance and interpretations, as it believes appropriate. US GAAP have the reputation around the world of being more prescriptive and detailed than accounting standards in other countries. In order to organise and make clear what is meant by US GAAP, a GAAP hierarchy has been established which contains four categories of accounting principles. The sources in the higher category carry more weight and must be followed when conflicts arise. The table given below summarises the current GAAP hierarchy for financial statements of non-governmental entities.

Established Accounting Principles in the US

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| Category (a) | Financial Accounting Standards Board (FASB) Statements and Interpretations, American Institute of Certified Public Accountants (AICPA), Accounting Principles Board (APB) Opinions, and AICPA Accounting Research Bulletins (ARB). |
| Category (b) | FASB Technical Bulletins, cleared AICPA Industry Audit and Accounting Guides, and cleared AICPA Statement of Position (SOPs). |
| Category (c) | Consensus positions of the FASB Emerging Issues Task Force (EITF) and cleared Accounting Standards Executive Committee of the AICPA (ACSEC) Practice Bulletins. |
| Category (d) | AICPA Accounting Interpretations, FASB Implementation Guides (QSAs), and widely recognised and prevalent industry practices. |
| Other Accounting | Other accounting literature, including FASB concepts statements, |
| Literature | APB Statements; AICPA Issues Papers; International Accounting Standards Committee Statements; Pronouncements of other professional associations or regulatory agencies; AICPA Technical Practice Aids; and accounting textbooks, handbooks, and articles. |

The US GAAP provisions differ somewhat from International Financial Reporting Standards though efforts are underway to reconcile the differences so that reports created under international standards will be acceptable to the SEC for companies listed on US markets.

## 4.1 AICPA

The AICPA sets generally accepted professional and technical standards for CPAs in many areas. Until the 1970's, the AICPA held a monopoly in this field. In the 1970's, however, it transferred its responsibility for setting generally accepted accounting principles (GAAP) to the newly formed Financial Accounting Standards Board (FASB.) Following this, it retained its standards setting function in areas such as financial statement auditing, professional ethics, attest services, CPA firm quality control, CPA tax practice and financial planning practice. Before passage of the Sarbanes-Oxley law, AICPA standards in these areas were considered "generally accepted" for all CPA practitioners.

Accounting Principles Board (APB) Opinions were published by Accounting Principles Board (APB). APB was the main organization setting the US GAAP and its opinions are still an important part of it.

## 4.2 FASB

The Financial Accounting Standards Board (FASB) is a private, not-for-profit organization whose primary purpose is to develop generally accepted accounting principles in the United States (US GAAP). The FASB's mission for the private sector is similar to that of the Governmental Accounting Standards Board (GASB) for local and state governments in the United States. The FASB was created in 1973, replacing the Accounting Principles Board of the American Institute of Certified Public Accountants (AICPA). The FASB's mission is "to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information."

The U.S. Securities and Exchange Commission (SEC) has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. The SEC designated the FASB as the organization responsible for setting accounting standards for public companies in the U.S.

FASB has so far issued 158 Statements of Financial Accounting Standards (FAS).

### 4.3 COMPONENTS OF US GAAP

Given below are important components of US GAAP:

- FASB Statement of Financial Accounting Standards (FAS).
- FASB Interpretations (FIN).
- FASB Statements of Financial Accounting Concepts(FAS Conc.).
- FASB Technical Bulletins (FTB).
- AICPA Accounting Research Bulletins (ARB).
- AICPA Accounting Principles Board Opinions (APB Opinions)
- AICPA Accounting Interpretations (AIN).

Not only there are an extremely large number of different standards under US GAAP, the volume and complexity is also increasing. This complexity of US GAAP makes it critically important that the independent accountants that are assisting a company in filing with the SEC are knowledgeable and experts in US GAAP.

