AS 30 – Accounting of Financial Instruments

Presentation at WIRC Seminar

By Jayesh Gandhi **May 29, 2010**

Why an AS for Financial Instruments ?

- At present, no Comprehensive standard in Indian GAAP
  - AS 11 – deals with foreign currency transactions including derivatives.
  - AS 13 – deals with all investments, including property.
  - AS 16 – deals with accounting of borrowing cost and element of cost.
- Diverse accounting practices followed have made comparability of performance difficult.
- Due to non disclosure, effect of derivatives were hidden in the financial statements and huge impact was known only on expiry / cancellation.

AS – 30 Applicability

- Comes in effect for accounting periods beginning on or after April 1, 2011
- Early adoption is permissible. However, it can not be done in parts.
- Early adoption for derivative accounting mandated by the institute as per circular of March, 2009, to the extent of loss.

Scope – applies to all Financial instruments except:

- Interest in Subsidiaries, Associates and Joint Ventures covered by AS 21, 23 & 27 except as mentioned in those standard;
- Lease transaction covered by AS 19. However lease receivables, payables & derivatives embedded in lease will be covered by this standard;
- Insurance Contracts. However financial guarantee contracts and derivatives embedded in insurance contract covered by this standard;
- Contingent consideration for the acquirer or business combinations to buy or sell at a future date;
- Loan commitments, other than specific inclusions – when held for sale;
- Share based payments (incl ESOPs) and Employers rights and obligations under AS 15;
- Own use commodity contracts other than those which are generally settled net in cash MCX, NCDEX transactions, which at present cannot get settled through delivery ?

Scope – applies to all Financial instruments except: (contd.)

- Items are scoped out of the standard if another standard is more prescriptive in dealing with such items.

- From the date of the applicability of this standard following will be withdrawn:
  - AS 13 on "Accounting for Investment" except for portion pertaining to Investment properties
  - AS 11 on "The effect of changes in Foreign Exchange Rates" to the extent it covers forward exchange contracts
  - AS 4 on "Contingencies and Event Occurring After the Balance Sheet Date" to the extent it covers contingencies
  - Guidance Notes on:

    (i) Guarantees and counter Guarantees given by companies

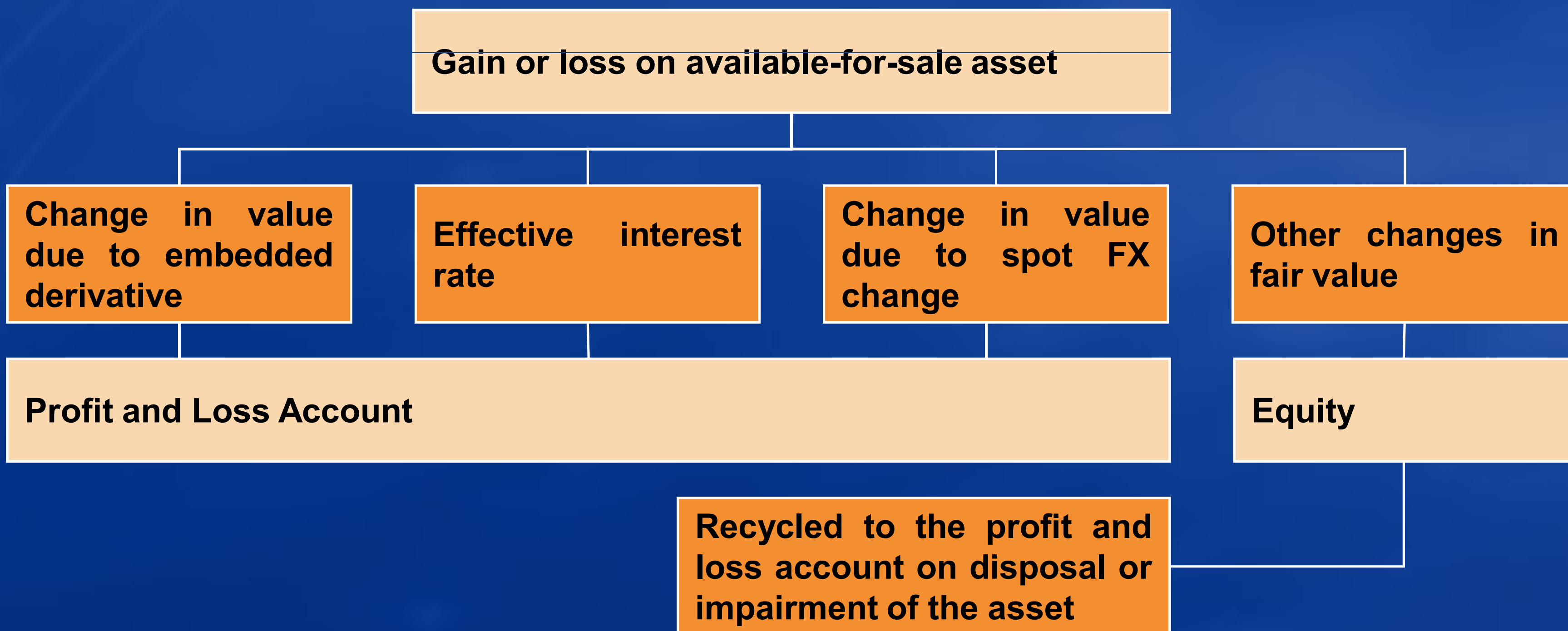
    (ii) Accounting for Investment in the Financial Statements of Mutual Fund

    (iii) Accounting for Securitisation

    (iv) Accounting for Equity Index & Equity Stock Futures and Options

Available-for-sale financial assets - accounting

- All available for sale assets are marked to market through a separate component of equity (Investment revaluation reserve account)
- Gains and losses on AFS assets are recognised in the profit and loss account on disposal or impairment of the asset. However, there are a number of other complications with available for sale gains and losses



