OVERVIEW OF INTERNATIONAL FINANCIAL REPORTING STANDARDS [IFRS], FINANCIAL INSTRUMENTS AND CONVERSION FROM IGAAP TO IFRS

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PART A

PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) - AN OVERVIEW

Chapter I

HISTORY OF ACCOUNTING

Early History

Ancient economic thought of the Near East facilitated the creation of accurate records of the quantities and relative values of agricultural products, methods that were formalized in trading and monetary systems by 2000 BC. Simple accounting is mentioned in the Christian Bible (New Testament) in the Book of Matthew, in the Parable of the Talents. The Islamic Quran also mentions simple accounting for trade and credit arrangements.

Luca Pacioli and the birth of modern accountancy

Luca Pacioli (1445 - 1517), also known as Friar Luca dal Borgo, is credited for the "birth" of accountancy. His Summa de arithmetica, geometrica, proportioni et proportionalita (Summa on arithmetic, geometry, proportions and proportionality, Venice 1494), was a textbook for use in the abbaco schools of northern Italy, where the sons of merchants and craftsmen were educated. It was a compendium of the mathematical knowledge of his time, and includes the first printed description of the method of keeping accounts that Venetian merchants used at that time, known as the double-entry accounting system.

Post-Pacioli

The first known book in the English language on accounting was published in London, England by John Gouge (or Gough) in 1543. It is described as A Profitable Treatyce called the Instrument or Boke to learn to know the good order of the kepyng of the famous reconynge, called in Latin, Dare and Habere, and, in English, debtor and Creditor

Origin in India

Ancient India is a prime example of a culture whose accounting practices merit more attention due to their complexity and innovation. Looking back at Indian history, one finds that the art and practice of accounting were present in India even in Vedic times The Rig-Veda has references to accounting and commercial terms like kraya (sale), Vanij (merchant), sulka (price). As Prof. Max Mueller observed

There is very clear evidence of the highly developed Hindu accounting tradition in "Arthashastra" written by Kautilya (also known as Chanakya and Vishnugupta) around 300 B.C.

When literally translated, it means ‘Scripture of Wealth’. Though it focuses on creation and management of wealth, it is a masterpiece covering a wide range of topics like statecraft, politics, warfare, law, accounting systems, taxation, fiscal policies, civil rules, internal and foreign trade etc.

Chapter II

HISTORY AND DEVELOPMENT OF ACCOUNTING STANDARDS

Financial Accounting Standards Board

The impetus for the Financial Accounting Standards Board dates back to the economic boom of the 1920s, the stock market crash of 1929, and the Great Depression that followed. By the mid-1930s, both the financial community and the federal government had responded to the obvious need for uniform accounting standards, particularly for the financial statements of publicly traded corporations. The New York Stock Exchange and what is now the American Institute of Certified Public Accountants (AICPA) ventured preliminary guidelines in the jointly published Audits of Corporate Accounts of 1934. The congressional Securities Act of 1933 and the Securities Exchange Act of 1934 threatened to supersede such efforts by establishing the U.S. Securities and Exchange Commission (SEC), which was authorized, among other functions, to prescribe standards for the preparation of financial reports. In 1938, however, the SEC voted to forgo this prerogative and allow the private sector to regulate its accounting practices

The AICPA's Committee on Accounting Procedure (CAP) assumed the financial accounting standard-setting role in 1939. The AICPA shifted this responsibility to its Accounting Principles Board (APB), equipped with its own research staff, in 1959. Even so, the APB's main contribution—Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises, published in 1970—was criticized as achieving too little, too late. In 1971, a special committee of the AICPA suggested that the association turn over the standard-setting role to an autonomous body. In 1973, therefore, the Financial Accounting Standards Board within the Financial Accounting Foundation was established. Soon thereafter, the SEC ratified

the FASB's role in promulgating financial accounting and reporting "principles, standards, and practices."

International Accounting Standards

Some of the most significant dates in the history of international accounting standards from the 1960s to 2005 are given below.

1966

In 1966, there was a proposal to establish an International Study Group comprising the Institute of Chartered Accountants of England & Wales (ICAEW), American Institute of Certified Public Accountants (AICPA) and Canadian Institute of Chartered Accountants (CICA).

1967

In February 1967 the Accountants International Study Group (AISG) was formed and they began to publish papers on important topics every few months .Many of these papers led the way for the standards that followed, when in March 1973 it was finally agreed to establish an international body writing accounting standards for international use.

1973

In June 1973 the International Accounting Standards Committee (IASC) came into existence, with the stated intent that the new international standards it released must "be capable of rapid acceptance and implementation world-wide". The IASC survived for 27 years, until 2001, when the organisation was restructured and the International Accounting Standards Board (IASB) came into existence.

Between 1973 and 2000 the International Accounting Standards Committee (IASC) released a series of standards called 'International Accounting Standards' in a numerical sequence that began with IAS 1 and ended with IAS 41 Agriculture which was published in December 2000.

IASB stated that they would adopt the body of standards issued by the Board of the International Accounting Standards Committee (which would continue to be designated 'International

Accounting Standards' but any new standards would be published in a series called International Financial Reporting Standards (IFRS)

1997

The Standing Interpretations Committee (SIC) was established in 1997 to consider contentious accounting issues that needed authorative guidance to stop widespread variation in practice.

2002

The European Council of Ministers realizing the benefits of a truly international standards, approved a regulation on 6th June, 2002 that would require all EU companies listed on a regulated market to prepare accounts in accordance with International Accounting Standards for accounting periods beginning on or after 1 January 2005

2003

The first IFRS was published in June 2003 (IFRS 1: First-time Adoption of International Financial Reporting Standards).

2005

Listed companies in the UK were required to present their financial statements using the international accounting standards adopted by the EU for periods commencing on or after 1 January 2005.

Other international accounting standards

International Public Sector Accounting Standards (IPSAS)

IPSAS are accounting standards for application by national governments, regional (e.g., state, provincial, territorial) governments, local (e.g., city, town) governments and related governmental entities (e.g., agencies, boards and commissions). IPSAS standards are widely used by intergovernmental organizations. IPSAS do not apply to government business enterprises.

IPSAS are issued by IPSASB (International Public Sector Accounting Standards Board).

Islamic Financial Services Board (IFSB),

The Islamic Financial Services Board (IFSB), which is based in Kuala Lumpur, serves as an international-standard setting body of regulatory and supervisory agencies that have vested interest in ensuring the soundness and stability of the Islamic financial services industry, which is defined broadly to include banking, capital market and insurance. In advancing this mission, the IFSB promotes the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing international standards consistent with Islamic Shari'ah principles, and recommend them for adoption.

The 178 members of the IFSB include 42 regulatory and supervisory authorities as well as International Monetary Fund, The World Bank, Bank for International Settlements, Islamic Development Bank, Asian Development Bank, and 130 market players and professional firms operating in 34 jurisdictions.

IFSB has published standards 1 to 7 so far

Chapter III

ACCOUNTING STANDARDS IN INDIA

1. Accounting Standards Board (ASB)

The Institute of Chartered Accountants of India (ICAI) being a member body of the IASC, constituted the Accounting Standards Board (ASB) on 21st April, 1977, with a view to harmonize the diverse accounting policies and practices in use in India. After the vowed adoption of liberalization and globalization as the corner stone's of Indian economic policies in early '90s, and the growing concern about the need of effective corporate governance of late, the Accounting Standards have increasingly assumed importance. While formulating accounting standards, the ASB takes into consideration the applicable laws, customs, usages and business environment prevailing in the country. The ASB also gives due consideration to International Financial Reporting Standards (IFRSs)/ International Accounting Standards (IASs) issued by IASB and tries to integrate them, to the extent possible, in the light of conditions and practices

prevailing in India. ICAI has issued 32 Accounting standards so far and has announced that it will fully converge to IFRS by 2011.

The Accounting Standards will be mandatory from the respective date(s) mentioned in the Accounting Standard(s). The mandatory status of an Accounting Standard implies that while discharging their attest functions, it will be the duty of the members of the Institute to examine whether the Accounting Standard is complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the Accounting Standard, it will be their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviation.

Ensuring compliance with the Accounting Standards while preparing the financial statements is the responsibility of the management of the enterprise. Statutes governing certain enterprises require of the enterprises that the financial statements should be prepared in compliance with the Accounting Standards, e.g., the Companies Act, 1956 (section 211), and the Insurance Regulatory and Development Authority (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000.

Financial Statements cannot be described as complying with the Accounting Standards unless they comply with all the requirements of each applicable Standard

2. Companies (Accounting Standard) Rules, 2006

Accounting standards are also notified by Central Government in exercise of the powers conferred by clause (a) of sub-section (1) of section 642 of the Companies Act, 1956 , read with sub-section (3C) of section 211 and sub-section (1) of section 210A of the said Act, in consultation with National Advisory Committee on Accounting Standards. Central Government notified Accounting Standards in Companies (Accounting Standard) Rules, 2006 by notification o. G.S.R. 739 (E), dated 7th December, 2006[AS 1 to 7 and 9 to 29 of ICAI]. It also issued Companies (Accounting Standards) Amendment Rules, 2008 by notification no. G.S.R. No. 212 (E), dated 27th March, 2008 making some modification in existing rules so as to harmonize them

with accounting standards issued by ICAI. These standards are applicable to preparation of general purpose financial statements for accounting periods commencing on or after 7-12-2006

3. Sec 145 of Income Tax Act, 1961- Method of Accounting

Sec 145 (2) has empowered The Central Government may notify in the Official Gazette from time to time accounting standards to be followed by any class of assessees or in respect of any class of income.

Vide Notification S.O.69 (E) dated 25.01.1996, the Central Government has notified the following accounting standards to be followed by all assessees following the mercantile system of accounting, namely

Accounting standard I- Disclosure of Accounting policies

Accounting Standard II relating to disclosure of prior period and extraordinary items and changes in accounting policies

4. Accounting Standards for Local Bodies, issued by the Council of the Institute of Chartered Accountants of India.

The term ‘Local Body’ may be defined as a local self-government at the third tier of governance in an administrative and geographical vicinity, e.g., a municipal corporation, a municipality or a panchayat. In many cases, the Local Bodies delegate their functions such as building of schools, city roads, parks, running transport services, providing water supply etc., to some other bodies that may or may not be controlled by the Local Bodies, e.g. development authorities, boards, parastatals. Such bodies may be constituted, in partnership with private sector or otherwise, directly or indirectly by or on behalf of a Local Body to promote or carry out some specific objective(s) or function(s) of the Local Bodies. Such bodies may be constituted under a statute. The term ‘Local Body’ would also encompass such bodies.

The Accounting standards issued so far include:

1. Accounting Standard for Local Bodies (ASLB) 3- Revenue from Exchange Transactions

(Based on corresponding IPSAS 9)

2. Accounting Standard for Local Bodies (ASLB) 4- Borrowing Costs (Based on corresponding IPSAS 5)

5. Cost Accounting Standards

Institute of Cost and Works Accountants of India [ICWAI] has issued seven Accounting standards which are recommendatory in nature and every member of the institute is expected to honour the same.

Cost Auditors have to adopt and encourage the adoption of the standards, wherever applicable, in maintenance of Cost Accounting Records Rules under Section 209(1)(d) and report deviations, if any, in the Audit Reports under Section 233B

So far ICWAI has issued CAS 1 TO 7. CAS 8 TO 12 is in draft stage

Chapter IV

NEED FOR IFRS

A single set of accounting standards would have the following benefits:

a) Ease to standardize training and assure better quality of accounting profession

b) It would also permit international capital to flow more freely

c) It would enable companies to develop consistent global practices on accounting problems.

d) It would be beneficial to regulators as a complexity associated with needing to understand various reporting regimes would be reduced.

e) It would enhance comparability between financial statements of various companies across the globe

f) It would reduce time and resources required to prepare different set of accounts for companies listed in various exchanges of the world and for companies having global group companies.

India and IFRS

Accounting Standards in India are issued by Accounting Standard Board (ASB) of Institute of Chartered Accountants of India and are largely based on IFRS. However, India has not been able to keep pace with the amendment and additions made in IFRS from time to time. This is largely because of its sensitivity to local conditions including the conflicting legal and economic environment. However, with the opening of Indian economy in near past, the convergence to IFRS has become unavoidable. Keeping this in view, ASB decided to form an IFRS task force in August 2006. Based on the recommendation of this task force, the Council of ICAI, in its 269th meeting decided to fully converge with IFRS from the accounting periods commencing on or after 1st April 2011. At initial stage, this convergence will be mandatory for listed and other public interest entities like banks, insurance companies, NBFCs, and large sized organizations with high turnover or annual income.

Why this convergence?

Converging with IFRS will have multiple benefits for Indian entities especially those who aspire to go global. Some of the benefits of convergence with IFRS are explained below:

a) Accessibility to foreign capital markets

The force of globalization has enabled the concept of 'open economy' and increasing numbers of countries has opened doors for foreign investment and foreign capital. Many Indian entities expanding and making their presence felt in international arena. Huge amount of capital commitment are required in this process for which entities have to list their shares in various stock exchanges around the world. Majority of stock exchanged either require or permit IFRS complaint accounts. Adaptation of IFRS will enable Indian entities to have access to international capital markets.

b) Reduced Cost

At present when Indian entities list their securities abroad they have to make another set of accounts which are acceptable in that country. Convergence with IFRS will eliminate this need for preparation of dual financial statements and thereby reduce the cost of raising capital from foreign markets.

c) Enhance Comparability

If the Financial statements of Indian entities are made in lines of IFRS, they will have greater comparability and will enable foreign companies to have broader and deeper understanding of the entities relative standing. This will also facilitate mergers, amalgamation and acquisition decisions.

d) Boon for multinational group entities

Entities in India may have a holding, subsidiary or associate company in some other nation. Compliance with IFRS for all group entities will enable the company management to have all the financial statements of the group in one reporting platform and hence will facilitate the consolidation process.

e) New Opportunities for the professionals

Migration to IFRS will not only be beneficial for Indian corporates, it will also be a boon to Indian accounting and other associated fields. India is a country with immense human resource. With knowledge of IFRS Indian professional can immerge as leading accounting service provider around the globe. This convergence will also open the flood gate of opportunities for valuers and actuaries as IFRS is fair value based accounting standard.

Chapter V

IASC FOUNDATION CONSTITUTION

The International Accounting Standards Committee (IASC) was formed in 1973 through an agreement made by professional accountancy bodies from Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom and Ireland, and the United States of America. Additional sponsoring members were added in subsequent years, and in 1982 the sponsoring "members" of the IASC comprised all of the professional accountancy bodies that were members of the International Federation of Accountants (IFAC).

Accounting standards were set by a part-time, volunteer **IASC Board** that had 13 country members and up to 3 additional organisational members. Each member was generally represented by two "representatives" and one "technical advisor". The individuals came from a wide range of backgrounds – accounting practice, business (particularly multinational businesses), financial analysis, accounting education, and national accounting standard-setting. The Board also had a number of observer members (including representatives of IOSCO, FASB, and the European Commission) who participated in the debate but did not vote

The New Structure: Background and Chronology

After nearly 25 years of achievement, IASC concluded in 1997 that to continue to perform its role effectively, it must find a way to bring about convergence between national accounting standards and practices and high-quality global accounting standards. To do that, IASC saw a need to change its structure. In late 1997 IASC formed a Strategy Working Party to re-examine its structure and strategy. (Jacques Manardo, Deloitte Touche Tohmatsu Global Managing Partner-Strategic Clients, was a member of that group.)

The Strategy Working Party published its Report, in the form of a Discussion Paper, in December 1998. After soliciting comments, the Working Party published its Final Recommendations in November 1999.

The IASC Board approved the proposals unanimously in December 1999, and the IASC member bodies did the same in May 2000. A new IASB Constitution took effect 1 July 2000. It would operate under a new International Accounting Standards Committee Foundation (IASCF).

On 1 April 2001, the new IASB took over from the IASC the responsibility for setting International Accounting Standards.

Key Differences between IASC and IASB

The IASB differs from the IASC Board, its predecessor body, in several key areas:

Unlike the IASC Board, the IASB does not have a special relationship with the international accounting profession. Instead, IASB is governed by a group of Trustees

of diverse geographic and functional backgrounds who are independent of the accounting profession.

Unlike the members of the IASC Board, members of the IASB are individuals who are appointed based on technical skill and background experience rather than as representatives of specific national accountancy bodies or other organizations.

Unlike the IASC Board, which only met about four times a year, the IASB Board usually meets each month. Moreover, the number of technical and commercial staff working for IASB has increased significantly as compared with IASC. (Similar to IASC, the headquarters of the IASB is located in London, the United Kingdom.)

The interpretive body of the IASC (SIC), has been replaced by the International Financial Reporting Interpretations Committee (IFRIC).

Overview of the Restructured IASB

The IASB is organised under an independent Foundation named the International Accounting Standards Committee Foundation (IASCF). That Foundation is a not-for-profit corporation created under the laws of the State of Delaware, United States of America, on 8 March 2001. Components of the new structure:

1. International Accounting Standards Board – has sole responsibility for establishing International Financial Reporting Standards (IFRSs).

2. IASC Foundation – oversees the work of the IASB, the structure, and strategy, and has fundraising responsibility.

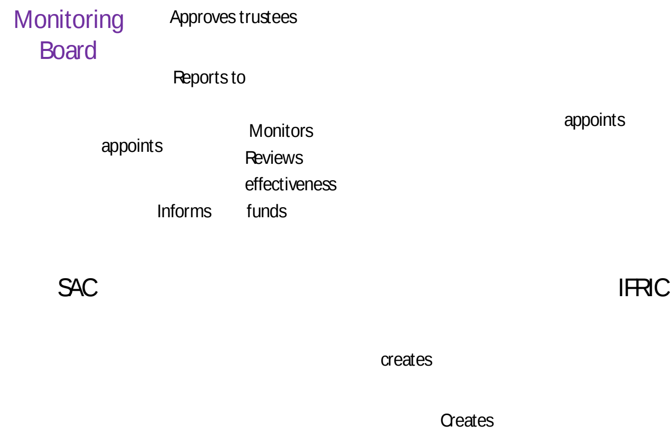
3. International Financial Reporting Interpretations Committee (IFRIC) – develops interpretations for approval by the IASB.

4. Standards Advisory Council (SAC) – advises the IASB and the IASCF.

5. Working Groups – expert task forces for individual agenda projects.

6. Monitoring Board of Public Authorities- effective 01.02.2009

Diagrammatic representation of the bodies associated with IFRS



Chapter VI

FRAMEWORK FOR THE PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

The IASB Framework was approved by the IASC Board in April 1989 for publication in July 1989, and adopted by the IASB in April 2001.

Purpose of the framework

The purpose of the Framework is:

(a) To assist the Board of IASC

in the development of future International Accounting Standards and in its review of existing International Accounting Standards;

in promoting harmonization of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by International Accounting Standards;

(b) To assist national standard-setting bodies in developing national standards;

(c) To assist preparers of financial statements in applying International Accounting Standards and in dealing with topics that are not yet the subject of an International Accounting Standard;

(d) To assist auditors in forming an opinion as to whether financial statements conform with International Accounting Standards;

(e) To assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with International Accounting Standards; and

(g) To provide those who are interested in the work of IASC with information about its approach to the formulation of International Accounting Standards.

Scope of Framework

The scope of the Framework is to explain

(a) The objective of financial statements;

The financial statement of any enterprise should serve at its minimum the following objectives

I. To provide information regarding financial position, performance and changes in financial performance of an entity

II. To show the results of stewardship of management

III. To provide information regarding the liquidity of the entity

However, the financial statements need not provide all information that an user may require to arrive at decision as they contain only financial information and not the non financial information.

(b) The qualitative characteristics that determine the usefulness of information in financial statements;

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are

i. **Understandability**- users with reasonable knowledge of the business and economic activities may be able to comprehend the financial statements.

ii. **Relevance**- The users should find the information contained in the financial statements as a useful relevant tool in taking important economic decisions on the basis of past evaluations and projecting future predictions on past basis.

iii. **Reliability** - Information in financial statements is reliable if it is free from material error and bias and can be depended upon by users to represent events and transactions faithfully. Information is not reliable when it is purposely designed to influence users' decisions in a particular direction.

iv. **Comparability** - Users must be able to compare the financial statements of an enterprise over time so that they can identify trends in its financial position and performance. Users must also be able to compare the financial statements of different enterprises. Disclosure of accounting policies is essential for comparability. [F.39-42]

(c) The definition, recognition and measurement of the elements from which financial statements are constructed;

Elements of Financial Statements

(1) Assets:

Definition: It is resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow.