## 5. COMPARATIVE POSITION OF BASIC CONCEPTS OF IAS / IFRS, US GAAPS, AND INDIAN ACCOUNTING STANDARDS

This table focuses on measurement similarities and differences most commonly found in practice. This summary, not necessarily justify the differences of details that exist among Indian Accounting Standards, IAS / IFRS and US GAAPs. Even if the summary given is similar, there can be differences in the detailed application, which could have a material impact on the financial statements.

| Topic | Indian Accounting Standards | IFRS / IAS | US GAAPs |
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| Historical cost | Historical cost is used for valuing the assets. It is one of the accounting concept. However, property, plant and equipment may be revalued to fair value.<br>Certain derivatives are carried at fair value but no accounting standards on derivatives and biological assets have been issued by the ICAI till date. | For valuation purpose, in general, historical cost is used but some intangible assets; property plant and equipment and also investments may be revalued to fair value.<br>IFRS / IAS also requires tevaluation of Derivatives, biological assets and certain securities at fair value. | US GAAPs do not recommend revaluation of assets except for certain types of securities and derivatives to fair value. |
| First-time adoption of accounting frameworks | In India, there is no specific guidance on first time adoption of | There is a specific statement by IASB to apply IFRS for the first | First-time adoption of US GAAP requires retrospective application. However, US GAAP |

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| | Accounting frameworks. | time.<br>First time adoption of IFRS requires full retrospective application of IFRS effective at the reporting date for IFRS based financial statements of an entity.<br>It has provided certain releifs, exemptions and imposes certain requirements and disclosures. | does not give specific guidance on first time adoption of its accounting principles. |
| Constituents of financial statements | Required a company's standalone- two years' balance sheets, income statements, cash flow statements, and accounting policies and notes. | Two years' consolidated balance sheets, income statements, cash flow statements, changes in equity and accounting policies and notes.<br>In some circumstances or on a voluntary basis, an entity may present standalone financial statements along with its consolidated financial statements. | For US Companies and SEC registrants (public companies) two years' balance sheet and three years income statements, cash flow statements, changes in equity statement and accounting policies and notes. However, in certain circumstances for foreign private issuers there is a relief from the three-year requirement.<br>Non-US companies with registered securities in US have an option to prepare their financial statements, either based on US GAAPs or on IFRS along with the reconciliation of net income and equity to US GAAPs, as a disclosure in the notes. |
| Balance sheet | Accounting standards do not prescribe a particular format of balance sheet. It accepts the format prescribed by the Companies Act or by other industry regulations like banking, insurance, as applicable. However, accounting Standard states certain items, which must be presented on the face | IFRS too do not prescribe any particular format of balance sheet. As per requirements of IFRS, certain items must be presented on the face of the balance sheet.<br>There is a requirement of separate presentation of total assets and total liabilities. A liquidity presentation of assets | Entities may present either a classified or non-classified balance sheet. Decreasing order of liquidity is used for the presentation of the items on the face of the balance sheet.<br>Public companies should follow SEC regulations. |

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| | of the balance sheet. | and liabilities is used, instead of a current/non-current presentation, only when a liquidity presentation provides more relevant and reliable information. . | |
| Income statement | Accounting standards do not prescribe a particular format of income statement. Industry-specific formats are prescribed by industry regulations.<br>However, accounting Standard states certain items, which must be presented on the face of the income statement. | IFRS too do not prescribe any particular format of income statement. An entity selects the presentation of its expenses either by function or nature. Expenses by nature are disclosed as afootnote if an entity selects functional presentation.<br>However, IFRS requires certain items to be presented on the face of the income statement. | US GAAP requires income statement to be presented in either of two formats - single-step or multiple-step format.<br>Expenditures are presented by function.<br>Public companies should follow SEC regulations. |
| Extraordinary items | Events or transactions, clearly distinct from the ordinary activities of the entity, which are not expected to recur frequently and regularly, are termed as extra-ordinary items.<br>Disclosure of the nature and amount of such item is required in the income statement to perceive the impact on current and future profits. | Not allowed. | Defined as being both infrequent and unusual, and are rare. Negative goodwill is presented as an extraordinary item.on the face of the income statement net of taxes. Disclosure of such is required either in the income statement or in the notes. |
| Statement of changes in share (stock) holders' equity | No separate statement is prepared for it.<br>A separate schedules of 'Share capital' and 'Reserves and surplus' id prepared to show the changes in | It is a primary statement required to be prepared as a part of financial statements unless Statement of recognized income and expenses (SoRIE) | SEC rules allow certain information to be included in the notes and not in the primary statement. |