Amortised cost and effective interest method

Amortised cost	=	Initial Recognition	–/+	Cumulative amortisation using effective interest method	–	impairment /un-collectibility	–	Principal Repayments

Effective Interest Method - Method of calculating amortisation cost and of allocating interest Income / Expenses over the relevant period

Effective Interest Rate – Rate that exactly discounts estimated future cash payments and receipts through the expected life of the financial instrument

At each reporting date apply the effective interest rate to carrying amount to determine interest income and interest expense

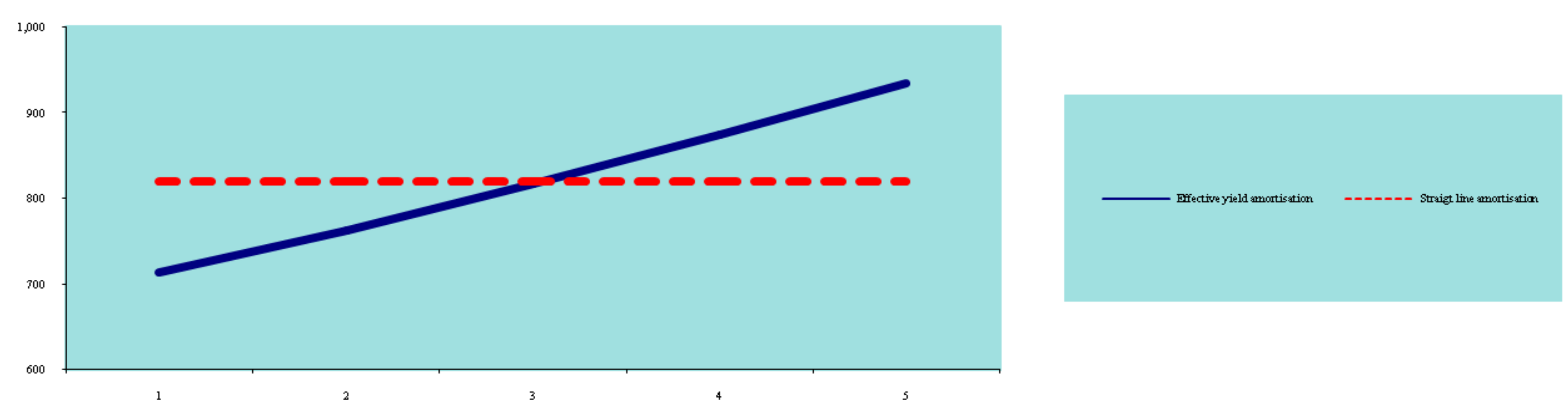
Calculating amortised cost - Example

- Treasury note with face value Rs. 100,000, 5 year maturity, 6% coupon rate
- Purchase price Rs. 95,900
- Discount Rs. 4,100
- IRR (i.e. effective rate) is 7%

Note : Any expenditure incurred for raising finance can also be considered in the working of IRR.