Recognition: When it is probable that future economic benefits will flow to and the asset has cost or value that can be reliably measured

(2) Liabilities:

Definition: It is the present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Recognition: When it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be reliably measured.

(3) Equity

Definition: it is the residual interest in the asset of the entity after deducting all its liability.

(4) Income

Definition: Income is the increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities those results in increase in equity, other than those relating to contribution from equity participants. It encompasses both revenue and gains.

Recognition: When an increase in the future economic benefits related to an increase in an asset or decrease in a liability has arisen that can be reliably measured.

(5) Expenses

Definition: It is the decrease in economic benefits during the accounting period in the form of outflows or depletion of assets or incurrence of liabilities those results in decrease in equity, other than those relating to contribution to equity participants. It encompasses both losses and expenses that arise in the course of ordinary activity of the entity.

Recognition: When an decrease in the future economic benefits related to an decrease in an asset or increase in a liability has arisen that can be reliably measured

Measurement of the Elements of Financial Statements

Measurement involves assigning monetary amounts at which the elements of the financial statements are to be recognised and reported.

The Framework acknowledges that a variety of measurement bases are used today to different degrees and in varying combinations in financial statements, including:

- Historical cost
- Current cost
- Net realisable (settlement) value
- Present value (discounted)

Historical cost is the measurement basis most commonly used today, but it is usually combined with other measurement bases. The Framework does not include concepts or principles for selecting which measurement basis should be used for particular elements of financial statements or in particular circumstances. The qualitative characteristics do provide some guidance, however.

(d) Concepts of capital and capital maintenance.

The concept of capital maintenance is concerned with how an entity defines the capital that it seeks to maintain. It provides the linkage between the concepts of capital and the concepts of profit because it provides the point of reference by which profit is measured; it is a prerequisite for distinguishing between an entity's return on capital and its return of capital; only inflows of assets in excess of amounts needed to maintain capital may be regarded as profit and therefore as a return on capital. Hence, profit is the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income. If expenses exceed income the residual amount is a loss.

Users of financial statement and their information needs

The Framework notes that financial statements cannot provide all the information that users may need to make economic decisions. For one thing, financial statements show the financial effects of past events and transactions, whereas the decisions that most users of financial statements have to make relate to the future. Further, financial statements provide only a limited amount of the non-financial information needed by users of financial statements.

While all of the information needs of these user groups cannot be met by financial statements, there are information needs that are common to all users, and general purpose financial statements focus on meeting these needs.

Responsibility for Financial Statements

The management of an enterprise has the primary responsibility for preparing and presenting the enterprise's financial statements.

Investors	Risk inherent in, and return provided by, their investments. Such Information is needed for decision making and to determine their return
Employees	stability and profitability of their employers Information which enables them to assess the ability of the enterprise to provide remuneration, retirement benefits and employment opportunities.
Lenders	Whether loans repayments and interest will be paid when due and to access their security
Suppliers and other trade creditors	Whether amounts owing to them will be paid when due.
Customers	Continuance of an enterprise, especially when they have a long-

	term involvement with, or are dependent on, the enterprise.
Government and their agencies	Allocation and utilization of resources and the activities of the enterprise To regulate the activities of enterprises, determine taxation policies and as the basis for national income and similar statistics.
Public	Contribution to the local economy Trends and recent developments in the prosperity of the enterprise and the range of its activities.

LIST OF IFRS:

* Note: IFRS 2 was amended on 18.06.2009 and subsequently IFRIC 8 AND 11were withdrawn.

Sl. No.	IFRS / IAS / IFRIC / SIC	Number of IFRS / IAS / IFRIC / SIC	Name of IFRS / IAS / IFRIC / SIC
1	IFRS	1	First - time Adoption of International Financial Reporting Standards
2	IFRS	2	Share-based Payment
3	IFRS	3	Business Combinations
4	IFRS	4	Insurance Contracts
5	IFRS	5	Non-current Assets Held for Sale and Discontinued Operations
6	IFRS	6	Exploration for and evaluation of Mineral Resources
7	IFRS	7	Financial Instruments: Disclosures

Sl. No.	IFRS / IAS / IFRIC / SIC	Number of IFRS / IAS / IFRIC / SIC	Name of IFRS / IAS / IFRIC / SIC
8	IFRS	8	Operating Segments
9	IAS	1	Presentation of Financial Statements
10	IAS	2	Inventories
11	IAS	11	Statement of Cash Flows
12	IAS	8	Accounting Policies, Changes in Accounting Estimates and Errors
13	IAS	10	Events After the Reporting Period
14	IAS	11	Construction Contracts
15	IAS	12	Income Taxes
16	IAS	16	Property, Plant and Equipment
17	IAS	17	Leases
18	IAS	18	Revenue
19	IAS	19	Employee Benefits
20	IAS	20	Accounting for Government Grants and Disclosure of Government Assistance
21	IAS	21	The Effects of Changes in Foreign Exchange Rates
22	IAS	23	Borrowing Costs
23	IAS	24	Related Party Disclosures
24	IAS	26	Accounting and Reporting by Retirement Benefit Plans
25	IAS	27	Consolidated and Separate Financial Statements
26	IAS	28	Investments in Associates
27	IAS	29	Financial Reporting in Hyperinflationary Economies

Sl. No.	IFRS / IAS / IFRIC / SIC	Number of IFRS / IAS / IFRIC / SIC	Name of IFRS / IAS / IFRIC / SIC
28	IAS	31	Interests In Joint Ventures
29	IAS	32	Financial Instruments: Presentation – Disclosure provisions superseded by IFRS 7 effective 2007
30	IAS	33	Earnings Per Share
31	IAS	34	Interim Financial Reporting
32	IAS	36	Impairment of Assets
33	IAS	37	Provisions, Contingent Liabilities and Contingent Assets
34	IAS	38	Intangible Assets
35	IAS	39	Financial Instruments: Recognition and Measurement
36	IAS	40	Investment Property
37	IAS	41	Agriculture
38	IFRIC	1	Changes in Existing Decommissioning, Restoration and Similar Liabilities
39	IFRIC	2	Members' Shares in Co-operative Entities and Similar Instruments
40	IFRIC	4	Determining Whether an Arrangement Contains a Lease
41	IFRIC	5	Rights to Interests Arising from Decommissioning, Restoration and Environmental Rehabilitation Funds
42	IFRIC	6	Liabilities Arising from Participating in a Specific Market - Waste Electrical and Electronic Equipment
43	IFRIC	7	Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies

Sl. No.	IFRS / IAS / IFRIC / SIC	Number of IFRS / IAS / IFRIC / SIC	Name of IFRS / IAS / IFRIC / SIC
44*	IFRIC *	8	Scope of IFRS 2 (since withdrawn on18.06.2009)
45	IFRIC	9	Reassessment of Embedded Derivatives
46	IFRIC	10	Interim Financial Reporting and Impairment
47*	IFRIC *	11	IFRS 2: Group and Treasury Share Transactions(since withdrawn on18.06.2009)
48	IFRIC	12	Service Concession Arrangements
49	IFRIC	13	Customer Loyalty Programmes
50	IFRIC	14	IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction
51	IFRIC	15	Agreements for the Construction of Real Estate
52	IFRIC	16	Hedges of a Net Investment in a Foreign Operation
53	IFRIC	17	Distributions of Non-cash Assets to Owners
54	IFRIC	18	Transfers of Assets from Customers
55	SIC	7	Introduction of the Euro
56	SIC	10	Government Assistance – No Specific Relation to Operating Activities
57	SIC	12	Consolidation – Special Purpose Entities
58	SIC	13	Jointly Controlled Entities – Non-Monetary Contributions by Venturers
59	SIC	15	Operating Leases – Incentives
60	SIC	21	Income Taxes – Recovery of Revalued Non-Depreciable Assets
61	SIC	25	Income Taxes – Changes in the Tax Status of an

Sl. No.	IFRS / IAS / IFRIC / SIC	Number of IFRS / IAS / IFRIC / SIC	Name of IFRS / IAS / IFRIC / SIC
			Enterprise or its Shareholders
62	SIC	27	Evaluating the Substance of Transactions in the Legal Form of a Lease
63	SIC	29	Disclosure – Service Concession Arrangements
64	SIC	31	Revenue – Barter Transactions Involving Advertising Services
65	SIC	32	Intangible Assets – Web Site Costs

Chapter VII

PRESENTATION OF FINANCIAL STATEMENTS UNDER IFRS

7.1 INTRODUCTION

IAS 1: Presentation of Financial Statements prescribes the basis for preparation of General Purpose Financial Statements of entities complying with the IFRS. The purpose of the IAS 1 is to prescribe standards such that the financial statement presented under the IFRS is comparable with the:

- Entities financial statements of the previous period and;
- Financial statements of another entity

IAS 1 not only sets out the overall requirements for the presentation of financial statements, but also provides guidelines for their structure and minimum requirement for their contents. However, it does not prescribe any fixed format for presentation of Financial Statements though it includes a sample of illustrative financial statement structure in its *Guidance on Implementing IAS 1*which is optional.

Evolution of IAS 1

IAS 1: Presentation of Financial Statements was originally issued by IASC in September 1997. It replaces *IAS 1 Disclosure of Accounting Policies, IAS 5 Information to be Disclosed in Financial Statements* and *IAS 13 Presentation of Current Assets and Current Liabilities.* Thereafter a revised IAS 1 was issued in December 2003 and finally in September 2007. However, it cannot be said that even currently the IAS 1 has evolved to its desired form as IASB is in process of revising IAS 1 yet again.

Scope of IAS 1

IAS 1 applies to preparation and presentation of **General Purpose Financial Statement.** General Purpose Financial Statement are defined in paragraph 7 as those intended to meet the needs of users who are not in position to require an entity to prepare reports tailored to their particular information needs.

IAS 1 can be applied by all type of undertakings, including profit oriented and not-for-profit entities, public and private entities. However, not for profit entities may be required to change the descriptions used for the financial statements and line items within their financial statements. This standard applies to both Consolidated Financial Statements and Separate Financial Statements as defined in *IAS 27 Consolidated and Separate Financial Statements.* However, it does not apply to the structure of condensed interim Financial Statements prepared in accordance with IAS 34 *Interim Financial Reporting*

Purpose of Financial Statements

IAS 1 as revised till date refers to Financial Statements as structured representation of the financial performance and financial position of entity. Paragraph 9 of IAS 1 state that the objective of Financial Statements is to provide information about the entities financial position, its performance, and its cash flows, which is the utilized by the wide range of end users in making economic decisions. Moreover, it also shows results of management's stewardship of the resources entrusted to it.

IAS 1 defines a complete set of Financial Statements to be comprised of the following:

i. A statement of financial position as at the end of the period; (this was in earlier versions of IAS 1 referred to as 'Balance Sheet')

ii. A statement of comprehensive income for the period;

   - Components of profit or loss may be presented either as part of single statement of comprehensive income or in separate income statement

   - When an income statement is prepared it should be displayed immediately before the statement of comprehensive income

iii. A statement of changes in equity for the period;

iv. A statement of cash flows for the period; (earlier referred to as cash flow statement)

v. Notes, comprising a summary of significant accounting policies and other explanatory information; and

vi. A statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

The complete set may be for interim or annual period. Moreover, the titles may differ from those specified here for instance a 'statement of financial position' may be referred to as 'Balance Sheet'. Nevertheless, the titles of all the above mentioned components should be written with equal prominence and must be distinguished from other statements which management may decide to prepare at its discretion or under any regulatory requirements but which are out of the scope of IFRS.

Accounting policies may be presented as a separate statement or incorporated within notes. The notes are as important as any of the other four primary statements. Notes present the information which may be presented on the face of the statement of financial position or statement of comprehensive income or in notes. Beside these all those information which cannot be presented anywhere in the primary statements are disclosed through notes.

An entity may present additional information on a voluntary basis like report of financial review by management, environmental report or value added statement however, these statements and reports are out of scope of IFRS.

7.2 BASIS OF PREPARATION OF FINANCIAL STATEMENTS

1. Fair Presentation and compliance with IFRSs

It is required under IAS 1 that financial statements should *fairly* present the entity's financial position, financial performance and cash flows. Appropriate and consistent application of the Framework and IFRS is presumed to result in financial statements that give a fair presentation, which refers to faithful representation of the effects of transactions, other events and conditions. Paragraph 17 of IAS 1 states that *in virtually all circumstances* the use of IFRS will result in fair presentation. A fair presentation also requires an entity:

i. to select and apply accounting policies in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*

ii. to present information in a manner it provides relevant, reliable, comparable and understandable information

iii. to go beyond IFRS disclosure requirements in order to enable users to understand and assess the effects of significant unusual events, transactions or accounting treatments which may otherwise not be fully understood.

However, it should be noted that an entity cannot rectify an inappropriate accounting policy either by disclosure of the accounting policy used or by giving explanatory notes.

Under IFRS all entities complying with IFRS should make an explicit and unreserved statement of such compliance in the notes. This statement should not be made by the entity unless they comply with all the requirements of the IFRS. The requirement to comply in full with all IFRS and its interpretations is designed to prevent selective application of the standards and publication of so-called 'IFRS-lite' financial statements. Financial statements that do not comply with any one or more of specific standards are not IFRS-compliant. If an accounting matter is not

a subject of any particular IFRS, management must consider the appropriateness of such treatment in the light of "The Framework", other accepted practices and policies adopted.

Departure from IFRS under exceptional circumstances

The application of IFRS requirements in full, possibly supplemented by additional disclosures, will lead to a fair presentation of an entity's financial situation in virtually all circumstances. However, management can rebut this presumption in extremely rare circumstances if it believes that applying a particular IFRS requirement would be misleading. A departure from an IFRS is not permitted where it is made only in order to comply with national accounting and/or legal requirements. Departures from IFRS are very seldom seen in practice as the requirements and disclosures are very extensive. These disclosures make users aware that the entity has not complied with IFRS in all material respects. They give sufficient information to enable users to make an informed judgment as to whether the departure is necessary, and to calculate the adjustments that would be required to comply with the standard.

The purpose of such extensive disclosure is to enable the users of the financial statements to access the impact the compliance with IFRS would have had on the financial statements. The following disclosures should be made where management adopts to override IFRS requirements:

i. management's statement that the financial statements are presented fairly (despite the departure from a standard);

ii. a statement that the financial statements comply with IFRS in all other material respects;

iii. a statement that the financial statements depart from an IFRS, and identification of the standard;

iv. the nature of the departure and the reason for it;

v. the treatment normally required and the treatment actually adopted; and

vi. the financial impact of the departure on assets, liabilities, equity, net profit or loss and cash flows for each period presented.

Moreover, when assessing the need to depart from the requirements of any IFRS it is essential the management must consider the following:

- why the objective of the requirement cannot be made; and
- how the circumstances of the entity differs from those of the other entities who comply with IFRS.

After making these assessments, if there is a legitimate reason for departure from IFRS and the entity makes a departure, the financial statements would be regarded as compliant. In view of the strict criteria for departure from a requirement of an IFRS, IAS 1 includes a rebuttable presumption that if other entities in similar circumstances comply with a requirement, the entity's compliance with the requirement would not be so misleading that it would conflict with the objective of financial statement as stated in the *Framework. [IAS 1 BC30]*. It may happen in extremely rare circumstances that the management concludes that the compliance with IFRS would be misleading, however, as per the regulatory requirements the management may not be permitted to depart from the IFRS. In such circumstances, the entity should disclose the following:

i. the title of the IFRS in question
ii. the nature of the requirement
iii. the reason for management concluding that that complying would be misleading for each period presented, the adjustments to each item in the financial statements that management has concluded would be necessary to achieve a fair presentation.

2. Going Concern

In normal circumstances, an entity prepares its financial statements on the going concern basis. An entity is a going concern if the management has neither the intention nor the need to liquidate or to cease its operations within at least 12 months from the Statement of Financial Position date. Management has to make an assessment of entities ability to continue as going concern at each reporting date. While making assessment, it the management is aware of any material

uncertainties that exist the management should disclose such uncertainties that may cast significant doubt on the entity's ability to continue as a going concern.

Where the entity ceases to be a going concern, management should prepare the financial statements on a different basis such as on liquidation basis and the fact should be disclosed and the basis of preparation followed should be described. The reasons why the entity is no longer considered a going concern should also be disclosed.

A Case Study:

Entity X has incurred losses during the last five years of its operation, and its net worth has become negative. The entity has breached its loan covenants and is also in the process of negotiating with the banks for extension of terms of its loans. These factors raise substantial doubt that the entity will be able to continue as a going concern.

Solution

The Management of the entity A should disclose details of the uncertainty existing. Besides explaining the uncertainties the management should also give details of the actions proposed to address the situation. Management should also disclose the possible effects on the financial position. If it is it is impracticable to measure them, the fact should be disclosed. Additionally, management should state whether the financial statements include any adjustments that might result from the outcome of these uncertainties. In particular, if bank borrowings have been disclosed as non-current in the assumption that discussions with the bank will result in an extension of the loan facilities, details of this fact should be disclosed.

Sometimes it may happen that the management of the entity may decide to liquidate the entity after the reporting date but before the financial statements are authorized for issue. In such cases, also the management shall prepare the entity's financial statements on a basis other than going concern basis.

3. Accrual basis of accounting

All financial statements except the statement of cash flows should be made by entity using accrual basis of accounting. The accrual basis of accounting has been defined in the *Framework.*

It means that that the effect of the transactions and other events are recognised when they occur and not when the cash or other equivalent is received or paid and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. In other words, the entity recognises the elements of financial statements i.e. assets, liabilities, equity, income and expense when they satisfy the recognition criteria specified in the *Framework.*

4. Materiality and Aggregation

As per IAS 1, each material class of similar items should be presented separately in the financial statements. Immaterial items, however, should be aggregated with amounts of similar nature and function. Information is regarded as material if it might reasonably affect evaluations and decisions in respect of the reporting entity, or if its omission or misstatement could influence user's economic decisions. Information is also considered material where the nature and circumstances of the transaction or event are such that users of the financial statements should be made aware of them. For example, a related party transaction should be reported even if the amount involved is insignificant. When evaluating whether an item is material, each case must be judged by its size and nature. The assessment should be made in the context of the financial statements as a whole and in relation to relevant financial statement components while making assessment qualitative as well as quantitative factors should be assessed and the sensitivity of an item to adjustment should be considered.

A Case Study:

Entity X reclassifies a plant, from PPE used for industrial purposes to PPE used for administrative purposes. As a result, of which the related depreciation expense was previously part of cost of sales and has subsequently been reclassified to administrative expenses. The asset’s carrying value and depreciation expense for the period is not material as compared to overall entity.

The entities statement of Comprehensive Income shows the following:

Revenue	Rs. 40,00,000
Cost of sales	Rs. 39,95,000

Gross profit Rs. 5,000

Depreciation reclassified from cost of sales to administrative expenses was Rs. 8,000

Solution

In the above case, the management of the entity X should disclose the change in classification. The information is material as the entity has reported a 'gross profit' of RS. 5000 as a result of the reclassification rather than a 'gross loss' of Rs. 3000 which would have been presented has not the reclassification taken place. The presentation of a gross loss rather than a gross profit might alter the users' perception of the entity's performance.

5. Offsetting

Generally under IFRS, offsetting, or netting, of assets with liabilities or income with expenses is prohibited unless it is explicitly permitted or required by any another standard. Instances where the other IFRS permits offsetting would be

IAS 12 requires that the tax liability and tax asset should be offset where there is a legally enforceable right of offset and settlement is on net basis

IAS 20 permits offsetting of a capital grants against asset as an alternative to setting up of deferred credit.

Similarly, IAS 32 states that a financial asset and liability should be offset against each other, to present net amount in the Statement of Financial Position only when an enterprise has a currently enforceable right to set off the recognised amounts and intends to either settle on net basis or simultaneously settle the liability and realize the asset.

Offsetting, is only permitted where it reflects the substance of the transaction or other events otherwise it detracts the users to understand the transaction undertaken and to access the future cash flows of the entity. However, offsetting does not include the deduction of amounts representing an impairment of assets. Similarly, reporting the carrying amount of assets net of accumulated depreciation and amortization is not regarded as an instance of offsetting. There is no requirement to disclose the gross amount of accounts receivable and the related provision for bad and doubtful accounts. However, the valuation allowance against such accounts should be

included in the carrying amount. Moreover, the transactions that are in the ordinary course of business which do not generate revenue, but which are incidental to the main revenue-generating activities, may be presented on a net basis only if such presentation reflects the substance of the transaction. However, where the transactions are of such size or significance, separate disclosure should be given in order to give a fair presentation.