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| | shareholders' equity. | is prepared as a primary statement.<br>Statement shows capital transactions with owners, accumulated profits' movement and a reconciliation of all other components of equity. | |
| Cash flow statements – | Both indirect and direct method are used in the preparation of cash flow statement.. Cash flows are divided into three broad categories namely- operating, investing and financing.<br>Cash includes cash equivalents with short-term maturities (typically less than three months) except that bank overdrafts are excluded. | Similar to Indian Accounting Standard.<br>But cash includes cash equivalents like investments with short-term maturities (typically less than three months) and may include bank overdrafts repayable on demand but do not include short term borrowings as they are considered as financing item. | Similar to IFRS, but more specific guidance for items included in each category.<br>Both direct and indirect method is used. However, a reconciliation of net income to cash flows from operating activities is disclosed if the direct method is used.<br>Similar to Indian Accounting Standard. |
| Changes in accounting policy | In the year of change, the effect of change is included in income statement of that year and also the impact of change is disclosed. | Retrospective effect of the change in accounting policy is accounted. Also comparative figures are restated; where the effect of period(s) not presented is adjusted against opening retained earnings. | Similar to IFRS from the date of adoption of FAS 154. |
| Change in accounting estimates | Change is accounted in the income statement of the current year when identified. In general no retrospective effect is accounted for such change | Similar to Indian Accounting Standard | Similar to Indian Accounting Standard |
| Definition of subsidiary | Based on voting control or control over the composition of the board of directors. | Control is presumed to exist when parent owns, directly or indirectly through | Similar to IFRS. However, a bipolar consolidation model is used, which distinguishes between a variable interest |

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| | The existence of currently exercisable potential voting rights is not taken into consideration. | subsidiaries, more than one half of an entity's voting power.<br>The existence of currently exercisable potential voting rights is also taken into considerations.<br>A parent could have control over an entity in circumstances where it holds less than 50% of the voting rights of an entity. | model and a voting interest model.<br>Control can be direct or indirect and may exist with a lesser percentage of ownership (voting interest model). |
| Definition of associate | Based on significant influence; presumed if 20% or greater interest or participation in entity's affairs. | Similar to Indian accouting Standard | Similar to IFRS, although the term 'equity investment is used instead of 'associate'. |
| Presentation of associate results | In consolidated financial statements; equity method is used. Share of post-tax results is shown.<br>In standalone financials; at cost less impairment. | In consolidated financial statements; equity method is used. Share of post-tax results is shown.<br>In standalone financial; at cost or at fair value in accordance with IAS 39. | In consolidated financial statements; similar to IFRS. |
| Definition of joint venture | Contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.<br>Exclusion if it meets the definition of a subsidiary | Contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.<br>Exclusion if investment is held-for-sale. | A corporation owned and operated by small group of businesses as a separate and specific business or project for the mutual benefit of the members of the group. |
| Presentation of jointly controlled entities (joint ventures) | In consolidated financial statements, proportional consolidation is used.<br>In standalone financials; at cost less impairment. | In consolidated financial statements, both proportional consolidation and equity method is permitted.<br>In standalone financials; at cost or at fair value in accordance with IAS | In consolidated financial statements; equity method is required except in specific circumstances.<br>In standalone financials; at cost or equity method is used. |

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| | | 39. | |
| Business combinations | No particular Standard has been issued by ICAI till date. However all business acquisitions are business combinations except pooling of interest method for certain amalgamations | All business acquisitions are Combinations as per IFRS 3 | All business acquisitions are Combinations. |
| Purchase method-values on acquisition | For an entity acquired and held as a subsidiary, the assets acquired and liabilities assumed are incorporated in their existing carrying amounts for consolidation purposes.<br>On amalgamation, they may be incorporated at their existing carrying amounts or, alternatively, the consideration is allocated to individual identifiable assets and liabilities at their fair values.<br>On business acquisition, they may be incorporated at their fair values or value of surrendered assets.<br>No separate restructuring provision is recognized on acquisition. | Assets, liabilities and contingent liabilities of acquired entity are fair valued. If control is obtained in a partial acquisition of a subsidiary, the full fair value of assets, liabilities and contingent liabilities, including portion attributable to the minority (non-controlling) interest, is recorded on consolidated balance sheet. Goodwill is recognized as the residual between the consideration paid and the percentage of the business acquired.<br>Liabilities for restructuring activities are recognized only when acquiree has an existing liability at acquisition date. Liabilities for future losses or other costs expected to be incurred as a result of the business combination cannot be recognized. | Similar to IFRS, except minority interest is stated at pre-acquisition carrying value of net assets, and contingent liabilities of the acquiree are not recognised at the date of acquisition. Specific rules exist for acquired in-process research and development (generally expensed) and contingent liabilities.<br>Some restructuring liabilities relating solely to the acquired entity may be recognized if specific criteria about restructuring plans are met. |
| Minority interests at acquisition | Stated at minority's share of pre-acquisition carrying value of net assets. | Stated at minority's share of the fair value of acquired identifiable assets, liabilities and | Similar of Indian Accounting Standard |