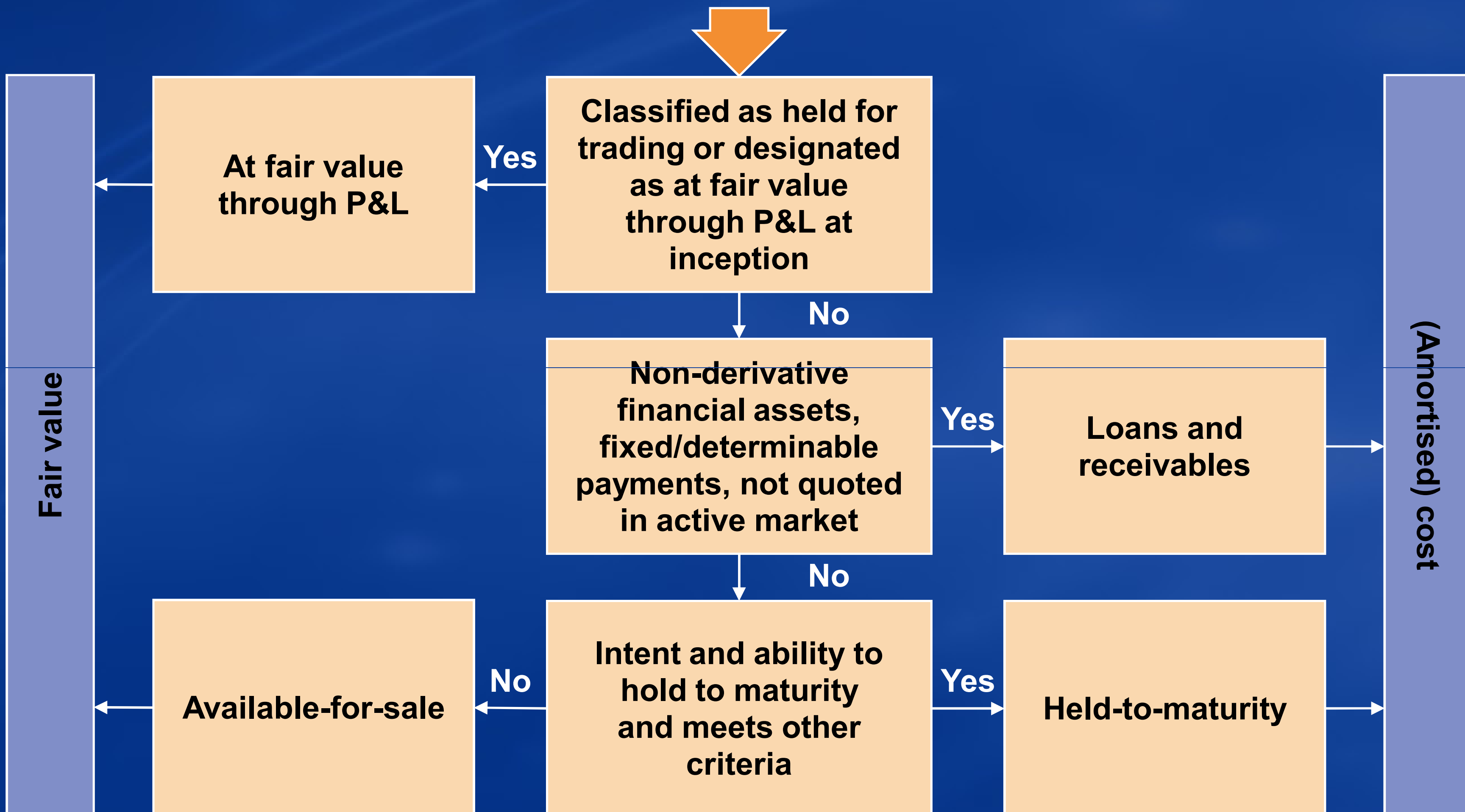
Calculating amortised cost - Example

Year	BB	Effective interest	Coupon	Discount amortisation	EB
	a	b=a*7%	c=100000*6%	d=b-c	e=a+d
1	95,900	6,713	6,000	713	96,613
2	96,613	6,763	6,000	763	97,376
3	97,376	6,816	6,000	816	98,192
4	98,192	6,873	6,000	873	99,065
5	99,065	6,935	6,000	935	100,000
Total		34,100	30,000	4,100	



Note : Over the period Rs. 4100 get adjusted.

Classification determines subsequent measurement of financial assets



… similarly applies to financial liabilities

Initial Recognition

Initial Recognition of a FA or FL to be done by an entity when, and only when it becomes a party to the contractual provisions of the instrument

All contractual rights & obligations under derivatives are to be recognized on balance sheet as asset or liability except:-

- If a transfer does not qualify for derecognition then
  - Transferor does not recognize derivatives of the FA / FL separately
  - Transferee does not recognize transferred FA / FL as its FA / FL

Initial Recognition…

Recognize assets to be acquired or liabilities to be incurred as a result of firm commitment to purchase or sell goods or services only when

- At least one of the parties has performed under the agreement or
- It is a firm commitment applicable under the Standard
  - But in case of an unrecognized firm commitment that is designated as "hedged item" in a fair value hedge, any change in net fair value attributable to hedged risk is recognized as asset or liability after inception of hedge

- Don't recognize FA/FL arising out of planned future transactions no matter how likely, as entity is not party to the contract

Initial Measurement

FA / FL @ FVTPL	*Short-term receivables / payables with no stated interest rate*	*Other FA / FL*
At fair value on date of acquisition or issue	Original invoice amount if effect of discounting is immaterial	At fair value + / - directly attributable transaction cost

If settlement date accounting is used for an asset that is subsequently measured at cost or amortized cost, then it is initially recognized at FV on the trade date

Fair value (FV)

- An amount for which an asset could be exchanged, or liability settled, between knowledgeable, willing parties in an arms length transaction

Presumption of FV

Entity is a going concern, without

- the intention or need to liquidate or
- curtail materially the scale of operations or
- to undertake a transaction on adverse terms

FV is not the amount that would be received or paid in

- a forced transaction,
- involuntary liquidation or
- distress sale

FV reflects credit quality of financial instrument

Fair Value …

Normally transaction price at initial recognition

Use valuation techniques if part consideration is for something other than the financial instrument

FV of non-market interest bearing long term loan or receivable can be estimated to be

- PV of future cash flows discounted at prevailing market rates for similar instrument with similar credit rating
- Additional amount lent is an expense or reduction of income unless it qualifies for recognition as some other type of an asset

Fair Value …

- Amount lent at below market rate and up-front fee received as compensation
  - Loan initially recognized as asset at its FV i.e. net of the fee received
  - Discount accreted to the profit & loss using effective interest rate method

Transaction Costs (TC)

TC = Incremental cost directly attributable to acquisition, issue or disposal of FA or FL

- Increment cost = cost that would not have been incurred if the entity had not acquired, issued or disposed off the financial instrument
  - For FA → TC are added to amount originally recognized
  - For FL → TC are deducted from amount of debt originally recognized

TC expected to be incurred on transfer or disposal of a FI are not included in its measurement

Transaction Costs…

TC not considered in fair value measurement at initial recognition

- FI @ FV through PL
- Short term receivables & payables

TC included in calculation of amortized cost using effective interest rate method and thus amortized through P & L over life of instrument

Transaction Costs…

For FA-AFS,

- TC are recognized in appropriate equity account as part of change in FV at next measurement

If AFS has fixed and determinable payments and does not have indefinite life then

- TC amortized through PL using effective interest method

If AFS does not have fixed and determinable payments and has indefinite life then

- TC recognized in PL when FA is derecognized or becomes impaired

Subsequent Measurement of FA…

FA @ FVTPL	*HTM Investments*	*Loans & Receivables*	*Available for Sale*
FV without deducting transactions costs that maybe incurred on sale or disposal	Amortized Cost using effective interest method	Amortized Cost using effective interest method except for short-term receivables that are carried at original invoice amount	FV without deducting transactions costs that maybe incurred on sale or disposal
No test for impairment to be performed	Test for impairment to be performed	Test for impairment to be performed	Test for impairment to be performed

- Unquoted Equity instruments whose fair value cannot be reliably measured and derivatives linked to such equity instruments → measured at cost
- For FA measured at FV and the FV is negative, then it is a FL
- Hedged FA items → to follow hedge accounting requirements

Subsequent Measurement of FL

At amortized cost using effective interest method except

- FL at FVTPL unless
  - Derivative liability linked to an unquoted equity instrument whose FV cannot be determined → measured at cost
- FL arising out of transfer of FA not qualifying for de-recognition
  - Recognize obligations retained by the entity
- Short-term payables at original invoice amount
- Financial Guarantee Contract & Commitments to provide Loans below Market Interest Rate, higher of
  - Amount determined as per AS 29 and
  - Amount initially recognized
- Hedged FL items → to follow hedge accounting requirements

Trade Date / Settlement Date

Regular Way Purchase or Sale of a Financial Asset

- Trade Date Accounting : The trade date is the date that an entity commits itself to purchase or sell an asset.
- Settlement Date Accounting : The settlement date is the date on which an asset is delivered to or by an entity.