In some cases netting off of with related expense arising out of same transaction is permitted. For example, gains/ losses on sale of noncurrent assets are reported after deducting carrying value and selling expenses from proceed. Moreover, expenditure directly related to a recognised provision that is reimbursed under the contractual arrangements with a third party may be netted against the reimbursement.

6. Frequency of Reporting

IFRS does not prescribe any fixed time period for or the frequency of financial reporting. However, it states that entity should present a complete set of account at least annually. It further requires that entity reporting for shorter or longer periods than one year should disclose the following:

The reason for using shorter or longer period; and

Te fact that the amounts presented in financial statements are not entirely comparable.

A Case Study:

An entity in the business of publishing weekly magazines wants to report on the weekly basis rather than for 1 year. Can it do so under IFRS?

Solution:

Yes, it is not precluded from doing so under IFRS provided it discloses the fact with reasons for doing so.

7. Comparative Information

Except when IFRSs permit or require otherwise, an entity shall disclose comparative information in respect of the previous period for all amounts reported in the current period's financial

statements. An entity shall include comparative information for narrative and descriptive information when it is relevant to an understanding of the current period's financial statements. In other words, a minimum an entity will be required to present at least two of each statement. However, in case where an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements it will be required to present an additional statement of financial position as at the beginning of the earliest comparative period. To illustrate this, suppose an entity's reporting period in 31st March, 2009. It reclassifies an item in its financial statements that requires it to reclassify retrospectively. In such a case entity would be required to make three statements of financial position viz. as at 31st March, 2009, as at 31st March 2008 and as at1st April 2007 (which is corresponding to statement of financial position as at31st march, 2007). It will make only two set of other statements and related notes.

8. Consistency of preparation

A change in presentation and classification of items from one period to the next is permitted only when it is a result of:

- a significant change in the nature of the entity's operations;
- identification of a more appropriate presentation; or
- the requirements of a new IFRS or SIC.

Where such changes are made, the corresponding figures for prior periods should also conform to the new presentation. The nature of reclassification, the amount of each item or class of items reclassified and reasons for the reclassification should also be disclosed.

An entity should disclose the reason for not reclassifying comparative information if it is impossible or economically unreasonable to determine comparable amounts for previous periods. The nature of changes that would have been made if the reclassification had been practicable should also be given.

Changes on the basis of a more appropriate presentation should only be made where the benefit of the alternative presentation is clear. The term 'appropriate' here would be demonstrated if the

financial statements prepared are more 'relevant' and 'reliable'. Such changes will therefore be infrequent.

7.3 STATEMENT OF FINANCIAL POSITION

Statement of Financial Position is a statement that presents assets, liabilities and shareholder's equity (net worth) at given point of time. The Statement of Financial Position presents the 'snapshot' of entities resources and claims to resources at a particular time. The other titles which are popularly used for this statement is Balance Sheet, Statement of Financial Condition or Statement of Assets and Liabilities. This statement is also sometimes described as 'stock' statement because it reflects the balances of the entity's accounts at a moment in time. Contrary to this, other basic financial statements are described as 'flow' statements as they reflect summarized results of transaction over a period of time

Structure and Content of Financial Statements in General

IFRS prescribes the following details to be always displayed in the heading of the Statement of Financial Position:

- the financial statements
- the reporting enterprise
- whether the statements are for the enterprise or for a group
- the date or period covered
- the presentation currency
- the level of precision (thousands, millions, etc.)

Elements Recognized in the Statement of Financial Position

The elements of financial statements are the broad classifications and groupings which convey the substantive financial effects of transactions and events on the position or performance of the

reporting entity. To be included in the financial statements the transaction or event should meet the definition, recognition, and measurement criteria set out in Framework or other IFRSs.

ASSETS

Definition: It is resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow.

Recognition: When it is probable that future economic benefits will flow to and the asset has cost or value that can be reliably measured

In other words, four important characteristics must be present for an asset to be recognised in the Statement of Financial Position are:

- The asset must provide probable future economic benefit that enables it to provide future net cash inflows.
- The entity is able to receive the benefit and restrict other entities access the benefit.
- The event that provide the entity with the right to benefit has occurred
- The asset is capable of being measured reliably.

Future Economic Benefit

Paragraph 53 of the *Framework* stats that 'the future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity'. This potential to contribute may take the form of convertibility into cash or equivalent, or reduce cash out flows or it may enhance the productivity of the operating activities of the entity. Therefore, the future economic benefits in an asset may flow to entity in many ways. For example:

- Most assets like machineries, plants etc. are used by entity to produce goods or services which are sold to the customers to and hence economic benefits flow to the entity.
- Assets like Financial Instruments may be exchanged for cash or other assets
- Assets like cash and bank balances may be used by entity to settle a liability.
- Assets may be distributed to the owners of the equity.

Past Event

The assets are the results of the past event or the past transaction. However, generally assets are either purchased or produced by the entity itself sometimes they may be procured by other means like government grants. Future transaction or events expected to occur in future does not give rise to an asset for example an intention to purchase or produce does not create an asset.

Reliability of measurement

Assets to be recognised should be capable of being reliably measured. The measurement is said to be reliable when it is free from material error and bias and users can depend upon it for making informed economic decisions. Some times IFRS permits the use of estimates if estimates give fair representations.

Nexus of Asset and Expenses

Generally, there is a nexus between incurrence of expenses and generating of asset though it is not essential that that the two events coincides. Thus, when entity incurs an expenditure it may happen that it does not give rise to an asset for example expenses incurred during the research phase of development of intangible asset may not be recognised in the asset. Similarly, an item may satisfy the definition of assets even in the absence of related expenditure as in the case of government grants or donations received by the entity.

Physical Form

Physical Form is not essential to the existence of an asset. The intangible assets like copyrights, goodwill etc. are recognised as assets despite the absence of physical form.

Legal right of ownership

Most assets are associated with legal right including right of ownership. However, it is not essential for existence of asset. For example, self-generated know how from which the entity can derive future economic benefit by keeping it secret.

Classification of Asset for presentation in statement of financial position

IAS 1 states that an entity should make a distinction between current and non current assets and liabilities, except when the presentation based on liquidity provides information that is more

reliable and relevant. An item is classified as current when it satisfies any of the following requirements:

- it is expected to be realized, or is held for sale or consumption in, the entity's normal operating cycle;
- it is expected to be realized within twelve months of the reporting date;
- it is held basically for trading purpose; or
- it is unrestricted cash or cash equivalent

All other assets that do not satisfy any of the above criteria should be classified as non-current assets. If current asset category includes an item that has the life of more than twelve month, the amount that falls into next financial year should be disclosed in the notes.

Here, it is important to understand what the normal operating cycle of an enterprise is. It is the time between the acquisition of material entering into a process and its realization in cash or its equivalent. Assets like inventories and trade receivable should be classified as current assets in a classified statement of financial position even if these assets are not expected to be realized within twelve months of the statement of financial position date. However, marketable security, even though more liquid than inventories and receivable, should not be classified as current until that are expected to realize within twelve months.

A Case Study:

An entity operates in the aircraft building industry and is involved in building aircrafts for local and export clients. The average operating cycle is 20 months, based on the length of time it takes to build an aircraft. Management presents a classified statement of financial position to distinguish the entity’s current and non-current assets and liabilities. The entity holds a held-to-maturity investment that is to mature in15 months.

Solution

The held –to-maturity investment should be classified as non-current. The concept of operating cycle does not apply to financial assets such as held-to-maturity investments.

Management should therefore classify the investment according to the 12-month benchmark. The length of the entity's operating cycle of 20 months is not relevant to the investment's classification.

In the above example, had it been trade receivables instead of HTM investment, entity could have classified it as current assts rather than non current despite the fact that it would be realized twelve months after the reporting date.

However, an entity that does not present a classified statement of financial position should present its assets and liabilities broadly in order of increasing or decreasing liquidity. Normally, entities in the banking and insurance industry tend not to use a current non-current classified statement of financial position A financial institution's assets and liabilities can usually be realized or settled within the near future. The most useful approach to the classification of assets and liabilities is therefore to group them by the nature and list them in the approximate order of their liquidity or maturity.

An entity may also choose to present its assets and liabilities in a mixed method wherein some items are classified as current or non- current whereas other are presented according to increasing or decreasing order of liquidity if this presentation is more reliable and relevant.

Items of Current Assets

Only assets that meet the definition of a current asset should be classified as current. All others should be classified as non-current assets. Therefore, current asset would include:

i. **Inventories**

IAS 2 defines inventory as assets held for sale in the ordinary course of business, in the process of production for sale, or in the form of materials or supplies to be consumed in production or in rendering services. The basis of valuation and method of pricing should be disclosed and in case of manufacturing concern the break up regarding the raw

materials, work-in-progress and finished goods should be disclosed either in the face of statement of financial position or in the notes.

ii. Receivables

It includes account receivables i.e. amount due from customers in the ordinary course of business, receivables from related companies, officers and employees of the company. Trade receivables and prepayments should be classified as current assets because they will be realized in the entity's operating cycle whereas Related party receivables should be classified as current only when there is both the ability and intention to realize those amounts within the next twelve months. If the expected realization of receivables exceeds twelve months from the reporting date, this should be disclosed. Allowances due to expected lack of collectibility and any amount pledged or discounted should be stated clearly.

iii. Prepaid Expenses

These are assets created by prepayment of cash or incurrence of a liability which expires and convert to expenses with passage of time, use or on happening of certain events. Often this is aggregated with other amounts, as the amount involved is generally not very material.

iv. Trading Investments

This includes investments those are held for generating a profit from short-term fluctuations and derivatives..

v. Cash and Cash Equivalents

This includes cash on hand, undeposited checks, money orders, drafts, deposits in banks etc. Cash equivalent as per IAS 7 is short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. Therefore, the money market instruments like treasury bills, commercial papers and money market funds are all example of cash equivalent.

Non Current Assets

All assets that do not satisfy the criteria of the current assets will be presented a non-current assets. It includes tangible, intangible, operating and financial assets of a long-term nature. Some of the examples of non current assets are as follows:

i. Held-to-maturity investments
ii. Investment Properties
iii. Property, plant and equipments
iv. Intangible Assets
v. Assets held for disposal
vi. Other Assets

LIABILITIES

Definition: A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits

Recognition: A liability is recognised in the statement of financial position when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably

In other words, the following characteristics must be present in a liability to be recognised in a statement of financial position:

- There is a present obligation which is settled by the probable future by the entity by probable future transfer of an asset on demand or on a particular date or on happening of certain event
- This obligation is not optional for the entity and hence cannot be avoided
- The event that creates the obligation has already taken place
- The amount required to settle the obligation could be reliably measured.

Present Obligation

Existence of an obligation is the moot point that gives rise to a liability. The term obligation signifies a duty or responsibility to act in a certain way. This obligation may be contractual or statutory. IFRS also in some cases recognises ‘constructive obligation’, which may arise because of normal business practices, customs, and desire to maintain good business relations or act in equitable manner.

The present obligation should not be confused with future commitment. Therefore, if an entity makes a future commitment for purchase of an asset at a future date, it does not give rise to a present obligation and hence no liability arises. The liability arises only when the assets are delivered or entity enters into irrevocable agreement to acquire the asset.

Outflow of resources

As we have seen in the definition, the settlement of a liability involves outflow of resources containing economic benefits. This settlement may take various forms like payment of cash, transfer of other assets, provision of services, replacement of the obligation by other obligation, or conversion of obligation to equity. Beside this, an obligation may in some exceptional cases be settled by extinguishment by the other party.

Reliability of measurement

A liability to be recognised in the statement of financial position should be reliably measurable. This does not necessarily mean exact measurement should be possible. The measurement is said to be reliable when it is free from material error and bias and users can depend upon it for making informed economic decisions. Some liabilities (normally called provisions) may require use of substantial degree of estimation. They are recognised despite the estimation required if they fulfill other criteria.

Current and non-current distinction for presentation in statement of financial position

An entity shall classify a liability as current when it satisfies any of the following criteria:

- it expects to settle the liability in its normal operating cycle; or
- it holds the liability primarily for the purpose of trading; or

- the liability is due to be settled within twelve months after the end of the reporting period; or
- The entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period.

An entity shall classify all liabilities, other than those meeting one of the criteria set out above as non-current.

An entity classifies its financial liabilities as current when they are due to be settled within twelve months after the reporting period, even if:

- the original term was for a period longer than twelve months; and
- An agreement to refinance, or to reschedule payments, on a long-term basis is completed after the reporting period and before the financial statements are authorized for issue.

A Case Study:

On 1st January 2002 entity X has entered into a facility arrangement with a financial institution to ensure the availability of X's bank financing for next 7 years. What will be the classification of this loan facility in the statement of financial position as on 31st March 2008 in the following situations?

a) There is no rearrangement?
b) There is an arrangement to refinance the amount of loan for another 7 years after the maturity date and arrangement is completed on 5th May 2008 and the financial statements are authorized for issue on 30th June, 2008;
c) There is an arrangement to refinance the amount of loan for another 7 years after the maturity date and arrangement is completed on 20th March 2008.

Solution:

The loan arrangement will be classified as follows:

a) In current Liabilities
b) In current liabilities

c) In noncurrent liabilities

If an entity expects, and has the discretion, to refinance or roll over an obligation for at least twelve months after the reporting period under an existing loan facility, it classifies the obligation as non-current, even if it would otherwise be due within a shorter period. However, it should be noted that when refinancing or rolling over the obligation is not at the discretion of the entity (e.g. there is no agreement for refinancing), the potential to refinance is not considered and the obligation is classified as current.

A Case Study:

Entity A's management has entered into a facility arrangement with a financial institution to ensure the availability of A's bank financing over the long term. The committed facility has a scheduled maturity and the lender is not able to cancel unilaterally. This facility does not expire within the next 12 months.

Solution

Entity A should classify the borrowing as a non-current liability as the borrowing can be rolled over at the entity's discretion. Conversely, where an entity does not have the discretion to refinance its borrowings, amounts due should be classified as current liabilities.

When an entity breaches a provision of a long-term loan agreement on or before the end of the reporting period with the effect that the liability becomes payable on demand, it classifies the liability as current, even if the lender agreed, after the reporting period and before the authorization of the financial statement for its presentation. This is so because, at the end of the reporting period, the entity does not have an unconditional right to defer its settlement for at least twelve months after that date

However, when an entity breaches a provision under a long-term loan agreement on or before the end of the reporting period with the effect that the liability becomes payable on demand, it classifies the liability as non-current if the lender has agreed by the end of the reporting period to

provide a period of grace ending at least twelve months after the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment.

A case study

An entity's long-term financing became payable on demand because certain conditions included in the financing agreement were breached. Management is negotiating with the relevant financial institution to get a waiver on the breach of the conditions. The negotiation was still ongoing on the day the financial statements were issued.

a) Can an entity classify borrowings as non-current liabilities on the basis of negotiations in progress with the lender on the reporting date?
b) Does the answer to this change if the negotiation is completed before the financial statements are approved?

Solution

a) No, the negotiation with the lender was not completed at the reporting date. A period of grace for at least twelve months after the reporting date was yet to be agreed by the lender. The borrowing is classified as a current liability.
b) No, the classification will remain as current as the negotiation is not complete by the reporting date.

In respect of loans classified as current liabilities, if the following events occur between the end of the reporting period and the date the financial statements are authorized for issue, those events are disclosed as non-adjusting events in accordance with IAS 10 *Events after the Reporting Period*:

a) refinancing on a long-term basis;
b) rectification of a breach of a long-term loan agreement; and
c) the granting by the lender of a period of grace to rectify a breach of a long-term loan agreement ending at least twelve months after the reporting period.

EQUITY

Equity is the third element that is dealt in the statement of financial position. It has been defined in the framework as the residual interest in the asset of the entity after deducting all its liabilities. It presents the cumulative net results of the past transactions and other events affecting the entity since the day one of its inception. Equity capital and reserves should be analyzed showing separately the various classes of paid-in capital, share premium and reserves. Depending on the materiality and significance of the analysis, much of the details can be presented in the notes rather than on the face of the statement of financial position. Minority interests in consolidated financial statements shall be presented as a component of equity, separately from the parent shareholders' equity.

Information to be presented in the statement of financial position

As a minimum, the statement of financial position shall include line items that present the following amounts:

a) property, plant and equipment;
b) investment property;
c) intangible assets;
d) financial assets (excluding amounts shown under (e), (h) and (i) below);
e) investments accounted for using the equity method;
f) biological assets;
g) inventories;
h) trade and other receivables;
i) cash and cash equivalents;
j) the total of assets classified as held for sale and assets included in disposal groups classified as held for sale in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*;
k) trade and other payables;
l) provisions;
m) financial liabilities (excluding amounts shown under (k) and (l) above);
n) liabilities and assets for current tax, as defined in IAS 12 *Income Taxes*;
o) deferred tax liabilities and deferred tax assets, as defined in IAS 12;

p) liabilities included in disposal groups classified as held for sale in accordance with IFRS 5;
q) minority interest, presented within equity; and
r) issued capital and reserves attributable to owners of the parent.

IAS 1does not prescribes the order or format in which an entity presents item. It simply lists items that are sufficiently different in nature or function to warrant separate presentation in the statement of financial position. In addition:

- line items are included when the size, nature or function of an item or aggregation of similar items is such that separate presentation is relevant to an understanding of the entity's financial position; and
- the descriptions used and the ordering of items or aggregation of similar items may be amended according to the nature of the entity and its transactions, to provide information that is relevant to an understanding of the entity's financial position (e.g. a financial institution may amend the above descriptions to provide information that is relevant to the operations of a financial institution).

Presentation of additional line items

An entity shall present additional line items, headings and sub-totals in the statement of financial position when such presentation is relevant to an understanding of the entity's financial position. This judgment to present additional items separately on the basis of an assessment of the nature and liquidity of assets, the function of assets within the entity and the amounts, nature and timing of liabilities.

In other words, the use of different measurement bases for different classes of assets suggests that their nature or function differs and, therefore, that an entity presents them as separate line items. For example, different classes of property, plant and equipment can be carried at cost or at revalued amounts in accordance with IAS 16, Property, Plant and Equipment.

Presentation of deferred tax asset or liability

When an entity presents current and non-current assets, and current and non-current liabilities, as separate classifications in its statement of financial position, it shall not classify deferred tax assets (liabilities) as current assets (liabilities).

IFRSs dealing mainly with assets and liabilities

- *Frame work*: definition and recognition of assets and liabilities
- IAS 1: Presentation of Financial Statements
- IAS 2: Inventories
- IAS 8: Accounting policies, changes in Accounting Estimates and Errors
- IAS 10: Events after Reporting Date
- IAS 16: Plant, Property and Equipment
- IAS 17: Leases
- IAS 27: Consolidated and Separate Financial Statement
- IAS 28: Investment in Associates
- IAS 31: Interest in Joint Venture
- IAS 32: Financial Instrument : Presentation
- IAS 36: Impairment of Assets
- IAS 38: Intangible Assets
- IAS 39: Financial Instrument: Recognition and Measurement
- IAS 40: Investment Property
- IAS 41: Agriculture
- IFRS 2: Share Based Payment
- IFRS 3: Business Combination
- IFRS 5: Non-current Assets held for sale and Discontinued Operations
- IFRS 6: Exploration for and Evaluation of Mineral Resources
- IFRS 7: Financial Instrument : Disclosures
- IFRS 8: Operating Segment

7.4 STATEMENT OF COMPREHENSIVE INCOME

Besides presenting the financial position of the entity at the reporting date, another most important objective of preparation and presentation of financial statements are to present the entity's financial performance during the reporting period. It is useful to assess potential changes in the economic resources that entity control in the future predict future cash flows and form judgment about the effectiveness with which the entity controls the resources. It includes all changes in net assets during a period, except those resulting from investments by owners and distributions to owners. Therefore it comprises the element of both 'profit and loss' and 'other comprehensive income'. IAS 1 *Presentation of Financial Statement* also deals with the presentation requirement of Statement of Comprehensive Income. The IASB's *Framework* states that comprehensive income is the change in entity's net assets over the course of the reporting period arising from non owner sources. The revised IAS 1 requires all non-owner changes in equity to be presented in either on statement of comprehensive income or two statements, a separate income statement and a statement of other comprehensive income. The present form of the statement of comprehensive income has evolved in the passage of time because of continuous revisions.

Earlier IAS 1 required presentation of income statement only and all unrealized gains and losses from non- owner activities were included in statement of changes in equity rather than income statement. The present form of the statement of comprehensive income emphasizes on 'all inclusive concept' of reporting. The option of presenting two separate statements is given because it is fealt that presentation in a single statement is not as important as presenting non owners changes in equity from owners changes in equity.