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| | | contingent liabilities. | |
| Purchase method- goodwill and intangible assets with indefinite useful lives | Goodwill on consolidation and business acquisitions; no specific guidance- practice varies, between no amortization versus amortization over a period not exceeding 10 years;<br>Goodwill on amalgamation is amortised over a period not exceeding 5 years, unless a longer period is justified;<br>Goodwill is reviewed for impairment whenever an indication of impairment exists at the CGU level.<br>Intangible assets are not classified into indefinite useful lives category. All intangible assets are amortised over a period not exceeding 10 years | Capitalised but not amortised. Goodwill and indefinite-lived intangible assets are reviewed for impairment at least annually at either the cash-generating unit (CGU) level or groups of CGUs, as applicable. | Similar to IFRS, although the level of impairment testing and the impairment test itself are different. |
| Purchase method- Capital Reserve | Negative goodwill is recorded in equity as capital reserve, which is not amortised to income.<br>However, in case of an amalgamation, the fair value of intangible assets with no active market is reduced to the extent of capital reserve, if any, arising on the amalgamation. | The identification and measurement of acquiree's identifiable assets, liabilities and contingent liabilities are reassessed. Any excess remaining after reassessment is recgonised in Income statement immediately. | Any remaining excess after reassessment is used to reduce proportionately the fair values assigned to non-current assets (with certain exceptions). Any excess is recognized in the income statement immediately as an extraordinary gain. |
| Pooling of interests method | Required for certain amalgamations when all the specified conditions are met. | Prohibited. | Same as IFRS. |

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| Revenue recognition | Indian Accounting Standard on revenue recognition does not give any guidance on revenue measurement.<br>Revenue from services is recognized only on the completion of the services. | IFRS states that based on several criteria, which require the recognition of revenue when risks and rewards have been transferred and the revenue can be measured reliably.<br>Revenue from services is recognized in proportion to the state of completion of the transaction at the balance sheet date. | Detailed guidance exists for specific types of transactions for the purpose of revenue recognition. US GAAP laid emphasis on persuasive evidence that an arrangement exists, and delivery has occurred or services have been rendered. |
| Construction contracts | Percentage of completion method is recommended if the outcome can be reliably measured. Expected loss to be recognized as an expense immediately. | Accounted for using percentage-of-completion method. Complete contract method is not allowed. | Similar to IFRS. However, completed contract method is permitted in rare circumstances when the extent of progress of completion cannot be measured reliably. |
| Employee share compensation | Guidance note issued by ICAI requires measurement of cost of benefits arising from employee share compensation plans on fair value.<br>Alternatively, the guidance note allows use of the intrinsic value method. | Expense for services purchased is recognized. Corresponding amount recorded either as a liability or an increase in equity, depending on whether transaction is determined to be cash or equity-settled. Amount to be recorded is measured at fair value of shares or share options granted. | With the adoption of FAS 123R, similar model to IFRS. Compensation expense is generally recognized based on fair value of awards at grant date. |
| Acquired intangible assets | If recognition criterias are satisfied then it can be capitalized. all intangibles are amortised over useful life with a rebuttable presumption of not exceeding 10 years.<br>Revaluations are not permitted. | If recognition criterias are satisfied then it can be capitalized. It is amortised over useful life. Intangibles assigned an indefinite useful life are not amortised but reviewed at least annually for impairment. | Similar to IFRS, except revaluations are not permitted. |