There is no bar in applying Trade Date Accounting for certain category of Financial Asset and Settlement Date Accounting for another category !!

Reclassifications

- At fair value through profit or loss category
  - No reclassification of a financial instrument either into or out of this category is permissible
- Held-to-maturity investments category
  - If, as a result of a change in intention or ability, it is no longer appropriate to classify an investment as 'held to maturity' or if because of sales or reclassification of more than an insignificant amount of held-to-maturity investments, no investment can be carried under this category:
    - Reclassify the investment as 'available for sale'
    - Remeasure it at fair value
    - Recognise the difference between its carrying amount and the fair value in the appropriate equity account (Investment Revaluation Reserve Account).

Reclassifications…

•From ‘Available-for-sale’ category to HTM category

•If as a result of a change in intention or ability; or because the ‘two year’ condition has ended, etc., and it becomes appropriate to carry an investment as held-to-maturity and measure it at amortised cost:

- the fair value on that date becomes its new cost.
- Any previous gain or loss recognised directly in the appropriate equity account:
  - Is amortised over the remaining life of the investment using the effective interest rate method.

Gains & Losses on changes in FV

- FA / FL @ FVTPL
  - Recognized in P & L
- AFS – FA
  - Appropriate Equity Account (Investment Revaluation Reserve) except
    - Impairment losses & Foreign Exchange Gains & Losses to P & L
  - When FA is derecognized, balance in this equity account is transferred to P & L
- FA / FL @ Amortized Cost
  - Recognized in P & L
  - Hedged items to follow Hedge Accounting requirements
- In case of settlement date accounting
  - Change in FV between trade date & settlement date is not recognized if the FA / FL is carried at cost
  - Otherwise it is taken to P & L or the Appropriate Equity Account

Objective evidence of impairment

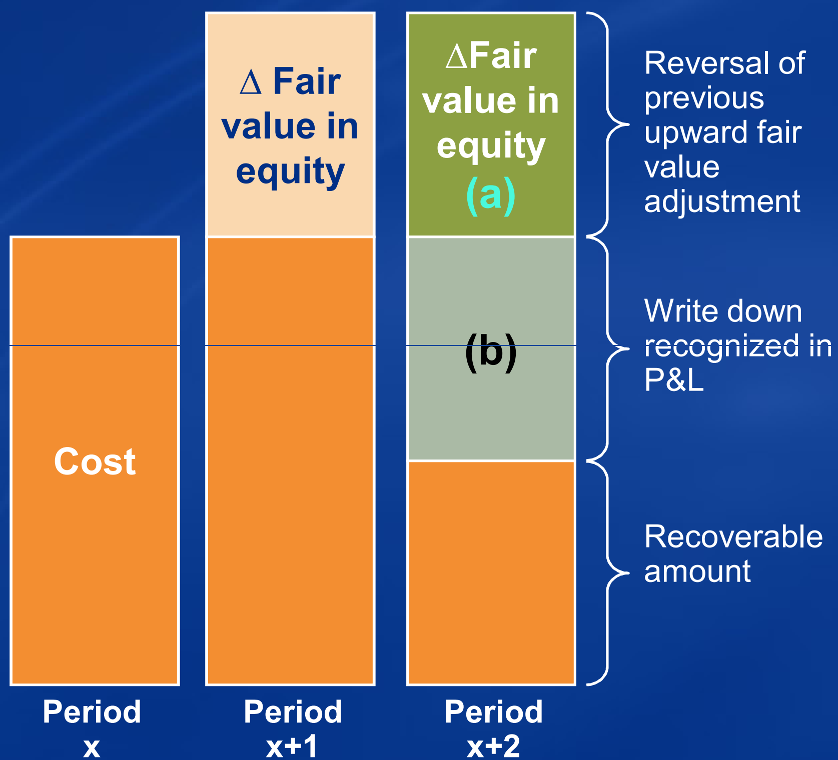
At each balance sheet date, the entity should assess whether there is objective evidence of impairment for an asset or group of financial assets

Evidence of impairment

- Significant financial difficulty of the issuer
- Default or breach of contract
- Granting of a concession by the lender due to the borrower's financial position
- Bankruptcy or financial reorganisation of the borrower
- Disappearance of an active market for the assets concerned because of financial difficulties
- Significant <u>or</u> prolonged decline in market price in the case of an equity security
- Observable data that there is a measurable decrease in the estimated future cash flows for a group of financial assets
  - Adverse changes in the payment status of borrowers in the group
  - National or local economic conditions that correlate with defaults on assets in the group