This change in concept is of utmost importance, as the gains and losses whether realized or not influences the decision of the investor regarding the equity of the entity. Under the current IFRS, some of the unrealized gains and losses are recognised while the others are not recognised.

Elements Recognised in the statement of comprehensive income

The statement of comprehensive income presents the information about income and expenses of the entity which also includes gains and losses.

INCOME:

Definition: Income is the increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities those results in increase in equity, other than those relating to contribution from equity participants. It encompasses both revenue and gains. Revenue arises in the normal course of business by its ordinary activities and is referred by different names like sales, fees, commission, rent, interest, dividend, royalty etc.

Recognition: When an increase in the future economic benefits related to an increase in an asset or decrease in a liability has arisen that can be reliably measured. The revenue recognition in general is dealt in details in the IAS 18 *Revenue.*

Measurement: Revenue in normal circumstances should be measured at the fair value of the consideration received or receivable.

EXPENSES

Definition: It is the decrease in economic benefits during the accounting period in the form of outflows or depletion of assets or incurrence of liabilities those results in decrease in equity, other than those relating to contribution to equity participants. It encompasses both losses and expenses that arise in the course of ordinary activity of the entity.

In other words, we can also say that the expenses are expired costs or items that were assets but remain no longer as an asset since they have no future value**.**

Recognition: When a decrease in the future economic benefits related to a decrease in an asset or increase in a liability has arisen that can be reliably measured. The matching principle requires that all expenses incurred in generating revenue should be recognised in the same period in which the related revenue is recognised.

Some costs like those on raw material, wages for direct labor consumed in manufacturing process are relatively easy to identify with related revenue generating activity. These costs are included in inventory and expensed as cost to sales when products are sold or revenue from it is realized.

On the other hand, certain expenses like depreciation, amortization of intangibles and allocation of indirect expenses, are more closely related to the accounting periods. In the absence of direct

and apparent relationship the expense and revenue, these expenses are allocated to the accounting periods in a rational and systematic manner to reduce subjectivity to the maximum extent possible.

There may remain costs, which can neither be identified as relating to particular revenue, nor can they be allocated on any systematic and rational basis, such costs should be expenses in the period in which they take place. These expenses include

i. the costs for which no future benefits can be perceived,
ii. cost which were recognised as assets in prior period but which has no remaining future benefits like impairment losses, and
iii. those administrative , general and selling overheads for which no rational allocation is possible

GAINS AND LOSSES

As per IASB's *Framework,* the gains and losses represent increases or decrease in the economic benefits and are therefore no different in nature from revenue and expenses. Hence, they are not regarded as separate element.

Form of statement of comprehensive income

As discussed in the earlier paragraph, the all non-owner changes in equity to be presented in either on statement of comprehensive income or two statements, a separate income statement and a statement of other comprehensive income. However, it is important to note that where an entity presents the components of profit and loss in the separate income statement, this statement should form part of complete set of financial statement and should be placed immediately before the statement of other comprehensive income.

Although IAS 1 uses the terms 'profit or loss', 'other comprehensive income' and 'total comprehensive income', an entity may use other terms provided the meaning is clear. However, IFRS prescribes the following details to be always displayed in the heading of the statement of comprehensive income:

- The name of the entity, which should be the exact name as written in the legal document that created it.

- The title of the statement
- The period covered in the statement
- The currency and the rounding off.

Information to be presented on the face of the statement of comprehensive income

The following information should be disclosed on the face of the statement of comprehensive income, together with any additional headings or sub-totals as may be required by individual standards or that may be required to give a fair presentation of the entity's performance

- Revenue
- Finance costs
- Share of the profit or loss of associates and joint ventures accounted for using the equity method
- Tax Expenses
- a single amount comprising the total of
  - the post-tax profit or loss of discontinued operations and
  - the post-tax gain or loss recognised on the disposal of the assets or disposal group(s) constituting the discontinued operation
- profit or loss
- each component of other comprehensive income classified by nature
- each component of other comprehensive income of associates and joint venture accounted using equity method; and
- total comprehensive income

The following items must also be disclosed on the face of the statement of comprehensive income as allocations of

- profit or loss for the period:
  a. profit or loss attributable to minority interest; and
  b. profit or loss attributable to equity holders of the parent.

- Total comprehensive income for the period as:
  - comprehensive income attributable to minority interest; and
  - comprehensive income attributable to equity holders of the parent.

The above mentioned items are the minimum items, additional line items, headings and subtotals should be presented on the face of the statement when this is relevant to understanding of the entity's financial performance.

Income Statement: Presentation and classification

As stated earlier, the entity can present the components of the statement of comprehensive income as singe statement of comprehensive income or in two statements segregating components of profit or loss and those pertaining to other comprehensive income. Where two statements are prepared, the income for the period reported in the income statement comprises of total income less expense excluding the components of other comprehensive income. Other comprehensive income is the total of income less expenses (including reclassification adjustments) that are not recognized in profit or loss as required or permitted by other IFRS.

When an entity presents the component of profit or loss in separate statement it should be presented just before the statement of other comprehensive income. The legal name of the entity must be used to identify the financial statement and the title 'income statement' or 'profit or loss account' as deemed appropriate should be used to distinguish the statement from the other statements presented.

The period covered by the income statement should also be clearly stated. Though, normally income statement are prepared for one year, entities may be required to present income statement for period in excess of short of one year. E.g. entities may be required to prepare interim statement or newly form subsidiary may be required to prepare statement corresponding to the accounting year of the holding company. In such, exceptional circumstances, the following additional disclosure should be made

- The reason for presenting the income statement for the period other than one year, and

- The fact that the comparative information is not actually comparable.

Sometimes, entity may present financial statements for 52 weeks or weeks ending on a particular day, in such cases entity should clearly state that the financial statements are for such period. For instance 'for fifty two weeks period ending on 30th mach, 2008'. Normally such statements are not materially different from those presented for one year

IAS 1 requires that entity should maintain consistency in presentation and classification of item from one period to another therefore, the items of income and expenses should be uniform from one period to another. However, if certain changes are to be made in the classification, the comparative information should also be reclassified so as to maintain comparability.

Component of income statement

Minimum line items to be presented in income statement are:

- Revenue
- Finance costs
- Share of the profit or loss of associates and joint ventures accounted for using the equity method
- Tax Expenses
- Discontinued operations
- Profit or loss
- Minority interest
- Net profit attributable to equity holders of the parents

Entity should not classify any item of income or expense as extraordinary item in income statement or in the statement of comprehensive income.

The entities are permitted to classify the line items of expenses in two different ways for their presentation in statement of comprehensive income which are:

- Classification by nature, or
- Classification by function.

The decision to select the presentation for the analysis of expenses in the income statement depends on which method presents the information more reliably and relevant. Moreover, historical and industrial factors and nature of entity should be considered while making the choice.

Analysis of expenses by the nature of expense method:

Under this method an entity aggregates expenses within profit or loss according to their nature (for example, depreciation, purchases of materials, transport costs, employee benefits and advertising costs), and does not reallocate them among functions within the entity. This method is generally simple to apply as allocations of expenses to functional classifications are necessary. An example of a classification using the nature of expense method is as follows:

Revenue	X	
Other income	X	
Changes in inventories of finished goods and work in progress		X
Raw materials and consumables used	X	
Employee benefits expense	X	
Depreciation and amortization expense	X	
Other expenses	X	
Total expenses		(X)
Profits before tax		X

Analysis of expenses by the function of expense method:

This form of analysis is also called 'cost of sales method'. Under this form of analysis entity classifies expenses according to their function as part of cost of sales or, for example, the costs of

distribution or administrative activities. At a minimum, an entity discloses its cost of sales under this method separately from other expenses.

This method can provide more relevant information to users than the classification of expenses by nature, but allocating costs to functions may require arbitrary allocations and involve considerable judgment. An example of a classification using the function of expense method is as follows:

Revenue	X	
Cost of sales	(X)	
Gross profit	X	
Other income	X	
Distribution costs		(X)
Administrative expenses		(X)
Other expenses		(X)
Profits before tax		X

One important point that should be noted here is that, when an entity classifies expenses by function, it shall disclose additional information on the nature of expenses, including depreciation and amortization expense and employee benefits expense as information on the nature of expenses is useful in predicting future cash flows.

A Case Study

Entity A has 5 subsidiaries. One of the subsidiaries, entity B, represents 30% of the consolidated group's results. B represents a separate business segment.

All entities in the group present a functional analysis of expenses in their separate IFRS financial statements, except for entity B, which presents an analysis by the nature of expenses.

As a functional analysis of B’s expenses has not been prepared, A’s management would like to present the consolidated income statement on a split-method basis. B’s results will be presented using a natural analysis, whereas the rest of the group’s results will be presented on a functional basis.

A’s management argues that because B’s business is from a different segment and therefore not comparable with the rest of the group, the use of a different presentation basis should be acceptable.

Solution

No, management cannot adopt a mix of the two types of analysis in the group’s financial statements. Management must choose which format, functional or natural, is most appropriate for the consolidated financial statements. The results of all entities within the group must be prepared on the chosen basis, which will require part of the group to convert their results from that used in their separate financial statements to that used in the consolidated financial statements.

OTHER COMPREHENSIVE INCOME

As we know the total comprehensive income of an entity comprise of two parts: the profit or loss part and the other comprehensive income. The other comprehensive income has been defined in IAS 1 as follows:

Other comprehensive income **comprises items of income and expense (including reclassification adjustments) that is not recognized in profit or loss as required or permitted by other IFRSs.**

The components of other comprehensive income include:

i. changes in revaluation surplus (see IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*);
ii. actuarial gains and losses on defined benefit plans recognized in accordance with paragraph 93A of IAS 19 *Employee Benefits*;

iii. gains and losses arising from translating the financial statements of a foreign operation (see IAS 21 *The Effects of Changes in Foreign Exchange Rates*);

iv. gains and losses on remeasuring available-for-sale financial assets (see IAS 39 *Financial Instruments: Recognition and Measurement*);

v. the effective portion of gains and losses on hedging instruments in a cash flow hedge (see IAS 39).

Also it should be noted that, the entity should disclose the amount of income tax relating to each component of other comprehensive income, including reclassification adjustments, either in the statement of comprehensive income or in the notes. Therefore, an entity may present components of other comprehensive income either net of related tax effects, or before related tax effects with one amount shown for the aggregate amount of income tax relating to those components.

RECLASSIFICATION ADJUSTMENTS

IAS 1 defines reclassification adjustments as follows:

Reclassification adjustments are amounts reclassified to profit or loss in the current period that were recognized in other comprehensive income in the current or previous periods. In other words, where other IFRSs requires the entity to reclassify amounts previously recognized in other comprehensive income to profit or loss, such reclassifications are referred to in IAS 1 as reclassification adjustments. IAS 1 requires an entity to disclose reclassification adjustments relating to components of other comprehensive income. A reclassification adjustment is included with the related component of other comprehensive income in the period that the adjustment is reclassified to profit or loss. For example, gains realized on the disposal of available-for-sale financial assets are included in profit or loss of the current period. These amounts may have been recognized in other comprehensive income as unrealized gains in the current or previous periods. Those unrealized gains must be deducted from other comprehensive income in the period in which the realized gains are reclassified to profit or loss to avoid including them in total comprehensive income twice.

An entity may present reclassification adjustments in the statement of comprehensive income or in the notes. An entity presenting reclassification adjustments in the notes presents the components of other comprehensive income after any related reclassification adjustments.

It should be noted that, reclassification adjustments do not arise on changes in revaluation surplus recognized in accordance with IAS 16 or IAS 38 or on actuarial gains and losses on defined benefit plans recognized in accordance with paragraph 93A of IAS 19. These components are recognized in other comprehensive income and are not reclassified to profit or loss in subsequent periods. Changes in revaluation surplus may be transferred to retained earnings in subsequent periods as the asset is used or when it is derecognized. Actuarial gains and losses are reported in retained earnings in the period that they are recognized as other comprehensive income.

Information to be presented in the statement of comprehensive income or in the notes

All items of income or expense that are material, an entity should disclose their nature and amount separately. Circumstances that would give rise to the separate disclosure of items of income and expense include:

- write-downs of inventories to net realisable value or of property, plant and equipment to recoverable amount, as well as reversals of such write-downs;
- restructurings of the activities of an entity and reversals of any provisions for the costs of restructuring;
- disposals of items of property, plant and equipment;
- disposals of investments;
- discontinued operations;
- litigation settlements; and
- Other reversals of provisions.

7.5 STATEMENT OF CHANGES IN EQUITY

IAS 1 requires an entity to present a statement of changes in equity as a separate component of the financial statements. The statement must show:

- profit or loss for the period

- each item of income and expense for the period that is recognised directly in equity, and the total of those items;

- total income and expense for the period (calculated as the sum of (a) and (b)), showing separately the total amounts attributable to equity holders of the parent and to minority interest

- for each component of equity, the effects of changes in accounting policies and corrections of errors recognised in accordance with IAS 8

The following amounts may also be presented on the face of the statement of changes in equity, or they may be presented in the notes:

- capital transactions with owners
- the balance of accumulated profits at the beginning and at the end of the period, and the movements for the period

- a reconciliation between the carrying amount of each class of equity capital, share premium and each reserve at the beginning and at the end of the period, disclosing each movement

7.6 STATEMENT OF CASH FLOWS

The statement of cash flows is an important primary statement. It shows a company's flow of cash. In fact, a complete set of Financial Statements should be comprised of a statement of financial position as at the end of the period, a statement of comprehensive income; statement of changes in equity; a ***statement of cash flows for the period***; notes, comprising a summary of significant accounting policies and other explanatory information; and a statement of financial position as at the beginning of the earliest comparative period when accounting policy is applied retrospectively or there is a retrospective restatement or reclassification of items in its financial statements.

The statement of cash flows shows how changes in statement of financial position and income accounts affect cash and cash equivalents, and breaks the analysis down to operating, investing, and financing activities. As an analytical tool, the statement of cash flows is useful in

determining the short-term viability of a company, particularly its ability to pay bills. Even profitable entities will collapse if they do not have access to sufficient cash resources when it becomes necessary to settle a bill. Very few businesses could survive a prolonged outflow of cash.

The Statement of financial position, statement of comprehensive income and statement of changes in equity are based on accrual accounting and provide only partial information about flows of funds and cash. The profit figure usually does not have any direct relationship to the increase or decrease in the entity's bank balance over that period. Similarly, several items in the statement of comprehensive income, such as depreciation, do not involve inflow or outflow of cash. There are also many types of cash transactions, such as the proceeds of a share issue or a loan repayment which have no immediate impact on profit. This means that it would be possible for an entity to be trading at a profit and still run into liquidity problems.

The bank balance can, of course, be obtained from the statement of financial position. Comparing the statements at the beginning and end of the year will even show whether cash has increased or decreased. It is, however, difficult to identify the major causes of changes in the balance from doing so. Shareholders and other readers require a more structured presentation of the cash flows.

The cash flow statement, therefore, is intended to answer questions such as:

a) Why has the bank overdraft increased, despite the entity having had a profitable year?

b) Is the entity capable of generating funds, as opposed to profit, from its trading activities?

c) What was done with the loan that was taken out during the year?

d) Why is the company in a liquidity crisis when it has been profitable over the past few years?

Evolution

Cash basis financial statements were common before accrual basis financial statements when fund flow statements were prepared. In 1971, the Financial Accounting Standards Board (FASB) defined rules that made it mandatory under Generally Accepted Accounting Principles (US

GAAP) to report sources and uses of funds, but the definition of "funds" was not clear. "Net working capital" might be cash or might be the difference between current assets and current liabilities. In 1987, FASB Statement No. 95 (FAS 95) mandated that firms provide cash flow statements. In 1992, the International Accounting Standards Board issued International Accounting Standard 7 (IAS 7), Cash Flow Statements, which became effective in 1994, mandating that firms provide cash flow statements.

IAS 7 Statement of cash flows

The objective of IAS 7 is to require the provision of information .about the historical changes in cash and cash equivalents by means of a statement of cash flows which classifies cash flows during the period according to operating, investing, and financing activities.

Information about the cash flows of an entity is useful in providing users of financial statements with a basis to assess the ability of the entity to generate and utilise cash and cash equivalents. Regardless of the type of entity's activities, entities need cash for their operations, payment of obligations etc.

Fundamental Principle in IAS 7

All enterprises that prepare financial statements in conformity with IFRSs are required to present a statement of cash flows. [IAS 7.1]

The statement of cash flows analyses changes in cash and cash equivalents during a period. Cash and cash equivalents comprise cash on hand and demand deposits, together with short-term, highly liquid investments that are readily convertible to a known amount of cash, and that are subject to an insignificant risk of changes in value. An investment normally meets the definition of a cash equivalent when it has a maturity of three months or less from the date of acquisition. [IAS 7.7]Equity investments are normally excluded, unless they are in substance a cash equivalent (e.g. preferred shares acquired within three months of their specified redemption date). Bank overdrafts which are repayable on demand and which form an integral part of an enterprise's cash management are also included as a component of cash and cash equivalents. [IAS 7.8]

Cash flows **exclude** transfers between 'cash' and 'cash equivalents' hence, it is essential to determine what makes up cash

Presentation of the Statement of Cash Flows

Cash flows must be analysed between operating, investing and financing activities.

Key principles specified by IAS 7 for the preparation of a statement of cash flows are as follows:

- Operating activities are the main revenue-producing activities of the enterprise that are not investing or financing activities. Separate disclosure is required as cash flow from operating activities is a key indicator of the extent to which the operation of the entity has generated sufficient cash flows for maintaining its operating capability etc.

- Investing activities are the acquisition and disposal of long-term assets and other investments that are not considered to be cash equivalents . Separate disclosure is important as they represent the extent to which expenditure has been made for resources intended to generate future income and cash flows.

- Financing activities are activities that alter the size and composition of equity capital and borrowing structure of the enterprise. Separate disclosure is useful in predicting claims on future cash flows by providers of capital to the entity.

- for operating cash flows, the direct method of presentation is encouraged, but the indirect method is acceptable [IAS 7.18]

Direct and indirect method

The direct method shows each major class of gross cash receipts and gross cash payments. The statement of cash flows under the direct method would appear something like this:

Cash flow from operations

Cash receipts from customers	xx,xxx	
Cash paid to suppliers	(xx,xxx)	
Cash paid to employees	(xx,xxx)	

Cash paid for other operating expenses	(xx,xxx)	
Interest paid	(xx,xxx)	
Income taxes paid	(xx,xxx)	
Net cash from operating activities		xx,xxx

Cash flow from investing activities

Acquisition of subsidiary	(xx,xxx)	
Purchase of property, plant and equipment	(xx,xxx)	
Proceeds from sale of equipment	xx,xxx	
Interest received	xx,xxx	
Dividend received	xx,xxx	
Net cash used in investing activities		(xx,xxx)

Cash flow from financing activities

Proceeds from issue of share capital	xx,xxx	
Proceeds from long term borrowings	xx,xxx	
Payment of finance lase liabiities	xx,xxx	
Dividend paid	xx,xxx	
Net cash used in financing activities		(xx,xxx)

The indirect method adjusts accrual basis net profit or loss for the effects of non-cash transactions. The operating cash flows section of the statement of cash flows under the indirect method would appear something like this:

Profit before taxes		xx,xxx
Add back depreciation	xx,xxx	
Add back amortisation of goodwill	xx,xxx	

Increase in trade and other receivables	xx,xxx	
Decrease in inventories	xx,xxx	
Increase in trade payables	xx,xxx	
Cash generated from operations	xx,xxx	
Interest expense	xx,xxx	
Less Interest accrued but not yet paid	xx,xxx	
Interest paid		xx,xxx
Income taxes paid		xx,xxx
Net cash from operating activities		xx,xxx

Foreign currency cash flows

The exchange rate used for translation of transactions denominated in a foreign currency and the cash flows of a foreign subsidiary should be the rate in effect at the date of the cash flows.

Cash flows of foreign subsidiaries should be translated at the exchange rates prevailing when the cash flows took place.