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| | | Revaluations are permitted in rare circumstances. | |
| Internally generated intangible assets | Research costs are expensed as incurred. Development cost is capitalized and amortised only when specific criteria are met. | Similar to Indian Accoutning Standard. | Research and development costs are expensed as incurred. Some software and website development costs are capitalized. |
| Property, plant and equipment | Historical cost is used. Revaluations are permitted, however, frequency of revaluation has not mentioned.<br>On revaluation, an entire class of assets is revalued, or assets to be revalued are selected on systematic basis. | Historical cost or revalued amounts are used. On opting revaluation option, regular valuations of entire classes of assets are required. | Historical cost is used; revaluations are not permitted. |
| Non-current assets held for sale or disposal | There is no requirement to classify and present an asset as held for sale on the face of the balance sheet or in the notes. | Non-current asset is classified as held for sale if its carrying amount will be recovered through a sale transaction rather than through continuing use. A non-current asset classified as held for sale is measured at the lower of its carrying amount and fair value less costs to sell. Comparative balance sheet is not restated. | Similar to IFRS. |
| Impairment of assets | Assets are impaired at higher of fair value less costs to sell and value in use based on discounted cash flows.<br>Impairment test is to be conducted every year and if there is upward increase in the vaue of asset than | Similar to Indian Accounting Standard.<br>However, assets are classified and disclosed separately on the face of the balance sheet as held for sale or disposal. | Impairment is assessed on undiscounted cash flows for assets to be held and used. If less than carrying amount, impairment loss is measured using market value or discounted cash flows.<br>Reversal of losses is prohibited. |

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| | reversal of impairment losses is required in certain circumstances.<br>Assets are not separately classified or disclosed as held for sale on the face of the balance sheet. | | |
| Capitalisation of borrowing costs | There is no choice rather to capitalize the borrowing cost. | Permitted as a policy choice for all qualifying assets, but not required. | Required. |
| Investment property | Treated as a long-term investment and is carried at cost less impairment..<br>Revaluation of such property is not applicable. | IFRS gives the choice of measuring the investment property at depreciated cost or fair value, with changes in fair value recognized in the income statement.<br>Regular revaluations should be made so that the carrying amount does not differ materially from fair value | Treated the same as for other properties (depreciated cost). Industry-specific guidance applies to investor entities (for example investment entities) |
| Inventories | Carried at lower of cost and net realizable value. FIFO or weighted average method is used to determine cost. LIFO method is however, prohibited. | Carried at lower of cost and net realizable value. For cost determination, FIFO or weighted average method is used. LIFO basis of valuation is prohibited.<br>Reversal is required for subsequent increase in value of previous write-downs. | Similar to IFRS; however, use of LIFO is permitted.<br>Reversal of write-down is prohibited. |
| Biological assets | No specific guidance has been issued. Historical cost is used.in general. | Measured at fair value less estimated point-of-sale costs. | No specific guidance has been issued. Historical cost is used.in general. |
| Provisions – general | Provisions relating to present obligations from past events recorded if outflow of resources is probable and can be reliably | Provisions relating to present obligations from past events recorded if outflow of resources is probable and can be reliably | Similar to IFRS, with rules for specific situations such as environmental liabilities. Loss contingencies, etc. |

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| | estimated.<br>Discounting of provision is not permitted. | estimated.<br>Provisions are discounted to present value where the effect of the time value of money is material. | |
| Contingencies | Contingent liabilities are disclosed unless the probability of outflows is remote. Contingent gains are neither recognized nor disclosed. | Unrecognised possible losses and probable gains are disclosed. | Similar to IFRS |
| Government grants | Grants related to fixed assets are shown as deduction from the gross value of the assets concerned.<br>Revenue related government grants are recognized on a systematic basis in the income statement over the periods to match them with the related costs.<br>Grants in the nature of promoter's contribution are credited to capital reserve and treated as a part of shareholder's funds. | Revenue based grants are deferred in the balance sheet and released to the income statement to match the related expenditure that they are intended to compensate.<br>Capital based grants are deferred and matched with the depreciation on the asset for which the grant arises.<br>Grants related to recognized assets are either presented in the balance sheet as deferred income and amortised. Entities may offset capital grants against asset values. | Similar to IFRS, except when conditions are attached to grant. In this case, revenue recognition is delayed until such conditions are met. Long-lived asset contributions recorded as revenue in the period received. |
| Dividends on ordinary equity shares | Presented as an appropriation to the income statement. Dividends are accounted in the year when proposed. | Presented as a deduction in the statement of changes in shareholders' equity in the period when authorized by shareholders. Dividends are accounted in the year when declared. | Similar to IFRS. |