Available for sale assets– recognizing impairment losses

- **Situation A: asset with gains recorded in equity**

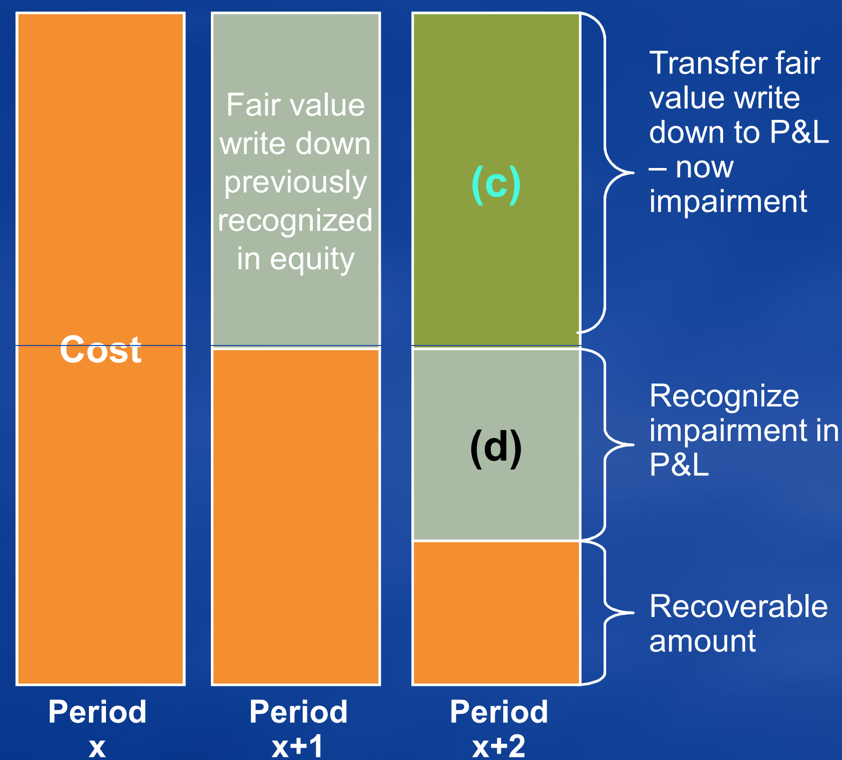


= *fair value*

(a) Equity Dr.
To Asset

(b) P & L Dr.
To Asset

- **Situation B: asset with losses recorded in equity**



(c) P & L Dr.
To Equity

(d) P & L Dr.
To Asset

Derecognition

Removal of a previously recognised Financial Asset (FA) or Financial Liability (FL) from an entity's balance sheet

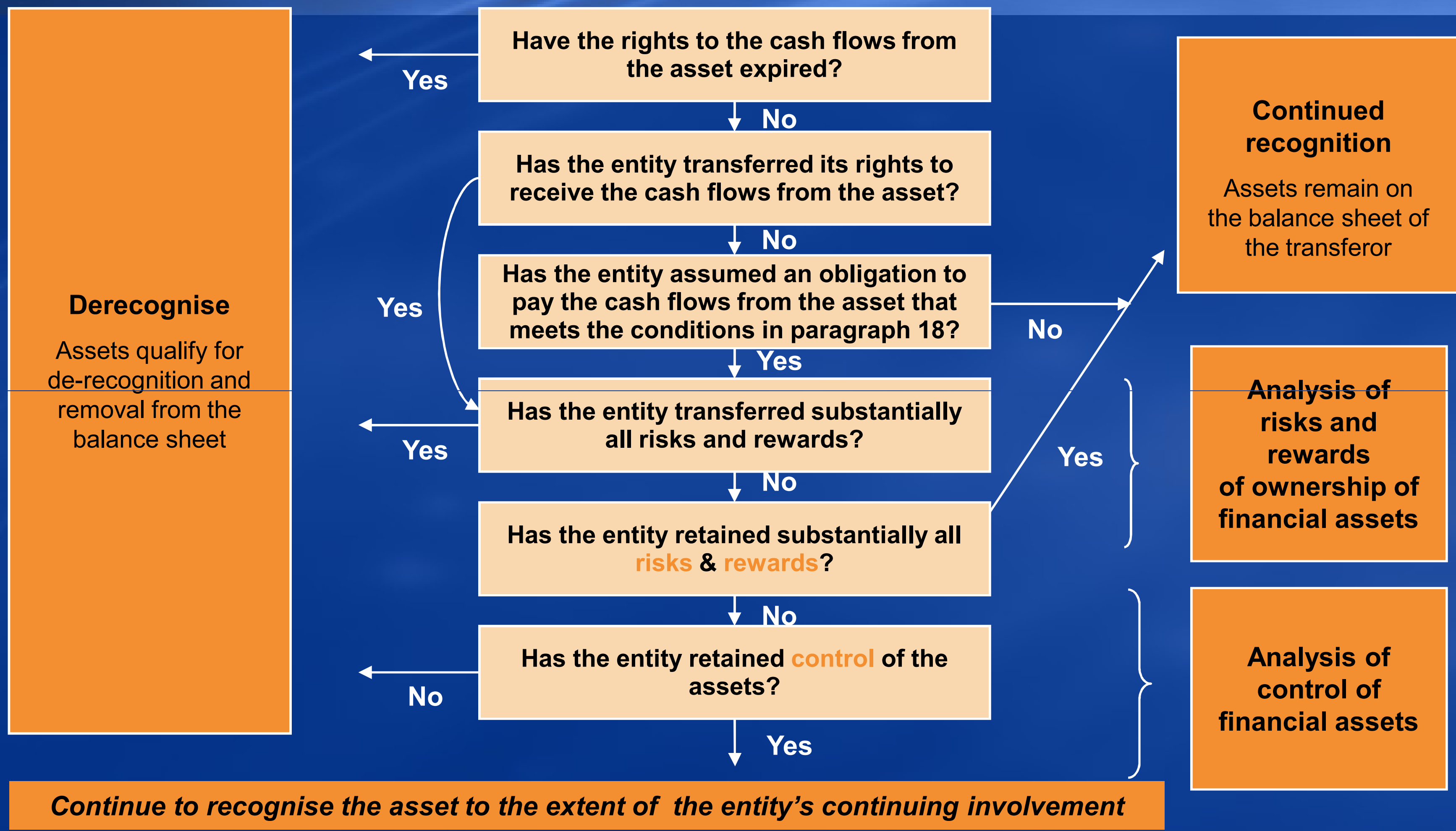
- Derecognition of a FA is on transfer of associated risks and rewards whilst that of a FL is on extinguishment of obligation

A transaction is treated as a transfer of FA if all three criteria are met:

- An entity has no obligation to pay amounts to the transferee unless it collects equivalent amounts from the original asset;
- An entity is prohibited from selling or pledging the original asset; and
- An entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay.