Investment in subsidiaries, associates and joint ventures

In case of associates and joint ventures, where the equity method is used, the statement of cash flows should report only cash flows between the investor and the investee; where proportionate consolidation is used, the cash flow statement should include the venturer's share of the cash flows of the investee

Aggregate cash flows relating to acquisitions and disposals of subsidiaries and other business units should be presented separately and classified as investing activities, with specified additional disclosures. The aggregate cash paid or received as consideration should be reported net of cash and cash equivalents acquired or disposed of

Other Accounting treatment

- Interest and dividends received and paid may be classified as operating, investing, or financing cash flows, provided that they are classified consistently from period to period [IAS 7.31]

- Cash flows arising from taxes on income shall be separately disclosed and are normally classified as operating, unless they can be specifically identified with financing or investing activities [IAS 7.35]

- cash flows from investing and financing activities should be reported gross by major class of cash receipts and major class of cash payments except for the following cases, which may be reported on a net basis: [IAS 7.22-24]

- cash receipts and payments on behalf of customers (for example, receipt and repayment of demand deposits by banks, and receipts collected on behalf of and paid over to the owner of a property)

- cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short, generally less than three months (for example, charges and collections from credit card customers, and purchase and sale of investments)

- cash receipts and payments relating to fixed maturity deposits

- cash advances and loans made to customers and repayments thereof

- investing and financing transactions which do not require the use of cash should be excluded from the statementof cash flows, but they should be separately disclosed elsewhere in the financial statements [IAS 7.43]

- the components of cash and cash equivalents should be disclosed, and a reconciliation presented to amounts reported in the statement of financial position [IAS 7.45]

- the amount of cash and cash equivalents held by the enterprise that is not available for use by the group should be disclosed, together with a commentary by management [IAS 7.48]

- Additional information that may be lead to better understanding of financial statements .

- Amount of undrawn borrowing facilities available for future operating activities and to settle capital commitment.

- Aggregate amount of cash flows that represent increase in operating capacity separately from those cash flows required to maintain operating capacity

- Amount of cash flows arising from operating, investing and financing activities of each reportable segment.

- Aggregate amount of cash flows from each operating, investing and financing activities related to each joint venture reported using proportionate consolidation.

7.7 NOTES TO THE FINANCIAL STATEMENTS

The notes must: [IAS 1.103]

- present information about the basis of preparation of the financial statements and the specific accounting policies used;
- disclose any information required by IFRSs that is not presented on the face of the balance sheet, income statement, statement of changes in equity, or cash flow statement; and

- provide additional information that is not presented on the face of the balance sheet, income statement, statement of changes in equity, or cash flow statement that is deemed relevant to an understanding of any of them.

Notes should be cross-referenced from the face of the financial statements to the relevant note. [IAS 1.104]

IAS 1.105 suggests that the notes should normally be presented in the following order:

- a statement of compliance with IFRSs
- a summary of significant accounting policies applied, including: [IAS 1.108]

    - the measurement basis (or bases) used in preparing the financial statements

    - the other accounting policies used that are relevant to an understanding of the financial statements
- supporting information for items presented on the face of the balance sheet, income statement, statement of changes in equity, and cash flow statement, in the order in which each statement and each line item is presented
- other disclosures, including:
    - contingent liabilities and unrecognised contractual commitments
    - non-financial disclosures, such as the entity's financial risk management objectives and policies

7.8 INTERIM FINANCIAL STATEMENTS

Interim financial reports are financial statements covering periods of less than a full fiscal year. Most commonly such reports are prepared quarterly or semi annually .The purpose of quarterly or other interim financial reports is to provide financial statement users with more timely information for making investment and credit decisions, based on the expectation that full-year results will be a reasonable extrapolation from interim performance. Additionally, interim reports can yield significant information concerning trends affecting the business and seasonality.

- The objective of IAS 34 - Interim Financial Statement is to prescribe the minimum content of an interim financial report and the recognition and measurement principles for an interim financial report.
- This is not a mandatory statement for all enterprises. This Standard applies if an entity is required or elects to publish an interim financial report in accordance with International Financial Reporting Standards.
- Minimum components of an interim financial report are:
    - condensed statement of financial position;
    - condensed statement of comprehensive income presented either as a condensed single statement or a condensed separate income statement and a condensed statement of comprehensive income;

  - condensed statement of changes in equity;
  - condensed statement of cash flows; and
  - selected explanatory notes.
- Prescribes the comparative periods for which interim financial statements are required to be presented.
- Materiality is based on interim financial data, not forecasted annual amounts.
- The notes in an interim financial report provide an explanation of events and transactions significant to understanding the changes since the last annual financial statements.
- Same accounting policies as used in annual financial statements.
- Revenue and costs are recognised when they occur, not anticipated or deferred.
- Change in accounting policy – restate previously reported interim periods.

7.9 ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

Accountants need to make many accounting estimates and policy decisions when preparing financial statements. This involves deciding on depreciable lives for assets, inventory costing method, valuations of assets, valuation of retirement benefits and such other judgments. These accounting estimates are driven by an entity's accounting policy as it applies to the issues at hand. These decisions could significantly affect a company's financial statements and how users understand a company's results and financial position. It is therefore vital that the selection and application of the company's accounting policies are appropriately reasoned. Business entities need to be aware that investors increasingly demand full transparency of accounting policies and their effects.

The entity's financial reporting and results imply a degree of accuracy, continuity and certainty that can be belied by rapid changes in the financial and operating environment that produced those measures. As a result, even a technically accurate application of accounting principles may nonetheless fail to communicate important information if it is not accompanied by appropriate and clear analytic disclosures to facilitate an investor's understanding of the company's financial status, and the possibility, likelihood and implication of changes in the financial and operating

status. This involves informing the users of the sensitivity of financial statements to the methods, assumptions, and estimates underlying their preparation. An entity needs to provide full explanations of accounting policies, the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions.

Therefore Accounting standards require information in financial statements about the accounting principles and methods used and the risks and uncertainties inherent in significant estimates.

- IAS 8 prescribes the criteria for selecting and changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and corrections of errors
- Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements
- Hierarchy for choosing accounting policies:
  - IASB Standards and Interpretations, taking into account any relevant IASB implementation guidance;
  - in the absence of a directly applicable IFRS, look to the requirements and guidance in IFRSs dealing with similar and related issues; and the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Framework for the Preparation and Presentation of Financial Statements; and
  - management may also consider the most recent pronouncements of other standard setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature, and accepted industry practices.
- Accounting policies are applied consistently to similar transactions.
- An accounting policy is changed only if required by an IFRS, or if the change results in reliable and more relevant information.
- If a change in accounting policy is required by an IFRS, the pronouncement's transition requirements are followed. If none are specified, or if the change is voluntary, the new accounting policy is applied retrospectively by restating prior periods.

- If restatement is impracticable, the cumulative effect of the change is included in profit or loss. If the cumulative effect cannot be determined, the new policy is applied prospectively.
- A change in accounting estimate is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Example change in mortality rate of the employees.
- Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.
- The effect of a change in an accounting estimate, shall be recognised prospectively i.e. changes in accounting estimates are accounted for in the current year, or future years, or both and there is no restatement.
- Prior period errors are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that
  - was available when financial statements for those periods were authorised for issue; and
  - could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.
- Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud
- All material errors are corrected by restating comparative prior period amounts and, if the error occurred before the earliest period presented, by restating the opening statement of financial position for the earliest prior period presented.
- Omissions or misstatements of items are material if they could, individually or collectively; influence the economic decisions of users taken on the basis of the financial statements.

7.10 EVENTS AFTER THE REPORTING PERIOD (IAS 10)

The events that occur up to the last day of the reporting period are critical in arriving at an entity's financial results and the financial position. However, sometimes events occurring after the reporting period may provide additional information about events that occurred before and up to the end of the reporting period .This information may have an impact on the financial results and the financial position of the entity. It is imperative that those reporting period events up to a certain "cutoff date" be taken into account in preparing the financial statements.

Additionally, certain events that occur after the reporting period may not affect the financial figures but may be important enough to require disclosure in notes to the financial statements. Providing information about post– reporting period events through such disclosures helps users make informed decisions with respect to the entity, keeping in mind the impact these reporting period events may have on the financial position of the entity

- **IAS 10 Events after the Reporting Period** prescribes when an entity should adjust its financial statements for events after the reporting period and the disclosures that an entity should give about the date when the financial statements were authorised for issue and about events after the reporting period.
- Events after the end of the reporting period are those events, both favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue.
- Adjusting events – the financial statements are adjusted to reflect those events that provide evidence of conditions that existed at the end of the reporting period (such as resolution of a court case after the end of the reporting period).
- Non-adjusting events – the financial statements are not adjusted to reflect events that arose after the end of the reporting period (such as a decline in market prices after year end, which does not change the valuation of investments at the end of the reporting period). The nature and impact of such events are disclosed.
- Dividends proposed or declared on equity instruments after the end of the reporting period are not recognised as a liability at the end of the reporting period. Disclosure is required.
- Financial statements are not prepared on a going concern basis if events after the end of the reporting period indicate that the going concern assumption is not appropriate.

- An entity discloses the date its financial statements are authorised for issue.

7.11 FOREIGN CURRENCY TRANSLATION

Companies which have transactions in foreign currencies and foreign operations need to account for it. For example, a multinational company is exposed to some exchange risk when it generates revenues or expenses in foreign currencies. This presents challenges for users comparing period-to-period operating results. Currency exchange–rate fluctuations are expected. In order to report consolidated financial statements, companies must effectively convert multiple currencies into a single reporting currency. In recent years, major currencies such as the British pound, the Euro, and the Canadian dollar have appreciated significantly against the U.S. dollar. This trend tends to inflate the revenues and expenses of an entity reporting in U.S. dollars.

Rapid fluctuations in currency rates could impact a parent company's income statement, even if local currency results remain the same. Consider company K, a U.S. dollar (US$)–reporting parent company with a major office in UK. Assume that the Euro was the functional currency of that office, which reported Euro100 million in revenues in 2007 and in 2008. In order to report revenues in U.S. dollars, company K would be required to translate Euro into U.S. dollars using the prevailing exchange rates. Due to rise in exchange rate , the parent company would report a revenue increase solely due to the impact of foreign currency, because the subsidiary's local revenues did not change. Note that sales also yield Euro receivables, which would also be impacted by exchange rate movements, but the net impact of all financials, are combined and accumulated in other comprehensive income.

IAS 21 -The Effects of Changes in Foreign Exchange Rates

Requirements

The purpose of IAS 21 is to set out how to account for transactions in foreign currencies and foreign operations. The standard prescribes the methodology to translate financial statements into a presentation currency, i.e. the currency in which the financial statements are presented. This contrasts with the functional currency, which is the currency of the primary economic

environment in which the entity operates. Key issues are the exchange rates, which should be used, and where the effects of changes in exchange rates are recorded in the financial statements.

Functional currency is a concept that was introduced into IAS 21, The Effects of Changes in Foreign Exchange Rates, when it was revised in 2003. The previous version of IAS 21 used a concept of reporting currency. In revising IAS 21 in 2004, the IASB's main aim was to provide additional guidance on the translation method and determining the functional and presentation currencies.

The functional currency should be determined by looking at several factors. This currency should be the one in which the entity normally generates and spends cash, and that in which transactions are normally denominated. All transactions in currencies other than the functional currency are treated as transactions in foreign currencies. The entity's functional currency reflects the transactions, events and conditions under which the entity conducts its business. Once decided on, the functional currency does not change unless there is a change in the underlying nature of the transactions and relevant conditions and events.

Foreign currency transactions should initially be recorded at the spot rate of exchange at the date of the transaction. An approximate rate can be used. Subsequently, at each end of reporting period, foreign currency monetary amounts should be reported using the closing rate. Non-monetary items measured at historical cost should be reported using the exchange rate at the date of the transaction. Non-monetary items carried at fair value, however, should be reported at the rate that existed when the fair values were determined.

Exchange differences arising on monetary items are reported in profit or loss in the period, with one exception. The exception is that exchange differences arising on monetary items that form part of the reporting entity's net investment in a foreign operation are recognised in the group financial statements, within a separate component of equity. They are recognised in profit or loss on disposal of the net investment. If a gain or loss on a non-monetary item is recognised in equity (for example, property, plant and equipment revalued under IAS 16), any foreign exchange gain or loss element is also recognised in equity.

Other Definitions

Presentation currency: The currency in which financial statements are presented.

Exchange difference: The difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Foreign operation: A subsidiary, associate, joint venture, or branch whose activities are based in a country other than that of the reporting enterprise.

Basic Steps for Translating Foreign Currency Amounts into the Functional Currency

Steps apply to a stand-alone entity, an entity with foreign operations (such as a parent with foreign subsidiaries), or a foreign operation (such as a foreign subsidiary or branch).

1. The reporting entity determines its functional currency

2. The entity translates all foreign currency items into its functional currency

3. The entity reports the effects of such translation in accordance with paragraphs 20-37 [reporting foreign currency transactions in the functional currency] and 50 [reporting the tax effects of exchange differences].

Reporting Foreign Currency Transactions

- A foreign currency transaction should be recorded initially at the rate of exchange at the date of the transaction (use of averages is permitted if they are a reasonable approximation of actual).
- At the end of each reporting period: [IAS 21.23]
- Foreign currency monetary amounts should be reported using the closing rate.
- Non-monetary items carried at historical cost should be reported using the exchange rate at the date of the transaction.
- Non-monetary items carried at fair value should be reported at the rate that existed when the fair values were determined.

- Exchange differences arising when monetary items are settled or when monetary items are translated at rates different from those at which they were translated when initially recognised or in previous financial statements are reported in other comprehensive income in the period, with one exception. The exception is that exchange differences arising on monetary items that form part of the reporting entity's net investment in a foreign operation are recognised, in the consolidated financial statements that include the foreign operation, in a separate component of equity; they will be recognised in other comprehensive income on disposal of the net investment. [IAS 21.32]

- If a gain or loss on a non-monetary item is recognised directly in equity (for example, a property revaluation under IAS 16), any foreign exchange component of that gain or loss is also recognised directly in equity. [IAS 21.30]

- Prior to the 2003 revision of IAS 21, an exchange loss on foreign currency debt used to finance the acquisition of an asset could be added to the carrying amount of the asset if the loss resulted from a severe devaluation of a currency against which there was no practical means of hedging. That option was eliminated in the 2003 revision.

- When there is a change in the functional currency, the entity shall apply the translation procedure applicable to the new functional currencies prospectively.

Translation from the Functional Currency to the Presentation Currency

The results and financial position of an entity whose functional currency is not the currency of a hyperinflationary economy are translated into a different presentation currency in the following manner:

- assets and liabilities for each statement of financial position presented (including comparatives) are translated at the closing rate at the date of that statement of financial position. This would include any goodwill arising on the acquisition of a foreign operation and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign operation are treated as part of the assets and liabilities of the foreign operation [IAS 21.47];

- income and expenses for each income statement (including comparatives) are translated at exchange rates at the dates of the transactions; and
- all resulting exchange differences are recognised as a separate component of equity.
- Special rules apply for translating the results and financial position of an entity whose functional currency is the currency of a hyperinflationary economy into a different presentation currency. [IAS 21.42-43]

Disposal of a Foreign Operation

- When a foreign operation is disposed of, the cumulative amount of the exchange differences deferred in the separate component of equity relating to that foreign operation shall be recognised in other comprehensive income when the gain or loss on disposal is recognised. [IAS 21.48]
- Where the foreign entity reports in the currency of a hyperinflationary economy, the financial statements of the foreign entity should be restated as required by IAS 29, Financial Reporting in Hyperinflationary Economies, before translation into the reporting currency. [IAS 21.36]
- The requirements of IAS 21 regarding transactions and translation of financial statements should be strictly applied in the changeover of the national currencies of participating Member States of the European Union to the Euro - monetary assets and liabilities should continue to be translated the closing rate, cumulative exchange differences should remain in equity and exchange differences resulting from the translation of liabilities denominated in participating currencies should not be included in the carrying amount of related assets. [SIC 7]

Tax Effects of Exchange Differences

Gains and losses on foreign currency transactions may have tax effects. These must be accounted for using IAS 12 Income Taxes.

Disclosure

- The amount of exchange differences recognised in profit or loss (excluding differences arising on financial instruments measured at fair value through profit or loss in accordance with IAS 39).

- Net exchange differences classified in a separate component of equity, and a reconciliation of the amount of such exchange differences at the beginning and end of the period. [IAS 21.52]

- When the presentation currency is different from the functional currency, disclose that fact together with the functional currency and the reason for using a different presentation currency. [IAS 21.53]

- A change in the functional currency of either the reporting entity or a significant foreign operation and the reason therefor. [IAS 21.54]

- When an entity presents its financial statements in a currency that is different from its functional currency, it may describe those financial statements as complying with IFRS only if they comply with all the requirements of each applicable Standard (including IAS 21) and each applicable Interpretation.

Convenience Translations

- An entity may display its financial statements or other financial information in a currency that is different from either its functional currency or its presentation currency simply by translating all amounts at end-of-period exchange rates. This is sometimes called a convenience translation. A result of making a convenience translation is that the resulting financial information does not comply with all IFRS, particularly IAS 21. In this case, the following disclosures should be made: [IAS 21.57]

- Clearly identify the information as supplementary information to distinguish it from the information that complies with IFRS.

- Disclose the currency in which the supplementary information is displayed.

- Disclose the entity's functional currency and the method of translation used to determine the supplementary information.

7.12 FINANCIAL REPORTING BY GROUP ENTITIES

Accounting for business combination has undergone a through makeover in recent years. In January 2008 IASB issued revised standards, IFRS 3 *Business Combination* and revised IAS 27 *Consolidated and separate financial statement* that significantly changed the accounting for business combinations and transaction with non controlling entities. All business combinations are now treated as acquisition for the purpose of accounting irrespective of the actual form of acquisition. As a result in all business combinations it is assumed that one entity takes management control of the other entity or of its assets and liabilities. Now, it is essential to identify an acquirer in all business combinations as pooling of interest method is no more recognised under IFRS and all business combinations are accounted using purchase method

Part B

PRINCIPLES OF ACCOUNTING FOR FINANCIAL INSTRUMENTS

Chapter VIII

FINANCIAL REPORTING STANDARDS ON FINANCIAL INSTRUMENTS

Need for Financial Reporting Standards on Financial Instruments

Every entity has financial instruments even if it is only cash, bank account or trade receivables and payables. Traditionally, investments were recorded at cost. Therefore, many derivative transactions that did not have investment to begin with were left unreported. This lead to unfair reporting as reporting at historic cost model did not always gave indication of inherent risks. The banking world was rudely shaken by large-scale failures such as Barings Bank collapse in February 1995. This was preceded by large derivatives-related losses in several corporations such as Proctor and Gamble and Gibson Greetings. Financial Reporting standard setters realized that the existing historical cost convention was unfit for financial instruments where the historical cost may give no indication of the inherent risks. A global concern developed for

rewriting financial reporting standards for financial instruments. In 1993, the Global Derivatives Study Group made certain recommendations, which included setting of financial reporting standards for derivatives.

History of International Financial Reporting Standards on Financial Instruments

Presently, there are three standards deal with the accounting for financial instruments:

1. IAS 32 Financial Instruments: Presentation
2. IAS 39 Financial Instruments: Recognition and Measurement
3. IFRS 7 Financial Instruments: Disclosure

However, before these standards were issued most financial instruments except for the non Statement of financial position items were covered under accounting for investments. In October, 1984 an exposure draft *E 26 Accounting for Investments* was issued which was finally adopted as IAS 25 *Accounting for Investments* in March, 1986. The work on separate standard on financial instruments started as early as September, 1991 when E40 *Financial Instruments* was issued. However, it was modified and re-exposed as exposure draft E48 *Financial Instruments.* The presentation and disclosures portion of this exposure draft was adopted as IAS 32 in 1995 whereas work on recognition and measurement portion still continued. IAS 32 underwent revisions in 1998 and 2000.

In June 1998 exposure draft E62 *Financial Instruments: Recognition and Measurement* was issued which was adopted as IAS 39 in December the same year. IAS 39 itself is by far the most difficult standard the International Accounting Standards Board (IASB) has produced. It was subject to revision in 2000, effective for periods beginning on or after 1 January 2001. In 2000 extensive implementation guidance was published in the form of questions and answers. The IASB, as part of its "improvements project", published in 2002 an Exposure Draft of amendments to both IAS 32 and IAS 39 and revised standards were issued in December 2003, together with application guidance and implementation guidance. Subsequently, there was a revision to one aspect of IAS 39 (macro hedging) in March 2004. IAS 32 until revision in 2005 contained both presentation and disclosures requirements for financial instruments. IAS 30 dealt with Disclosures in the Financial Statements of Banks and similar Financial Institutions. In

August 2005, IASB issued IFRS 7 *Financial Instruments: Disclosures* that dealt with disclosures requirement for Financial Instruments. Henceforth IAS 32 was revised and was restricted to presentation requirements and IAS 30 was withdrawn. IFRS 7 *Financial Instruments: Disclosures* has been amended several times since then.

Besides the above standards IFRIC 9 *Reassessment of Embedded Derivatives* and the recently issued IFRIC 16 *Hedges of Net Investment in a Foreign Operation* are also related to the financial instruments.