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| Hyper-inflationary economy | No specific guidance. | Hyperinflation is indicated by characteristics of economic environment of country, which include:<br>Population's attitude towards local currency and prices linked to price index; and if cumulative inflation rate over three years is approaching, or exceeds, 100%.<br>Entities of hyperinflationary economy have to restate their financial statements using a measurement unit current at balance sheet date. | Hyperinflation is generally indicated by cumulative three-year inflation rate of approximately 100% or more.<br>Generally does not permit inflation-adjusted financial statements; instead requires use of reporting currency (US dollar) as functional currency. |
| Earnings per share – diluted | Weighted average potential dilutive shares are used as denominator for diluted EPS, except in certain circumstances where advance share application money received is treated as dilutive potential equity shares. | Weighted average potential dilutive shares are used as denominator for diluted EPS. | Similar to IFRS. |
| Related-party transactions | Determined by level of direct or indirect control, joint control and significant influence of one party over another or common control by another entity. However, the determination may be based on legal form rather than substance.<br>Hence, the scope of parties covered under the definition of related party could be less than under IFRS or US | Determined by level of direct or indirect control, joint control and significant influence of one party over another or common control by another entity.<br>Name of the parent entity is disclosed and, if different, the ultimate controlling party, regardless of whether transactions occur. For related-party transactions, nature of | Similar to IFRS. Exemptions from disclosures are narrower than under IFRS. |

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| | GAAP.<br>Exemption from disclosure for certain SMEs having turnover or borrowings below certain limit. No exemption for separate financial statements of subsidiaries. | relationship (seven categories), amount of transactions, outstanding balances, terms and types of transactions are disclosed.<br>Some exemptions available for separate financial statements of subsidiaries. | |
| Segment reporting | Public entities: primary and secondary (business and geographic) segments are reported based on risks and returns and internal reporting structure.<br>Exemption only for certain SMEs having turnover or borrowings below certain threshold.<br>Group accounting policies or entity accounting policies apply.<br>Disclosures for primary segment include revenues, results, capital expenditures (capex), total assets, total liabilities and other items. For secondary segment, revenues, total assets and capex are reported. | Similar to Indian Accounting Standard | Reporting based on operating segments, and the manner in which chief operating decision-maker evaluates financial information for purposes of allocating resources and assessing performance.<br>Internal financial reporting policies apply (even if accounting policies differ from group accounting policy).<br>Disclosures of liabilities and geographical capex are not required. |
| Discontinued operations-definition and measurement | Operations and cash flows that can be clearly distinguished for financial reporting and represent a separate major line of business or geographical area of operations.<br>Measurement of discontinued operations is based on AS 28 and 29 | Simialr definition to Indian Accounting Standard. However, it also includes a subsidiary acquired exclusively with a view to resale.<br>Measured at lower of carrying amount and fair value less costs to sell. | Wider definition than IFRS:<br>component that is clearly distinguishable operationally and for financial reporting can be: reporting segment, operating segment, reporting unit, subsidiary or asset grouping.<br>Measurement is same as in IFRS. |
| Discontinued operations-presentation and | At a minimum, separately from continuing operations, | At a minimum, a single amount is disclosed on face of income | Similar to IFRS. Discontinued and held-for-sale operations are reported as separate line items |

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| main disclosures | pre-tax profit or loss, related taxes, pre-tax gain or loss on disposal should be disclosed on the face of the income statement:<br>Income and expenses line items separate from continuing and discontinued operations are disclosed in the notes; however, presented on a combined basis in the income sta tement.<br>No separate presentation for balance sheet items.<br>Exemption for certain SMEs having turnover or borrowings below certain threshold. | statement, and further analysis disclosed in notes for current and prior periods.<br>Assets and liabilities of discontinued operations are presented separately on balance sheet. No restatement of comparative balance sheet. | on face of income statement before extraordinary items. |
| Events occurring after the balance sheet date | Financial statements are adjusted for events after the balance sheet date, providing evidence of conditions at balance sheet date and materially affecting amounts in financial statements (adjusting events) except non-adjusting events which are not required to be disclosed in financial statements but are disclosed in report of approving authority e.g., Director's Report. | Financial statements are adjusted for events after the balance sheet date, providing evidence of conditions at balance sheet date and materially affecting amounts in financial statements (adjusting events). Non-adjusting events are disclosed. | Similar to IFRS. |

References / Sources:

Website of IASPLUS

Website of IASB

Accounting Standards and Corporate Accounting Practices

Miller GAAP Guide Level A- 2006

Website of FASB