Derecognition can be applied to a part of FA / FL or a part of a group of similar FA / FL

Main concepts of derecognition principles



If the entity retains the right to service the FA for a fee it should recognise a service asset or liability for that service contract

Derivatives accounting rules

•All derivatives are always marked-to-market (MTM) with changes in fair value recognised in the P&L (unless used as hedging instruments in cash flow hedge in which case, fair value changes are transferred to reserves) except for:

•Contracts for 'normal' purchases and sales of non-financial items

- Intended to meet purchase, sale or usage requirements
- Designated for that purpose
- Will be settled by delivery

•Regular way purchase or sale of a financial asset

- Delivery within a time frame established by regulation or convention in the market
- Apply trade date or settlement date accounting
- If the contract permits net settlement of the change in the value, such contract is accounted as a derivatives in the period from trade date to settlement date.

Embedded derivatives

•When to separate?

- The embedded derivative is not closely related to economic characteristics and risks of the host (e.g. leverage, optionality feature);
- Embedded derivative would be a derivative if it was freestanding; and
- The host contract is not carried at fair value through profit or loss

•How to identify?

- An implicit or explicit term in a contract that makes it behave like a derivative
- Instruments with conversion features
- Transactions in "third currency"
- Instruments with option to extend the term of debt
- Index linked payments
- Purchase or sale of contracts in foreign currency (other than currency of major party, or currency in which the contract is normally denominated)

Accounting for embedded derivatives

- **Accounting following separation:**
  - Host: apply rules of AS 30 or other applicable standard if host is not a financial instrument
  - Derivative: measure the separated derivative at fair value through profit or loss
- **Accounting when separation is difficult:**
  - If it is difficult to determine the fair value of the embedded derivative, it is deemed to be the difference between the fair value of the combined (hybrid) instrument and the fair value of the host contract
- **Accounting when impossible to separate:**
  - If the embedded derivative cannot be reliably identified and measured, the entire combined contract is accounted for as a financial instrument at fair value
- **Separate accounting for option and non option embedded derivatives**

Convertible Debentures

- Compulsory Convertible Debentures
- To be considered as Equity since inception as issuer and holder have no option but to convert
- Interest payable, net of tax is to be treated as dividend
- Optionally Convertible Debentures – to separate the value of option by computing value of debenture if it is redeemable at a fixed terms.
- Same treatment for FCCB

Objective of hedge accounting: get the timing right

	1	2	Cumul
• Hedged item	0	(20)	(20)
• Hedging instrument	20	A 0	20
	20	B (20)	0

A — Accelerate recognition of gain or loss on hedged item (fair value hedge)

B — Defer recognition of gain or loss on hedging instrument (cash flow hedge)

Components of a hedge relationship

Hedging relationship components

Hedged items	Hedgeable risks	Hedging instruments
- Recognised assets or liability - an unrecognised firm commitment or highly probable transaction - net investment in non-integral foreign operation		- Any derivatives other than written options - To hedge foreign currency risk, non derivative FA or FL can be designated - Instrument should be with the external party and not within the group

Designation of Hedging Instruments

- To be designated in its entirety, except for time element which can be separated
- The full period of hedging instruments should be covered i.e. if hedging instruments life is two years, one can not hedge item with one year maturity.
- A certain portion of hedging instruments, say 50% can be designated.
- It may cover more than one hedge item provided
  - the risk to be hedge is identified clearly
  - The effectiveness of the hedge can be demonstrated
  - It is possible to ensure specific designation.

Designation of Hedging Instruments (contd.)

- Two or more instruments can be combined and designated, provided it does not effectively become a net written option.

Hedge Items

- A group of assets or liabilities can be hedge items.
- In a portfolio hedge of interest rate risk, a portion of portfolio can be hedge item.
- HTM investment can not be hedge item for interest rate risk, as it is to held upto maturity. However, it can be hedged item in respect of foreign currency or credit risk.
- If the hedge item is a non – financial asset / liability, it should be for foreign currency risk or in its entirety for all risks, as it is difficult to isolate and measure the cash flow or fair value changes attributable.

Criteria for hedge accounting

1. **Hedge relationship must be documented at inception**
   - Risk management objective and strategy for the hedge
   - Identification of the hedging instrument
   - The related hedged item or transaction
   - The nature of the risk being hedged
   - How hedging instrument's effectiveness will be assessed

2(a) **Hedge relationship must be expected to be highly effective at inception and subsequent periods**

2(b) **Hedge effectiveness can be reliably measured**

2(c) **Actual hedge effectiveness must be measured**

3. **In the case of hedging future cash flows, there must be a high probability of that cash flow occurring**

Firm commitments and forecast transactions

- Firm commitment – definition:
  - A binding agreement for the exchange of a specified quantity of resources at a specific price on a specified future date(s)

- Forecasted transaction – definition
  - A transaction that is expected to occur (highly probable) for which there is not a firm commitment
  - Does not give an entity any present right to future benefits or a present obligation for future sacrifices

Qualifying hedging instruments – General rules

- Few restrictions on use of derivatives as hedging instruments
  - Important exception: net written options
- Natural hedges of FX risk permitted in limited circumstances
  - All of the derivative must be used in the hedge relationship
  - Derivative cannot hedge another derivative
  - More than one derivative can be used in a hedging relationship
  - Profit related hedges not permitted