Development of US accounting standards on financial instruments:

Given below is a brief rundown of the significant standards in the USA relating to financial instruments:

FASB 80 (1984) "Accounting for Futures Contracts" - This ruling established standards of accounting for exchange-traded futures contracts (other than foreign currency futures). It required that a change in the market value of an open futures contract be recognized as a gain or loss in the period of the change unless the contract qualifies as a hedge of certain exposures to price or interest rate risk.

FASB 105 (1990) "Disclosure of Information about Financial Instruments with Off-Balance Sheet Risk and Financial Instruments with Concentrations of Credit Risk" - This standard, which applies primarily to swap contracts, required disclosure of the face or contract amount; the nature and terms of the instrument; the cash requirements of the instruments; the related accounting policy; the accounting loss the entity would incur if any party to the financial instruments failed to perform according to the terms of the contract; the collateral or other security if the amount proved to be of no value to the entity; the entity's policy for requiring collateral or other security on financial instruments it accepts; and a description of collateral on instruments presently held. No fair value disclosures were required by FASB 105.

FASB 107 (1991) "Disclosure about Fair Value of Financial Instruments" - This standard requires all entities to disclose the fair value of financial instruments in the notes to their financial reports. If it was "not practicable" to determine fair value, information on how the market value was estimated was to be disclosed. However, FASB 107 does not require fair

values in the primary financial statements. Historical costs are shown on the statement of financial position itself.

FASB 119 (1994) "Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments" - This standard requires disclosure of amounts, nature, and terms of derivative financial instruments that are not subject to FASB 105 because they do not result in off-balance-sheet risk of accounting loss. It is applicable to derivative financial instruments such as futures, forwards, swaps, option contracts and other financial instruments with similar characteristics.

Deliberations for FASB 133 began as early as in 1992 but the standard finally became effective for accounting statements beginning after 15th June, 2000.

Development of Accounting Standards for Financial Instruments in India

Indian Accounting Standards are at verge of convergence to IFRS. The Accounting Standard Board of the Institute of Chartered Accountants of India has issued Accounting Standard 30: *Financial Instruments: Recognition and Measurement*, Accounting Standard 31: *Financial Instruments: Presentation* and Accounting Standard 32: *Financial Instruments: Disclosures.* These are in line with IAS 39, IAS 32 and IFRS 7 respectively.

Chapter IX

FINANCIAL INSTRUMENTS AND ITS PRESENTATION

9.1 Introduction

The definition of financial instruments is very extensive. Any contract that gives rise to a financial asset of one entity and financial liability or equity instrument of another entity, fall into the ambit of financial instruments. Cash, bank balances, trade receivables and payables, bank loans and overdrafts, issued debts, ordinary and preference shares, investments in securities like shares and debentures, derivatives are some of the example of financial instruments. Every entity has financial instruments, even if it is only cash, debtors or creditors.

9.2. Presentation of Financial Instruments

Proper presentation of financial instruments in book of accounts is very essential. It is important for the issuer, to understand the principles for presenting financial instruments as equity or liability and offsetting financial assets and liabilities. It applies not only to classification of financial instruments into liability and equity but also interest, dividends and losses and gains related to them.

IAS 32, *Financial Instruments: Presentation,* addresses the presentation of financial instruments as financial liabilities or equity. IAS 32 includes requirements for

- The presentation of financial instruments as either financial liabilities or equity, including when a financial instrument should be presented as a financial liability or equity instrument by the issuing entity;
- How to separate and present the components of compound financial instruments that contains both liability and equity elements;
- The accounting treatment of reacquired equity instruments of the entity;
- The presentation of interests, dividends, losses, and gains related to financial instruments; and
- The circumstances in which financial assets and financial liabilities should be offset
- IAS 32 complements the requirements for recognizing and measuring financial assets and financial liabilities in IAS 39, *Financial Instruments: Recognition and Measurement*, and the disclosure requirements for financial instruments in IFRS 7, *Financial Instruments: Disclosures.*

9.2.1. Debt/ Equity Classification

Financial Instruments should be presented based on their substance rather than their legal form. Any liability that is a contractual obligation to deliver cash or other financial assets, or to exchange financial assets or liabilities with other entity in terms that are potentially unfavourable to the entity, is a financial liability. Moreover, a contract that will or may be settled in the

entity’s own equity instruments and is non-derivative for which the entity is or may be obliged to deliver a variable number of entity’s own equity is also a financial liability.

On the other hand, an equity instruments is any contract that evidences residual interest in the assets of an entity after deducting all its liabilities. Therefore, an instrument is an equity instrument if, and only if both the conditions in (a) and (b) are satisfied.

(a) The instrument contains no contractual obligation

- To deliver cash or another financial asset to another entity; or
- to exchange financial assets or financial liabilities with another entity under conditions that is potentially unfavourable to the issuer.

(b) If the instrument will or may be settled in the company's own shares, it is

- a non-derivative for which the entity is not obliged to deliver a variable number of the entity’s own equity instruments; or
- a derivative that will or may be settled by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity’s own equity instruments. For this purpose the entity’s own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity’s own equity instruments.

A Case Study:

A start-up company is experiencing severe cash-flow problems. A supplier agrees to supply goods to the value of Rs. 1,00,000 in return for the company issuing to it, in 3 months time, shares that have a market value of Rs. 1,00,000. The number of shares that the company must deliver under this contract is variable i.e. it will depend on the market value of its shares at the settlement date.

Solution:

This contract would be classified as a financial liability, not an equity instrument as in essence it is no different from a contract that requires it to pay Rs. 1, 00,000 cash, or to deliver other assets worth Rs. 100,000, in exchange for the goods.

A financial instrument or its component parts should be classified upon initial recognition as a financial liability or equity instrument according to substance of the contractual arrangement. Once this classification is done, it is not subsequently changed. Here it is important to note that, though some instruments have legal form of equity instrument, their substance may be that of a liability. For instance, classification of preference shares may be done either as equity or as a liability depending on the substance of rights attached to it. The key feature in determining whether a financial instrument is a liability is existence of a contractual obligation of issuer, to deliver cash or another financial asset to the holder, or to exchange financial asset or liability under conditions that are potentially unfavourable. In case of equity instrument, the right to receive cash or other distributions is at issuer's discretion and there is no obligation to deliver cash or other financial asset to the holder. This is irrespective of the fact weather the dividends are cumulative or non-cumulative.

The items like warranty obligations and deferred revenue too, represents an obligation to deliver. However, in these cases the obligation is to deliver goods or services and not to deliver cash or other financial instrument. Hence, they are not financial liability. Similarly in case of obligation to pay tax or other dues to government which arises due to statutory requirements, though there is an obligation to deliver financial asset, these are not financial liability as the obligation is statutory and not contractual.

9.2.2 Presentation of dividends and interests

Proper presentation and classification of an issued financial instrument as either a financial liability or an equity instrument determines whether interest, dividends, gains, and losses relating to that instrument are recognized in profit or loss or directly in equity.

• Distributions to holders of a financial instrument classified as equity should be charged directly against equity and not against earnings. Therefore, dividends to holders of outstanding shares that are classified as equity are debited by the entity directly to equity.

•Interest, dividends, gains, and losses relating to an instrument classified as a liability should be reported in the statement of comprehensive income. This means that dividend payments on preferred shares classified as liabilities are treated as expenses.

•Changes in the fair value of equity instruments of the entity are not recognized in the financial statements

9.2.3 Offsetting a Financial Asset and a Financial Liability

A financial asset and liability should be offset against each other, to present net amount in the statement of financial position only when an enterprise has a currently enforceable right to set off the recognised amounts and intends to either settle on net basis or simultaneously settle the liability and realize the asset. Otherwise, in case of transfer of a financial asset that does not qualify for derecognition the entity should not offset the transferred asset and associated liability.

It is important to note that the existence of an enforceable right to set off financial asset and financial liability is by itself not sufficient basis for offsetting. Together with it, there should also be an intention to do so. When offset is applied entity has the right to pay or receive a single net amount in relation to two instruments and if it intends to do so, in effect the entity has single financial asset or financial liability.

Offsetting Vs Derecognition

Offsetting of a financial asset with a financial liability is different from derecognising financial assets or liabilities. Unlike de-recognition, offsetting does not remove an asset or liability from statement of financial position. Rather it amounts to net presentation of the asset or liability as either a net asset or a net liability. Moreover, derecognition of a financial instrument can give rise to gain or loss on Derecognition whereas there is no such gain or loss in case of offsetting.

Legal right to offset

Legal right to offset is debtor's legal right, by contract or otherwise to settle or otherwise eliminate all or portion of an amount due to creditor by applying against that amount due an amount due from the creditor. As the right here are legal right, the circumstance that gives rise to such a right will vary from one legal jurisdiction to another. Thus for each relationship between

two parties it is necessary to consider the particular laws applicable to it. Sometimes a debtor may have legal right to offset an amount due from third party against amount due from creditor, provided there is a legal agreement to do so between three parties.

Intention to offset

The existence of an enforceable right to set off financial asset and financial liability is by itself not sufficient basis for offsetting; there should also be an intention to do so. The intention of offset is presumed to be there either when entity intents to exercise the right to offset or to settle simultaneously an offsetting financial asset and financial liability. The intention of one or both parties to settle on net basis is not sufficient if there is no legally enforceable right to do so.

Chapter X

FINANCIAL ASSETS

Introduction

Financial Assets are any asset that is:

- Cash
- An equity instrument of another entity
- A contractual right
  - ➢ to receive cash or another financial asset from another entity
  - ➢ Exchange financial assets and liabilities with another entity under conditions that are potentially favourable to the entity
- A contract that will or may be settled in the entity's own equity instruments and is:
  - ➢ Non derivative for which the entity is or may be obliged to receive a variable number of entities own equity instrument; or
  - ➢ A derivatives that will or may be settled other than by the exchange of a fixed amount of cash or other financial asset for a fixed number of the entity own equity

instruments. For this purpose the entity's own equity instrument does not include instruments that are themselves contracts for future receipt or delivery of the entity's own equity instruments.

Some of the examples of financial assets are cash, bank balance, trade account receivables, loans, debt securities, etc.

Contracts and contractual rights

The terms 'contract', 'contractual right' and 'contractual obligation' is fundamental to the definitions of financial instruments, financial assets and financial liabilities. The reference to a 'contract' is to an agreement between two or more parties that have clear economic consequences and which the parties have little, if any, discretion to avoid, usually because the agreement is enforceable at law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing. Contractual rights and contractual obligations are rights and obligations that arise out of a contract. Assets and liabilities that are not contractual in nature are not financial assets or financial liabilities even though it may result in the receipt or delivery of cash.

Most contracts give rise to a variety of rights and obligations, and the rights and obligations arising from a contract will often change or be added to as the contract is performed. Some of these rights and obligations may fall within the definition of financial instruments and some may not. For example, an unperformed contract for the purchase or sale of tangible assets usually gives rise to rights and obligations to exchange a physical asset for a financial asset (although it is possible that, if the contract is breached, the exchange will involve the payment of compensation). These rights and obligations do not represent a financial instrument. Under the same contract, once the physical asset has been delivered, a debtor or creditor will usually arise and this will be a financial instrument.

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), meaning that each case is an example of a financial instrument. A company holding a convertible bond has a contractual right to receive another financial asset (shares, with cash as an alternative) from the issuer.

In very broad terms, financial assets will, or are likely to, lead to a company receiving cash in the future; financial liabilities will, or are likely to, lead to a company paying out cash in the future. But the cash may be received, or paid, via a whole chain of contractual rights or obligations – for example, a company may hold an option to acquire a convertible bond that can be converted into shares that can be sold for cash. So the definitions of financial asset and financial liability in IAS 32 are in general terms.

Exclusions from Financial Assets:

There are several exclusions from the normal classification and accounting rules for financial assets. The items excluded are:

i. a hedged item in a fair value hedge

ii. Interests in subsidiaries, associates and joint ventures, except where they are held temporally for disposal in near future.

iii. rights and obligations under leases, except for embedded derivatives included in lease contracts

iv. employers' assets and liabilities under employee benefit plans

v. rights and obligations under an insurance contract

vi. financial instruments issued by the entity that meet the definition of an equity instrument

vii. Contracts for contingent consideration in a business combination. This exemption applies only to the acquirer

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

ix. financial instruments, contracts and obligations under share based payment transactions, except for contracts that can be settled net in cash or another financial instrument

x. loan commitments that cannot be settled net in cash and which the entity has not designated as at fair value through profit or loss

Classification of Financial Assets: All financial assets are classified in any of the following four categories:

i. at fair value through profit or loss (FVTPL)
ii. available for sale (AFS)
iii. loans and receivables (LR)
iv. held to maturity (HTM)

Need for Classification: Classification of financial assets in one of the categories is essential for subsequent measurement of financial assets. The first two categories i.e. financial assets as at fair value through profit or loss and available to sale categories, are measured at Fair Value on subsequent measurement and the last two categories i.e. loans and receivables and held to maturity categories, are measured at amortized cost. However, equity instrument (and any derivative linked to or settled through it) that does not have a quoted market price or fair value of which cannot be reliably measured are held at cost. At initial measurement all are measured at fair value but transaction cost of all assets except those classified as at FVTPL are recognized in the fair value of instrument itself.

1. Financial Assets at Fair Value through Profit or loss:

This classification has further two sub classifications. First category contains financial assets that are held for trading purpose. Here, all derivatives except financial guarantee contracts and designated and effective hedging instrument are regarded as held for trading. Beside this all financial assets which are principally acquired for the purpose of sale or in case of portfolio of identified financial instruments that are managed together, there are evidences of short term profit making, are classified as at FVTPL. Second category includes financial assets that are on initial recognition designated as one to be measured at fair value with fair value changes in profit or loss.

Measurement: assets at FVTPL are initially and subsequently measured at Fair Value. Transaction costs associated with such assets are expensed. Gain or loss on subsequent measurement recognized in profit or loss.

Why is Financial Assets/Liabilities Designation at FVTPL?

Financial assets other than those held for trading may be designated as at fair value through profit or loss, so that:

- accounting mismatch can be eliminated or reduced
- more relevant information can be obtained
- burden of hedge accounting can be avoided
- difficulty of interpreting an asset as a held for trading could be avoided
- in case of hybrid instruments, burden of separating embedded derivative that are not closely related to host contract, can be avoided.

When can financial assets/liabilities be designated as at FVTPL?

Financial assets or financial liabilities can be designated as at FVTPL only when any of the following conditions are met:

Sometimes an entity has a liability, the cash flows or risks of which are associated with a financial assets. The classification of the asset and related liability may otherwise be such that it gives rise to a measurement and recognition inconsistency arising from measurement of asset and liability or recognition of gain or loss on them on different bases. Under this Standard, measurement of a financial asset or financial liability and classification of recognised changes in its value are determined by the classification of the item and whether the item is part of a designated hedging relationship. Those requirements can create a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') when, for example, in the absence of designation as at fair value through profit or loss, a financial asset would be classified as available for sale (with most changes in fair value recognised directly in the appropriate equity account) and a liability the entity considers related would be measured at amortised cost (with changes in fair value not recognised). In such circumstances, an entity may conclude that its financial statements would provide more relevant information if both the asset and the liability were classified as at fair value through profit or loss.

The entity need not enter into all of the assets and liabilities giving rise to the measurement or recognition inconsistency at exactly the same time. A reasonable delay is permitted provided that each transaction is designated as at fair value through profit or loss at its initial recognition and, at that time, any remaining transactions are expected to occur. *Appendix AG4E IAS 39 Financial Instrument: Recognition and Measurement* gives certain example where this condition is met.

When according to documented risk management or investment strategy, a group of financial assets and financial liabilities or both are managed and performance evaluated on fair value basis. Where an entity designates financial instrument as at FVTPL on this basis, it must designate all eligible financial instruments that are managed and evaluated together. The entity cannot make fair value choice for some instrument and leave the rest if they are managed together. Another essential aspect of meeting this condition is that the management policy should be documented though documentation need not be extensive.

In case of hybrid contract, containing one or more embedded derivative, entire contract can be designated as at FVTPL unless:

- the cash flows are not significantly modified because of embedded derivative; or
- Separation of embedded derivative is prohibited.

  The rules regarding the separation of derivative are discussed at length in later chapter.

A case study

An entity Y issues a debt instrument the interest of which are linked to the price of the equity of the company. The linking to the equity price is considered not closely related embedded derivative that would require separation. Therefore, entity Y is entitled to designate the whole debt instrument with embedded derivative as at fair value through profit or loss to avoid separating out embedded derivative.

Some other important aspects of financial assets or financial liabilities designated as at FVTPL

- The classification has to be done at initial recognition.

- Once fair value option is exercised for a financial asset or financial liability it cannot be revoked. The classification is irrevocable even if the instrument giving rise to accounting is derecognized.

- This option to classify a financial instrument as at FVTPL is not available for investments in equity instrument that do not have quoted market price in active market and fair value of which cannot be reliably measured. Such investments are measured at their costs.

- The choice given to entities to designate a financial asset or liability as at FVTPL is like a choice of accounting policy though it can be applied on instrument to instrument basis. It would not be acceptable to designate only some of the financial assets and financial liabilities as at fair value through profit or loss if to do so would not eliminate or significantly reduce the inconsistency and would therefore not result in more relevant information. However, it would be acceptable to designate only some of a number of similar financial assets or similar financial liabilities if doing so achieves a significant reduction (and possibly a greater reduction than other allowable designations) in the inconsistency.

A Case Study:

An entity XYZ borrows Rs 100 crores from a bank through a single instrument. It uses half of this borrowing to purchase quoted equity shares which are held for trading. The entity XYZ desires to reduce the measurement inconsistency by designating the loan liability as at fair value through profit or loss. However if the entity does so, it creates the accounting mismatch in profit or loss for remaining Rs. 50 crores which are not matched by assets held for trading. Therefore, the Entity XYZ is not permitted to apply fair value option as it does not significantly reduce accounting mismatch between asset and liability.

It cannot be applied to part of a single financial instrument.

Held-For-Trading Financial Assets

All derivatives other than derivative that is designated and effective hedging instrument are classified as held for trading. Beside this, a financial asset or liability is regarded as held for trading if it is acquired for purpose of sale in near future or when it is part of portfolio of

financial assets that are managed together for which there evidence of short term profit are making. Portfolio here would mean a group of financial assets that are managed together as a part of group. Even if a particular instrument is held for a longer period, it would qualify for as held for trading, if there are evidences of short term trading in other instrument held in portfolio to which it belongs. The standard does not limit the period for which such an instrument can be held. For a non-derivative asset to be classified as held for trading it must have been acquired principally for selling it in the near term. It is the principal purpose at acquisition that is relevant, rather than the actual period for which the asset is held. Moreover, there is no definition of "near term" but an entity should adopt a definition of near term and apply it consistently.

A case study: Entity X purchased quoted equity shares from the market with the intention of profiting from short-term price fluctuations on 1st March, 2004. It has classified the asset as held for trading financial asset. Entity X is holding the shares till last reporting date i.e. 31st December, 2007 due to a downturn in the stock market. Is entity X justified in its classification of equity shares?

Solution

Yes. The IAS 39 does not limit the time period for which such an instrument can be held.

For a non-derivative asset to be classified as held for trading it must have been acquired principally for the purpose of selling it in the near term. It is the principal purpose at acquisition that is relevant, rather than the actual period for which the asset is held. Moreover, there is no definition of "near term" in this standard. Therefore, Entity X should classify the quoted equity shares as held-for-trading as management's intention at acquisition was to profit from short-term price fluctuations.

Reclassification of financial assets and liabilities in and out of the FVTPL category while a financial asset is held is prohibited. This restriction also prevents an entity from reclassifying financial instrument in and out of held for trading category.

2. Held – To – Maturity Investments

Held-to-maturity (HTM) financial assets are:

- Non-derivative financial assets
- With fixed or determinable payments
- And fixed maturity
- That entity has positive intention and ability to hold till maturity

Other than those that are

- On initial recognition designated as at FVTPL
- Loans and receivables and
- Available for Sale financial assets

Measurement: Such investments are measured at their fair value +/- transaction cost, initially and at amortized cost using effective interest method on subsequent measurement

Fixed or determinable payments and fixed maturity

If an asset can be prepaid or extinguished by the issuer before substantially all of the recorded investment is recovered then it cannot be classified as HTM. If a debt instrument contains an embedded derivative which can be separated, then the host contract can be classified as HTM, if it has necessary characteristics. Since HTM financial assets have fixed payment and maturity, the contractual arrangement should state the amount and dates of payment to holder.