Types of hedges

Main types of hedging relationships

Fair value hedge

- a recognised asset or liability;
- an unrecognised firm commitment; or
- an identified portion of any of the above two, that is attributable to a particular risk

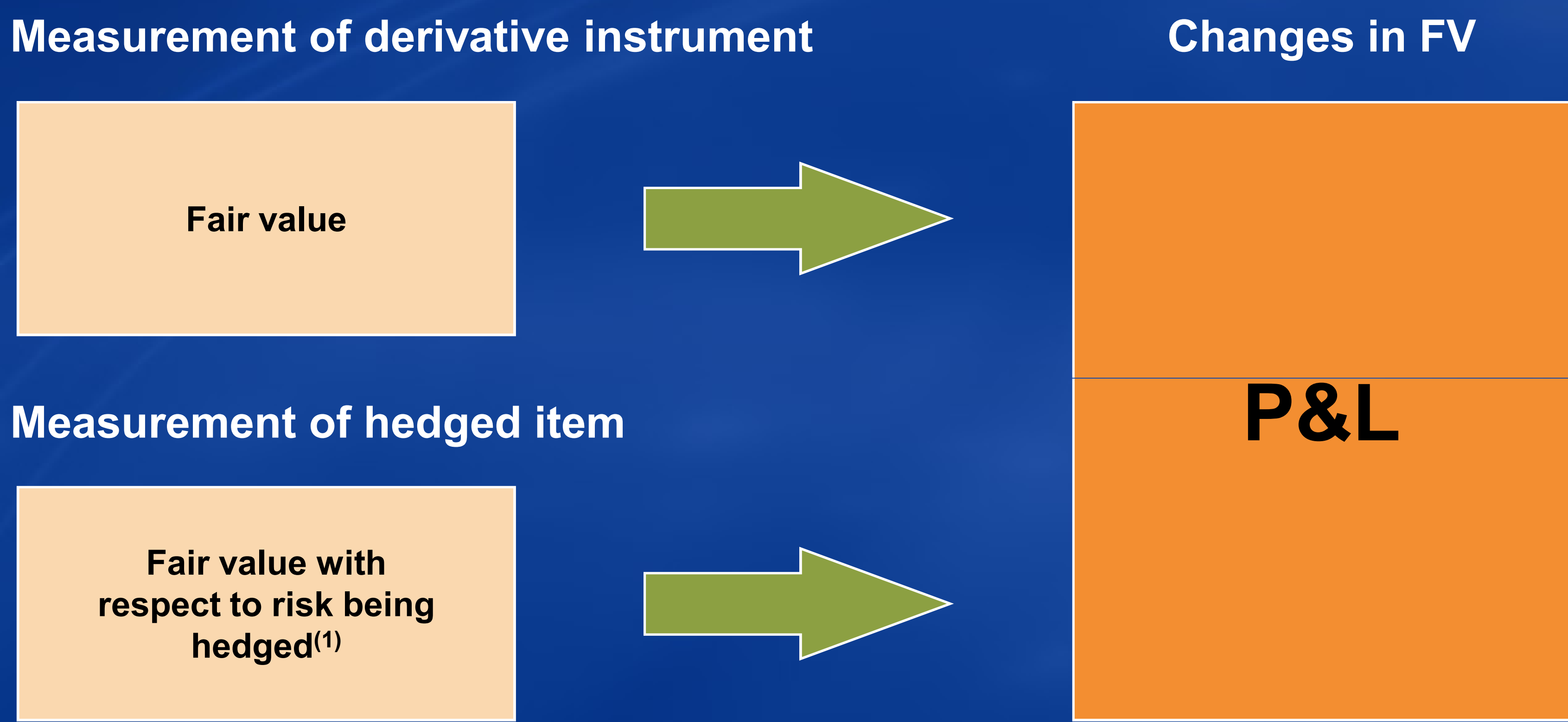
Cash flow hedge

- attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction; and
- could affect profit or loss

Net investment hedge

- Hedge 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 as per AS 13
- Hedging instruments can be foreign currency monetary items or derivatives

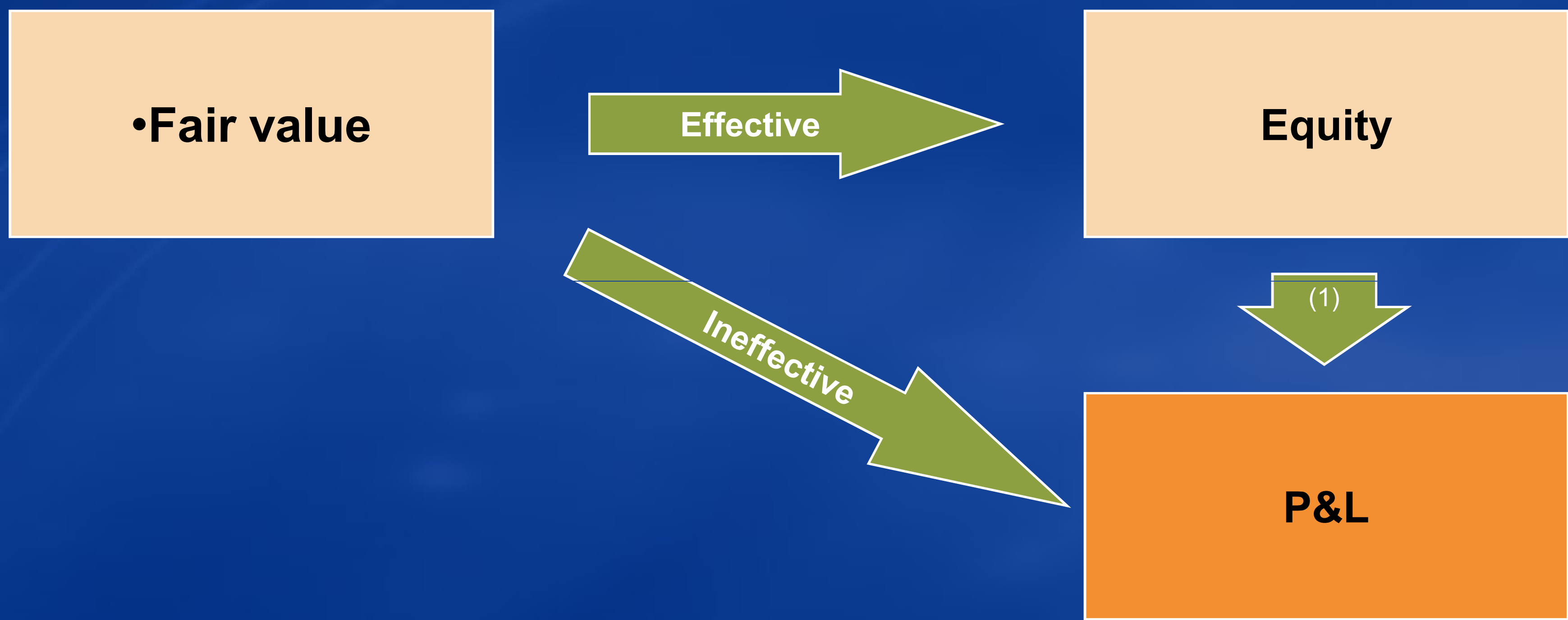
Fair value hedge accounting model



(1) This applies even if a hedged item is otherwise measured at FV with FV changes recognised in equity or if hedged item is measured at cost

Cash flow hedge accounting model

Measurement of derivative instrument **Changes in FV**



(1) Based on timing of earnings impact of hedged item (cost of sales, depreciation, interest)

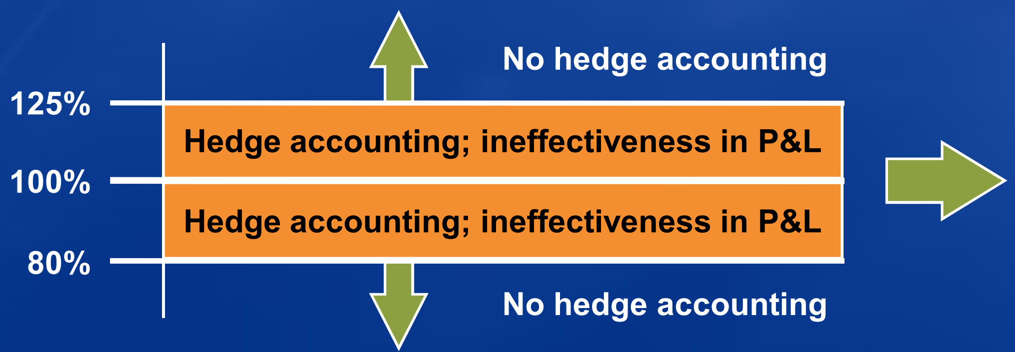
Hedges of a net investment

- Not for parent stand alone financial statements, group financial statements only
- Must meet criteria for hedge accounting
- Accounting treatment similar to that of cash flow hedges
- Effective portion of gain or loss on hedging instrument recorded in the same manner as the foreign currency translation gain or loss
- Ineffective portion is recognised in the profit or loss

Hedge effectiveness

Hedge relationship must be expected to be highly effective at inception and in subsequent periods

- General principles
- Hedge effectiveness criteria
  - highly effective at inception
  - satisfy 80-125% effectiveness back test



- Different notional and principal amounts for the derivative and hedged item
- Basis differentials
- Different maturity and re-set dates
- Currency differences
- Credit differences
- Inclusion of time value

any ineffectiveness must be recognized in P&L … even if hedge relationship is effective

When a hedge no longer is effective

•If the ongoing highly effective criterion fails, hedge accounting is discontinued

- Hedge activity recorded prior to loss of effectiveness is not affected.
- The hedge does not qualify for special accounting prospectively from the last time it was proven effective.
- There is therefore a trade off between performing effectiveness testing frequently to ensure effectiveness and the administration effort into doing this frequently

Discontinuation of hedge accounting

	•Fair value hedges	•Cash flow hedges
•Future changes in fair value of hedging instrument	● Continue to be taken to profit or loss	● Recognised immediately in profit or loss
•Changes in fair value of hedged item	● Treat as if not hedged ● For hedges of interest bearing assets, adjustments to date is amortized to profit or loss over the period to maturity	● N/A
• Amounts recorded to date in equity: a) hedged item still exist or still expected to occur b) hedged item or transaction sold or no longer expected to occur	● N/A	a) Transferred to profit or loss at the same time as the change in the hedged cash flows is recognised in profit or loss b) Transferred to profit or loss immediately

Tax related issues

1. Following should be allowed as a deduction in computing income
   - Amortization costs
   - Effect of adjustments to fair value
   - Impairment
2. Credit amounts to be transferred to equity not to be treated as income. Similarly debit adjustments to equity should not be allowed as a deduction. In any case when the amounts are drawn from equity to P & L (at the time of transfer / sale / disposal) then the amounts will need to be considered in computing taxable income
3. Effective interest rate / method concept needs to be aligned in Income Tax Act
4. Treatment of gains / losses on partial derecognition (transfers that do not qualify for recognition or continued involvement in a transferred asset) needs to be accepted by Tax Authorities
5. Accounting of Hedging as per AS 30 needs to be accepted by tax authorities

THANK YOU

????   Any Questions   ????