Equity instruments can never be classified as HTM as they have indefinite life and the cash flows from them has no fixed determinable pattern. Whereas preference shares with fixed payment and maturity can be classified as HTM investment (e.g. compulsorily redeemable preference share).

When there are debt instrument with variable interest rate they can still satisfy the criteria for HTM investments provided the terms of contract determining the amount and the timing of payment to the holder are specified in the contact. However, generally a perpetual debt instrument cannot be classified as HTM, as they have no fixed maturity date.

A case study:

Entity A purchases a 10 year debt instrument which pays variable rate of interest based on bank interest rate prevailing plus 1% and interests are paid annually in arrears. Can entity classify this as HTM asset?

Solution: yes, the entity A can classify this debt instrument as HTM if other conditions are met i.e. Entity has positive intention and ability to hold till maturity. Though the instrument pays variable interest, the maturity and timing of cash flows are fixed and are determined on a basis fixed in contract.

Positive intention and ability to hold until maturity

For an instrument to be classified as HTM there must be an intention to hold that instrument till maturity that should be fixed. Therefore, an intention to hold indefinitely will not enable the holder to classify them as HTM investments. Where any entity intents to sale an instrument in response to change in interest rates, payment risks, foreign currency risks, or change in availability and yield of alternative investments, or change in funding sources or terms, then it cannot be classified as HTM investment.

Moreover, hedging of HTM investment for interest or prepayment risk is prohibited as an entity can classify only those assets in this category where entity is indifferent to changes in the fair value of the financial asset.

In case of **callable securities** where issuer exercise its call option at option's price that is substantially close to its carrying cost such investment can be classified as HTM by the holder provided the holder intents to hold it till it is being called. In such cases maturity date is viewed as being accelerated.

As stated earlier, if an asset can be prepaid or extinguished by the issuer before substantially all of the recorded investment is recovered then it cannot be classified as HTM. Therefore, where a holder of a debt instrument purchases a conversion right, his intention to hold till maturity is questioned as exercising the option before maturity will lead to extinguishment of the debt contract before maturity. However, in case of **convertible debt instruments**, if it can be converted only on maturity it can be classified as HTM instrument as it does not raise question

on intention of the holder to hold the instrument till maturity. Similarly, p**uttable debt instruments** generally cannot be classified as HTM instrument as this shows holders intention to sell the asset in response to general market conditions. However, if the terms of put option are such that it can be exercised only in one of the permitted, isolated, non recurring circumstances it may be classified as held to maturity.

Qualification of an instrument which otherwise qualify as HTM, will not be effected even if there is significant risk of default on the behalf of the issuer. Securities that are pledged for borrowings can be classified as HTM where entity has intention and ability to pay back the loan without disposing the asset.

The ability to hold the financial asset to maturity cannot be demonstrated if the entity does not have the financial resources available to continue to finance the investment until maturity or is subject to legal or other constraints that could frustrate its intention to hold the financial asset to maturity.

Positive intention and ability to hold till maturity are to be assessed at each reporting date.

Tainting of held to maturity portfolio

When an investment which is earlier classified as HTM is reclassified or disposed off before its maturity date it is called tainting of HTM portfolio and as a result of it entity is debarred from using HTM classification for remaining portfolio of securities and also for any investment purchased for next two year. For this purpose, disposal or reclassification must be of more than significant amount. Moreover, an entity cannot have more than one portfolio of HTM category of investment. Generally, on tainting of HTM investment all remaining investment is to be classified as available for sale investments.

Exception to Tainting

There are certain exceptions to above rule i.e. under some circumstances disposal or reclassification does not result in tainting of investments. Such circumstances applicable to sale or transfers that:

- Are done so close to maturity/ call date of financial assets that change in market rate of interest would not have a significant effect on financial assets fair value. For this purpose period of less than three months can be regarded as close to maturity.
- Occur after the entity has collected substantially all of the financial assets original principals through scheduled payments and prepayments. Guidance as to what is substantial for this purpose has not been provided IAS 39. (but in US GAAP at least 85% of principal and interest due over its term)
- Are attributable to an unexpected isolated incident beyond entity's control and such incident is non-recurring in nature. In other words event must be extremely remote and unlikely to occur in practice. For e.g.

➢ a significant deterioration in issuer credit worthiness. Such deterioration must have occurred after acquiring the investment and there should be objective evidence of it, like decline in cash flow, brokers/analyst's report, less than projected results, sustained decline in earning, violation of covenants, etc. the reclassification should be done immediately in response to significant credit deterioration. However, a credit downgrade that can be reasonably anticipated by management or a credit downgrade that is not significant, e.g. from one rating class to the immediately lower rating class, would not qualify as an isolated event outside of management's control. A disposal of HTM investments in those circumstances would cast doubt on management's intent to hold other investments to maturity. Exchange of debt instruments out of HTM category on bankruptcy will also be permitted sale only if bankruptcy was unanticipated.

- A change in tax law that eliminates or significantly reduces tax exemption status of an instrument. In this case if sale is in anticipation of change of Law, it is not permitted.
- Major combination or sale that necessitates the sale or transfer of HTM investment. Such sale must be done concurrently or shortly after such combination. Sales in anticipation of business combination will taint the HTM category.

- sale in consequence of change in regulatory or statutory requirement modifying requirement of permissible investment or limit of particular investment.

However, all the above exception apply only if the sales or transfer do not involve more than insignificant amount of the entity's held to maturity portfolio.

A case study:

The entity X has investments in another country's government bonds that it has classified as HTM. Entity X sells the bonds before maturity following a significant downgrade of the bonds to below investment quality due to a recent economic crisis in that country. Entity X has other investments relating to other countries classified as HTM and management intend to continue to hold these other investments to maturity. Would a sale following a significant downgrading of a financial instrument cast doubt on management's intent to hold other investments to maturity?

Solution

No. The recent sale of the bonds would not raise a question about management's intent to hold other investments to maturity. Sales due to an isolated event that is beyond the entity's control such as a significant deterioration in the issuer's credit worthiness do not raise a question about management's intent to hold other investments to maturity.

Some other important points on tainting of HTM investments:

- in case of sale of HTM investment to an entity within a group, the HTM portfolio would not be tainted as far as consolidated statement are concerned, if buyer intents to and has an ability hold the investment till maturity. Nevertheless, in separate financial statement of seller such transfer will taint the HTM category of investments.

- If HTM category of any company of a group of companies has been tainted than the whole group will not be able to classify its investments as HTM

- If an entity intents to sale any investment from HTM category in permitted circumstances it need not reclassify them as available-to-sale.

- Sales in connection to change in management will taint the HTM category of investment.
- Catastrophic losses or high level of policy surrenders are not to be regarded as non-recurring or isolated incidence. Therefore, sale of investment from HTM portfolio will taint its position.
- If tainting of portfolio happens and it results in reclassification of the portfolio as available for sale comparative figures of the period should not be restated.
- Tainting affects all assets in the held-to-maturity category. Segregation of assets into separate portfolios does not 'protect' assets held in other portfolios

3. Loans and Receivables

Loans and receivables are financial assets that are:

- Non derivative financial assets
- With fixed and determinable payments
- Those are not quoted in an active market

Other Than

- Those that entity wants to sell immediately or in short term i.e. those classified as held for trading
- Those that entity on initial designation designates as at FVTPL
- Those that entity on initial recognition designates as available for sale

Those that are subsequently classified as available for sale as holder may not recover substantial portion of its investment for reason other than because of credit deterioration.

MEASUREMENT: Loans & Receivables are initially measured at fair value plus transaction cost directly attributable to acquisition or issue of financial asset or financial liability. Transaction costs are incremental costs that are directly attributable to the acquisition of a financial asset and include costs such as fees and commissions paid to agents, advisers, brokers

and dealers; levies by regulatory agencies and securities exchanges; and transfer taxes and duties. Transaction costs do not include debt premium or discounts, financing costs, or internal administrative or holding costs.

Subsequently Loans & Receivables are measured at amortized cost using effective interest method.

Loan origination fees and costs

Loan origination fees together with the related direct costs are deferred and recognised as an adjustment to the effective yield of a loan. A portfolio basis can be adopted if it is not possible to adjust the effective yield on an individual loan basis. Loan origination costs attributable to unsuccessful loans are expensed. An entity should therefore have a system for distinguishing successful from unsuccessful loans and for determining the related incremental and directly attributable origination costs.

Other important points:

- A financial asset that can be contractually prepaid or extinguished by receiver in such a way that the holder would not be able to recover substantially all of its recorded investment, other than because of credit deterioration, cannot be classified as L&R
- Investment in debt security not quoted in active market can also be classified as Loans and receivables.
- Negotiable Term deposits by banks in other banks, if not held for trading can be classified as L&R
- There is no tainting of this category.
- Evaluation of embedded derivative should be done and accounted separately. Host contract can thereafter be accounted as L&R if it meets the characteristics.
- Equity instrument cannot be L&R

- Preference shares with fixed payment and maturity like mandatorily redeemable preference share can be L&R.
- Purchase of interest in pool of assets that are themselves L & R can be classified as L&R if it meets the definition of L&R

4. Available for Sale Financial Assets

Available for Sale are non-derivative financial assets that are designated as available for sale, other than those

- Classified as loans & receivables
- Held to maturity
- Held for trading
- Designated as at FVTPL

Thus, AFS is a residual category. The AFS category will include all equity securities except those classified as fair value through profit or loss

MEASUREMENT: Available for sale financial assets are initially measured at fair value plus transaction cost directly attributable to acquisition or issue of financial asset or financial liability. Subsequently also they are measured at fair value with change in fair value recognized in equity and recycled in statement of comprehensive income at sale or impairment of asset. The cumulative gain or loss previously recognised in equity is recognised in profit or loss when the asset is derecognised. However, impairment losses, foreign exchange gains and losses (on AFS debt securities) and interest (on AFS debt investments) calculated using the effective interest method is recognised in profit or loss. Dividends on an available-for-sale equity instrument are recognised in profit or loss when the entity's right to receive payment is established.

RECLASSIFICATIONS:

Reclassification into and out of FVTPL and L&R are not permitted. Only exception to this is in case of hedging instrument which an entity is permitted to designate and de-designate in accordance with hedging strategy.

Reclassification provision amended in October 2008

In October 2008 the Board amended the provisions relating to reclassification thereby nullifying differences between the reclassification requirements of IAS 39 and US GAAP.

Erstwhile IAS 39 permitted no reclassifications for financial assets classified as held for trading. The Board was asked to consider allowing entities applying IFRSs the same ability to reclassify a financial asset out of the held-for trading category as is permitted by US GAAP SFAS 115 and SFAS 65.

Scope of the amendments

The amendments will only permit reclassification of certain non-derivative financial assets recognised in accordance with IAS 39. Financial liabilities, derivatives and financial assets that are designated as at FVTPL on initial recognition under the 'fair value option' cannot be reclassified. The amendments therefore only permit reclassification of debt and equity financial assets subject to meeting specified criteria.

The amendments do not permit reclassification into FVTPL.

The reclassification provisions are summarized in the table below:

Transfer to: **Transfer from**	**Trading**	**Loans and receivables**	**Held-to-maturity**	**Available for sale**
Trading	*Not Applicable*	The criteria for reclassification from trading account i.e. FVTPL	Any financial asset may be reclassified	Any financial asset may be reclassified

		to Loans and receivables depends on whether the asset would have met the definition of 'loans and receivables' (L&R) had it not been classified as at FVTPL. and if the entity has the intention and ability to hold the asset for the foreseeable future or until maturity.	from FVTPL to HTM if the financial asset is no longer held for the purpose of selling in the near term – but only in 'rare' circumstances.	from FVTPL to AFS, , if the financial asset is no longer held for the purpose of selling in the near term – but only in 'rare' circumstances.
Loans and receivables	*If pattern of short term profit making*	Not Applicable	Not Applicable	Not Applicable
Held-to-maturity	*Tainting*	Not Applicable	Not Applicable	Tainting
Available for sale	*If pattern of short term profit making*	A debt instrument classified as AFS that would have met the definition of L&R (if it had not been designated as AFS) may be reclassified to the L&R category if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity.	Change in intent and if all criteria met	Not Applicable

In its press release the IASB acknowledged that market conditions in the third quarter of 2008 are a possible example of a ‘rare’ circumstance. The Board also noted that rare circumstances arise from a single event that is unusual and highly unlikely to recur in the near term.

It should be noted that the amendments do not refer to the reclassification of AFS debt instruments to HTM because IAS 39 already permitted such reclassifications

Measurement at the reclassification date

All reclassifications must be made at the fair value of the financial asset at the date of reclassification. Any previously recognised gains or losses cannot be reversed. The fair value at the date of reclassification becomes the new cost or amortised cost of the financial asset, as applicable.

Measurement after the reclassification date

The existing requirements in IAS 39 for measuring financial assets at cost or amortised cost apply after the reclassification date (with one exception – see below). Therefore, for financial assets measured at amortised cost, a new effective interest rate will be determined at the date of reclassification.

For reclassifications out of AFS, IAS 39.54 requires the amounts previously recognised in other comprehensive income (OCI) to be reclassified to profit or loss either through the effective interest rate (if the instrument has a maturity) or at disposal (if the instrument has no maturity – i.e. it is perpetual). Amounts deferred in equity may also need to be reclassified to profit or loss if there is impairment.

The one exception to the existing measurement requirements is for reclassified debt instruments. If, after reclassification, an entity increases its estimate of recoverability of future cash flows, the carrying amount is not adjusted upwards as is currently required by IAS 39.AG8 for changes in estimates of cash flows. Instead, a new effective interest rate is determined and is applied from that date forward. Hence, the increase in the recoverability of cash flows is recognised over the expected life of the financial asset.

Disclosure

The Board decided to require additional disclosures about the situations in which any such reclassification is made, and the effects on the financial statements. The Board regards such information as useful because the reclassification of a financial asset can have a significant effect on the financial statements

Exceptional nature of the amendment

The Board normally and publishes an exposure draft of any proposed amendments to standards to invite comments from interested parties. However, given the requests to address this issue urgently in the light of market conditions, and after consultation with the Trustees of the IASC Foundation, the Board decided to proceed directly to issuing the Amendments without following a due process

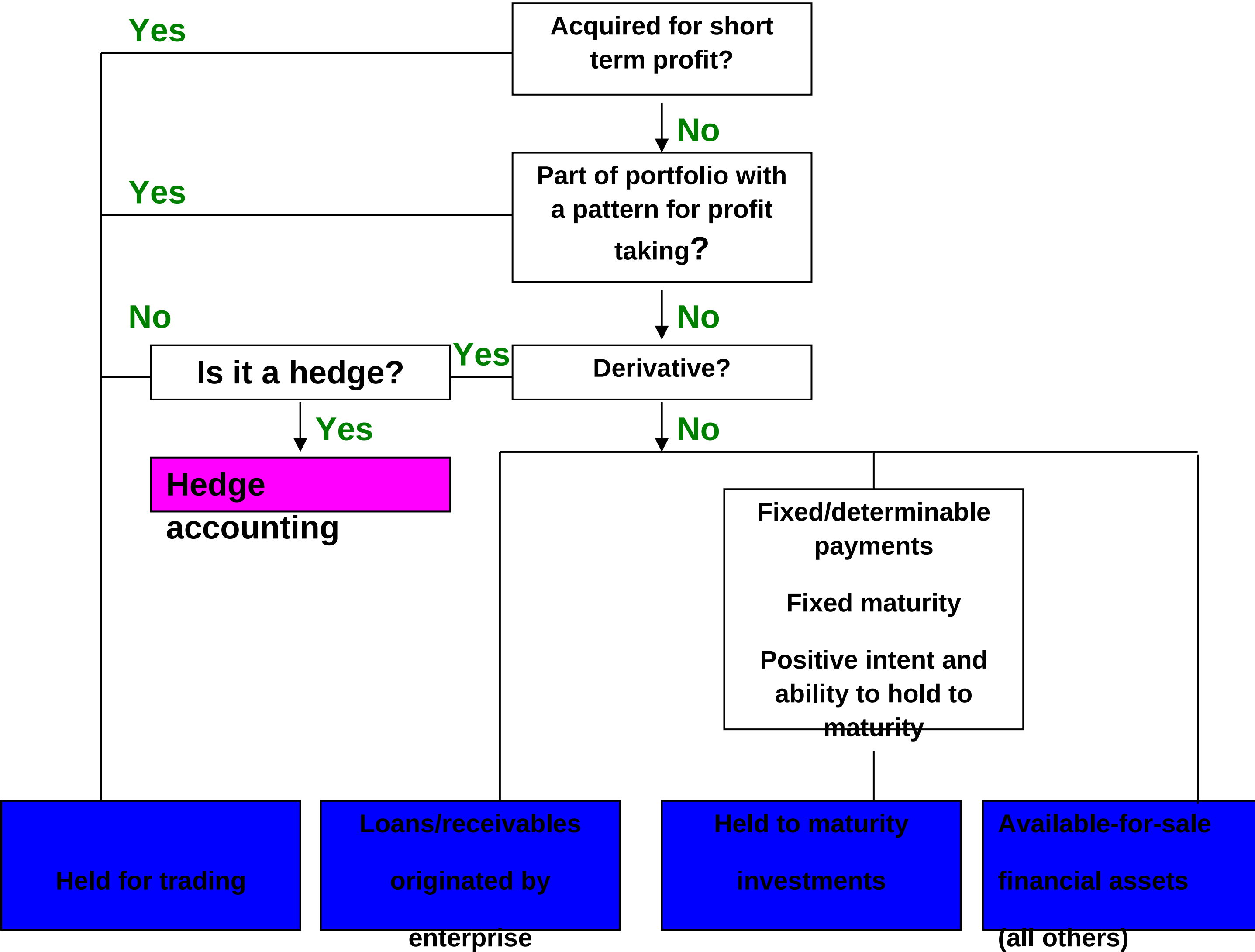
On reclassification of HTM assets as AFS assets on tainting, the difference between the carrying amount and fair value is recognized in equity.

On subsequent reversal of it i.e. after two years of tainting has expired, then assets can be reclassified as HTM if entity intends or is able to hold the asset till maturity. On transfer the assets carrying amount becomes the assets new amortized cost. Any previous gain or loss on the assets that have been recognized directly into equity is amortized to profit & loss over remaining life of the financial asset using effective interest method.

Sometimes for investments in equity instrument the fair value becomes insufficiently reliable, and then instrument is to be measured at cost. Any gain or loss till date recorded in profit or loss will not be reversed and any fair value gains or loss included in equity will remain in equity till such asset is sold.

When subsequently a reliable measure becomes available for an equity instrument or a derivative linked to it that was previously held at cost, the asset shall be re measured at fair value. Any difference between carrying amount and fair value will be recognized in profit or loss in case of assets classified as at FVTPL and through profit or loss or directly in equity for assets classified as available for sale.

The decision for categorization of financial assets can be summarized in the following flow chart.



Chapter XI

FINANCIAL LIABILITIES

Introduction

The issuer of a financial instrument has to classify the financial instrument or its component part as a financial liability or equity in accordance with the **substance** of the contractual arrangement **rather than legal form**. The basic principle is, if the issuer has unavoidable obligation to deliver cash and where contract does not is in substance the residual interest, it will be a liability rather than equity.

Financial Liability as per the standard is any liability that is

- a contractual obligation
  - to deliver cash or other financial assets to another entity; or
  - to exchange financial assets or liabilities with other entity in terms that are potentially unfavourable to the entity; or
- a contract that will or may be settled in the entity's own equity instrument and is
  - a non derivative for which the entity is or may be obliged to deliver a variable number of entity's own equity instruments; or
  - is a derivative that will or may be settled other than by fixed amount of cash or another financial asset for a fixed number of entities own equity instruments.

The standard defines **equity instrument** as any contract that represents a residual interest in assets of the entity after deducting all its liability.

Sometimes the terms of financial instrument are such that they contain components of both equity and liability such instruments are called **compound instruments.** The liability and equity components of a compound instrument are required to be accounted for separately.

Equity- Liability Classification

Many instruments that have the legal form of equity are, in substance, liabilities. A financial instrument should be classified as a financial liability or an equity instrument depending on the substance of the arrangement rather than the legal form. Liabilities arise when the issuer is contractually obligated to deliver cash or another financial asset to the holder of the instrument. An instrument is an equity instrument only if the issuer has no such obligation, i.e. it has an unconditional right to avoid settlement in cash or another financial asset. The ability to defer payment is not enough to achieve equity classification, unless payment can be deferred indefinitely. Generally, an obligation for the entity to deliver its own shares is not a financial liability because an entity's own shares are not considered its financial assets. An exception to this is where an entity is obliged to deliver a variable number of its own equity instruments.

The key questions that must be addressed when determining classification as a financial liability or equity instrument are therefore:

- Is settlement in cash or another financial asset neither mandatory nor at the option of the holder?
- Does the issuer have the unconditional right (i.e. full discretion) to avoid payments in cash or other financial assets or to defer payment indefinitely?
- if settlement in cash, another financial asset or a variable number of shares is dependent on the outcome of uncertain future events beyond the issuer's and the holder's control, is the event that would cause such settlement extremely rare, highly abnormal and very unlikely to occur?
- If the instrument is, or may be, settled in own shares, is the number of shares that will or may be delivered fixed, so that the holder is fully exposed to fluctuations in the issuer's share price?

Now let us study each of these issues in some details

Obligation to deliver cash or another financial asset

The obligation to deliver cash or another financial asset may arise explicitly or it may arise indirectly through the terms and conditions of the financial instrument. All the terms and conditions of the contract should be carefully assessed to determine the nature of obligation.

A case study:

Entity X has issued some preference shares. The shares provide the holders with a mandatory fixed cumulative annual dividend of 10% that is payable provided Entity B has sufficient distributable profits. The dividend is payable regardless of whether a dividend is paid on the entity's ordinary shares. The shares are redeemable at the issuer's option.

Solution:

Although, the preference shares are redeemable only at the issuer's option, in substance, they are debt instruments. To classify an instrument as equity, the issuer must assess the various rights attached to the share to determine whether it exhibits the fundamental characteristic of a liability. In this case, the dividend rights attached to the shares are such that the issuer cannot use its discretion to avoid payment of the dividend. Such a mandatory fixed cumulative dividend is similar to an interest payment that provides the shareholder with a lender's rate of return. Hence, the entity X should classify the entire preference shares as financial liabilities.

Unconditional right to avoid payment

An instrument qualifies to be classified as equity only if the entity has absolute discretion to avoid delivering cash or another financial asset. Otherwise, the instrument meets the definition of a financial liability. The management should have discretion to unilaterally set the timing and amount (including zero) of the payment. Such discretion should exist indefinitely for an instrument to be classified as equity. For example, an ability of the management of the issuer to unilaterally set the amount of any dividends, combined with no stated redemption date, might result in equity classification.

A potential inability or restriction on the ability of an entity to satisfy its obligation to transfer financial assets does not mean the entity has an unconditional right to avoid payment. For instance, an instrument requiring fixed payments only if there are distributable profits but not otherwise, is not an equity instrument. The presence or absence of distributable profits is not

within management's control, and therefore does not give management the discretion to avoid payment of dividends.

For similar reasons the following factors do not affect classification of a preference share as either a financial liability or an equity instrument:

- A history of making distributions
- An intention to make distributions in the future
- A possible negative impact on the price of ordinary shares of the issuer if distributions are not made
- The amount of an issuer's reserves
- An issuer's expectation of profit or loss for a period
- An ability or inability of the issuer to influence the amounts of its profit or loss for the period

Settlement based on uncertain future events

The terms of some instruments may give rise to an obligation to pay cash or transfer another financial asset only on the occurrence of one or more uncertain future events. For instance, an instrument may include clauses which call for redemption in the event of changes in tax legislation or failure to comply with financial performance measures or covenants etc. Where such specified events are beyond the entity's control, the entity does not have the unconditional right to avoid payment, and hence the instrument is classified as a liability. Liability treatment may be avoided only where an entity can demonstrate that either:

➢ the related contingent settlement provision is not genuine. An example may be where settlement is contingent upon the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur

➢ settlement in cash or another financial asset is only required in the event of liquidation of the issuer

Settlement in entity's own shares

Since the entity's own equity instruments do not represent financial assets of the entity, an entity's obligation to deliver its own equity instruments is generally not a financial liability. However, where there is an obligation of an entity to deliver a variable number of its own equity instruments or to exchange a fixed number of its own equity instruments for a variable amount of cash or other assets is a financial liability. In such cases, the entity is using its own shares as currency to settle an obligation that is either fixed in amount or those changes with a variable other than the price of the entity's own shares. As a result, the holder of the contract is not fully exposed to changes in the entity's share price and the contract does not evidence a residual interest in the entity's assets after deducting all of its liabilities.

Some examples:

ITEMS	CLASSIFICATION
Ordinary shares	equity, since right to receive cash if form of cash or otherwise at issuers discretion
Advance received	not financial liability, since obligation to deliver goods or services
Warranty obligations	-do-
Tax provisions	Non financial liability, since it is statutory obligation and not contractual obligation
Company's registration fees, etc.	-do-
Mandatorily redeemable shares	Financial liability
Bill payables	Financial liability
Trade creditors	Financial liability
Perpetual instruments with mandatory coupon payments	Financial liability
Puttable instruments	Financial liability

Instrument requiring mandatory payment of % of profit	Financial liability
Instrument redeemable at option of issuer	Equity, since outflow of cash avoidable
Instrument redeemable mandatorily on fulfilment of certain condition	Financial liability
Deposits	Financial liability
Contingent settlement	Financial liability, if provisions genuine and not limited to liquidation
Dividends	Not a financial liability if declaration at discretion of issuer
Declared dividend	Financial liability
Dividend pusher/stopper	Not financial liability
Bank overdraft	Financial liability

Amendments relating to Puttable instruments and obligations arising on liquidation

On 14 February 2008, the International Accounting Standards Board (IASB) published amendments to IAS 32 Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements. . There are many legitimate reasons for put features, and the IASB concluded that its constituents should not be forced to await the outcome of the long-term project on liabilities and equity and hence amended the relevant provisions in IAS 32.

The amendments are relevant to entities that have issued financial instruments that are

(i) puttable financial instruments, or

(ii) instruments, or components of instruments, that impose on the entity an obligation to deliver to another party a pro-rata share of the net assets of the entity only on liquidation.

Under the revised IAS 32, subject to specified criteria being met, these instruments will be classified as equity whereas, prior to these amendments, they would have been classified as financial liabilities.

The amendments are effective for annual periods beginning on or after 1 January 2009, with early adoption permitted. The amendments deal with these two types of instruments separately and set out extensive detailed criteria that need to be met in order to present the instrument as equity.

Purpose of the amendments

Under the current requirements of IAS 32, if an issuer can be required to pay cash or another financial asset in return for redeeming or repurchasing a financial instrument, the Instrument is classified as a financial liability. This principle applies even if the amount payable is equal to the holder's interest in the net assets of the issuer, or if the amount is only ever payable at liquidation and liquidation is certain because, for example, there is a fixed liquidation date.

Also, the effect of applying IAS 32 and IAS 39 *Financial Instruments: Recognition and Measurement* to financial instruments puttable at fair value may be that the entire market capitalisation of an entity is recognised as a liability. Consequently, when the entity performs well and the fair value of the liabilities increases, a loss is recognised. When the entity performs poorly and the fair value of the liability decreases, a gain is recognised. The amendments propose to classify these instruments as equity, provided specified criteria are met.

The impact of the amendments is restricted to the specific cases cited – no analogies can be made to these requirements.

Puttable financial instruments

Puttable financial instruments will be presented as equity only if all of the following criteria are met:

(i) the holder is entitled to a pro-rata share of the entity's net assets on liquidation;

(ii) the instrument is in the class of instruments that is the most subordinate and all instruments in that class have identical features;

(iii) the instrument has no other characteristics that would meet the definition of a financial liability; and

(iv) the total expected cash flows attributable to the instrument over its life are based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity (excluding any effects of the instrument itself).

Profit or loss or change in recognised net assets for this purpose is as measured in accordance with relevant IFRSs. In addition to the criteria set out above, the entity must have no other instrument that has terms equivalent to (iv) above and that has the effect of substantially restricting or fixing the residual return to the holders of the puttable financial instruments.

Instruments that impose an obligation to deliver a pro-rata share of net assets only on liquidation

The criteria for equity classification for instruments, or components of instruments, that impose on the entity an obligation to deliver to another party a pro-rata share of the net assets of the entity only on liquidation are the same as above except (iii) and (iv) do not apply. Criterion (iii) does not apply because, if there is a component of the instrument that meets the definition of a liability (other than the right at liquidation itself), this will be recognised separately as a financial liability and the instrument will be presented as a compound instrument, i.e. with both liability and equity components.

Criterion (iv) does not apply because should any cash flows be paid to the holder of the instrument during the instrument’s life, will reduce the amount ultimately payable at liquidation.

Derivatives over instruments in the scope of the amendment

Even though the amendments permit certain instruments that were previously presented as financial liabilities to now be presented as equity, derivatives over such equity instruments may not be presented as equity.

Reclassifications

The amendments require reclassification from or to equity when the specified criteria are no longer met, or when they are subsequently met. If the instrument presented as equity is reclassified as a financial liability, it will be measured at fair value at the date of reclassification with any difference between the fair value and the carrying amount to be recognised in equity.

When the inverse applies, the financial liability will be reclassified to equity at its carrying amount at the date of reclassification.

Disclosures

Additional disclosures are required about the instruments affected by the amendments.

Compound Instruments:

A compound instrument has a legal form of a single instrument, but substance is that of both of equity and liability. E.g. a bond that is convertible to equity. Here there is a financial liability to deliver cash, in form of principle or interest payment, till the bond is converted and also a written option to holder to convert into fixed number of equity shares.

1. Recognition of compound instrument:

Equity and liability elements of compound instrument are to be separated at initial recognition and are not subsequently revised.

2. Initial measurement of compound Instrument:

The fair value of a compound instrument at issuance is assigned to its respective debt and equity components so that no gain or loss arises from recognising each component separately. There is a prescribed method for assigning the fair value to each component. Fair value of liability component is ascertained and this is regarded as initial carrying amount of liability component. For this purpose, fair value of liability component would be the contractual stream of future cash

flows discounted at the market rate of interest that would be applied to similar instrument without conversion option. Similar borrowing is one of comparable credit status and providing substantially the same cash flows on the same terms. Similar borrowing is one of comparable credit status and providing substantially the same cash flows on the same terms. Transaction costs relating to the issue of a compound instrument are allocated to the liability and equity components in proportion to the allocation of the fair value of the instrument upon initial recognition

A case study:

On 1 January 2008, an entity issued 2000 convertible bond of three year term with face value of Rs.1000 per bond. The interest is payable at the end of the year at 6%. The bond is convertible into 100 equity shares of the entity. The market interest rate for similar bonds without conversion option is 9%. The liability component has not been designated upon initial recognition as at fair value through profit or loss.

Solution:

The method prescribed for determining the relative values of the debt and equity components is to establish a fair value for the liability component by measuring the fair value of a similar liability that does not contain an equity conversion option and assign the balance of the fair value of the compound instrument as a whole to the equity element. Thus in case the liability component is calculated using the discount rate of 9%.

On 1 January 2008 the bond's carrying amount may be allocated as follows:

Fair Value of Liability component:

Present value of the interest payments discounted at 9% 3,03,755

Present value of Rs 1000 due in 10 yrs discounted at 9% 15,44,367

Therefore, FV of liability component 18,48,122

Fair value of convertible bond 20,00,000

FV of liability component 18,48,122

Therefore the residual equity component 1,51,878

In case of compound instrument, there may also be an embedded derivative. In such cases, value of such embedded derivative is allocated to liability component. Further analysis is then required to establish whether the embedded derivative is closely related to liability component. For example, the liability component of a callable convertible bond is adjusted to include the value of the embedded call feature. The equity component is again calculated as the residual amount, after deducting the liability component, adjusted to include the embedded call feature, from the fair value of the instrument as a whole

3. Subsequent measurement of compound instrument:

Subsequently, the liability component will be measured depending on classification whereas equity component will not be re-measured.

Upon conversion of compound instrument, equity is issued and liability component is derecognized. The equity component recognized initially remains so and there is no profit or loss on conversion. Amount of liability=loss/gain recognized in the statement of comprehensive income.

However, an entity may extinguish a convertible instrument before maturity, through early redemption or repurchase. The amount paid on early termination is allocated to the debt and equity components using the same method of allocation that is used on initial recognition. This means the fair value of the instrument as a whole less the fair value of the liability component are both recalculated at the date of repurchase or redemption, with the fair value of the equity component representing the balancing (or residual) amount. Any gain or loss on the liability component is recognised in profit or loss. The amount of the consideration paid in relation to the equity component is recognised in equity. If however an entity amends the terms of a convertible instrument, perhaps to induce early conversion, the difference between the fair value of the consideration to be paid under the amended terms and that which would have been paid under the original terms is all charged to profit or loss at the date when the terms are amended.

If the conversion option is not exercised and lapses, the equity element are reclassified to another caption within shareholders' equity, usually either retained earnings or a capital reserve. The equity element is never recognised in the statement of comprehensive income.

Treatment of Interests, Dividends Etc.: any interest, dividend, losses and gains relating to a financial liability are recognized as income or expenses in statement of comprehensive income whereas distribution to holder of equity instrument or transaction cost directly attributable for acquiring or issuing an entity's own equity instruments are accounted within equity. Transaction costs directly attributable to issue of compound financial instrument are allocated to liability and equity in proportion to allocation of their proceeds.

Classification of Financial Liabilities: Financial liabilities are classified into one of the two categories:

i. Financial liabilities at fair value through profit or loss

ii. Other financial liabilities

Financial liabilities at FVTPL can be further classified as held for trading and financial liabilities designated by entity as at FVTPL.

1. Held for Trading Financial Liabilities: All derivatives except financial guarantee contracts and designated and effective hedging instrument are regarded as held for trading financial liabilities. Beside this all financial liabilities which are principally acquired for the purpose of repurchasing in near future or in case of portfolio of identified financial instruments that are managed together, there are evidences of short term profit making, are classified as at FVTPL and regarded as held for trading.

2. Financial liabilities designated at FVTPL: Financial assets/liabilities can be designated as at FVTPL only when following conditions are satisfied:

- Sometimes an entity has a liability, the cash flows or risks of which are associated with an financial assets. The classification of the asset may otherwise be such that it gives rise to a measurement and recognition inconsistency arising from measurement of asset and liability or recognition of gain or loss on them on different bases.

- When according to documented risk management or investment strategy, a group of financial assets and financial liabilities or both are managed and performance evaluated on fair value basis.

In case of hybrid contract, containing one or more embedded derivative, entire contract can be designated as at FVTPL unless:

- the cash flows are not significantly modified because of embedded derivative; or
- Separation of embedded derivative is prohibited.

The designation of financial liability as at FVTPL is irrevocable.

Other Financial Liabilities: financial liabilities not classified as at FVTPL are other liabilities. Such liabilities are measured at amortized cost.

Reclassification: reclassification into and out of FVTPL is prohibited except in case of derivatives designated and de designated as hedging instrument.

Chapter XII

DERIVATIVES AND EMBEDDED DERIVATIVES

Derivatives are defined as financial instruments or other contracts with all of the following characteristics

- Its value changes in response to change in a variable like interest rate, financial instrument price, commodity price, foreign exchange rate, credit rating etc., provided in case of non-financial variable that variable is not specific to party to contract.
- It requires no or smaller initial net investment as compared to what would be required for other contract to have similar response to market change.
- It is settled at future date.

A derivative typically includes futures, forwards, swaps and options contracts. Beside these some of the derivatives which are selectively covered by IAS 39 *Financial Instrument: Recognition and Measurement* include:

- Derivatives on interest in a subsidiaries, associates or joint ventures unless the derivative meet the definition of equity instrument.
- Derivatives embedded in the lease agreements if they are separable from host contract.
- Derivatives embedded in insurance contracts if the derivative itself is not a contract covered by the IFRS 4 *Insurance Contracts*.
- Loan commitments that can be settled net in cash or by delivering or issuing another financial instrument.
- Loan commitments and whole class of such loan commitments, where the entity has past practice of selling the resulting loan assets shortly after its origination.
- Contracts to buy or sell a non financial instrument that can be settled net in cash or other financial instrument or by exchanging financial instruments, unless it was entered into and continues to be held for purpose of delivery of a non financial item in accordance with the entity's expected purchase, sale or usage requirements.

The Variable

The Variable is also called Underlying. Some examples of variable would include a security price, commodity price, interest rate, credit rating, foreign exchange rate, index price or rates of them, etc.

A variable along with notional amount or a payment provision determines settlement amount of a derivative. A derivative usually has a notional amount like number of shares or amount of index or number of units or weight, etc. However, sometimes a derivative contract may instead require a fixed payment or payment of an amount that can change, on happening of a future event that is unrelated to a notional. Such payments are called payment provision. Beside this, a

derivative contract may not have a notional amount or a fixed payment provision, but instead a multiple underlying.

SOME EXAMPLES of derivative contracts:

Terms of contract	Underlying	notional	Payment provision
A company enters into a forward contract to purchase $500 @ Rs 50 after 3 months	Exchange rate between $ and Rs.	$ 500	-
A contract to buy 10,000 equity shares for Rs 10 lacs if price increase by 5 Rs in 2 months	Price of shares	-	Rs 10 lacs
Exporter enters into a contract with a bank to convert all proceeds in $ to Rs at fixed rate for next six months.	Sales volume Exchange rate between $ and Rs.	-	-

Another important point in regards to variable is that in case of non-financial variable that variable should not be specific to any party to contract.

A case study:

An entity enters into a contract for the purchase of goods. The contract has a provision according to which supplier is required to pay a compensation for the actual loss suffered by the entity if the supplier does not deliver the goods under the contractual terms. The amount of compensation is based on the cost to the entity of acquiring the goods from another source, associated transport and other transaction costs, lost profits and any other losses suffered by the entity.

Solution:

The value of the embedded derivative is based on actual loss suffered by the entity. This variable is a non-financial variable that is specific to a party to the contract. Therefore, the non-performance clause does not meet the definition of an embedded derivative.

Initial Net Investment

Second most important thing in the definition of derivative is that it should have no initial investment or smaller investment as compared to other contract that may have similar impact of change in variable conditions. The amount paid at inception can be significant but it has to be smaller than that otherwise payable.

A case study:

An entity enters into a contract with another company that requires it to pay a variable interest rate based on the bank rate and receive a fixed rate at 9% on notional amount of Rs. 10,00,000. No initial payment is required at inception of the contract by either party. Is it a Derivative Contract?

Solution: This is a derivative contract as it has all the features of a derivative.

Some important points:

- In case of an option, premium paid may be significant but is likely to be smaller than the amount required buying an instrument with similar response.
- Currency swap may require exchange of currencies. Here net effect of change is considered which is zero.
- Sometimes forward contracts are prepaid so that initial net investment approximates to that would be required for other type of contract with similar response. Such contract does not meet the definition of derivatives.
- Two or more non-derivative contracts can be considered together as in case of offsetting loans where substance of such loans taken together is that of a derivative. This can be done if they are done at same time and for contemplating each other and have same counterparty and relate to same risk.

Future Settlement

Finally, third consideration is that contract must be settled at future date. Here settlement can take various forms and does not necessarily mean exchange of cash. Expiry of the contract also amounts to its settlement even though there is no exchange of cash.

EMBEDDED DERIVATIVES

An embedded derivative is a component of hybrid instrument that also includes non derivative host contract, such that some of cash flows of hybrid instrument vary in way similar to a standalone derivative. In other words, an embedded derivative is a derivative instrument that is combined with a non-derivative host contract to form a single hybrid instrument. The host contract might be a debt or equity instrument, a lease, an insurance contract or a sale or purchase contract. An e.g.

Company X holds a bond which is convertible into the ordinary shares of Company Y.

Hybrid contract:	Convertible bond
Host contract:	Bond asset
Embedded derivative:	Convertible option

The convertible option is an embedded derivative. It fulfils all the three conditions that define derivative.

All freestanding derivatives, except for designated and effective hedging instruments, are measured at fair value with all changes in fair value recognised in profit or loss. This requirement on embedded derivatives is designed to ensure that measurement at fair value cannot be avoided by embedding a derivative in another contract or financial instrument that is not carried at fair value. However, a derivative contained in a financial asset or liability that is carried at fair value through profit or loss is not separated, as changes in its value are included in changes in the value of the combined instrument and hence are already reported in profit or loss. A derivative that is attached to a financial instrument but is contractually transferable independently, or has different counterparty from that instrument, is not embedded derivative, but separate financial instrument.

Conditions for Separation of Derivative:

The economic characteristics and risks of embedded derivatives are not closely related to that of host contract

Separate instrument with same terms meet the definition of embedded derivative (i.e. it must have underlying, no or lesser initial net investment, settlement at future date)

Hybrid instrument is not measured at fair value through profit or loss (such classification can be done unless embedded derivative does not significantly modify cash flow or where it is evident that separation is prohibited)

The term "closely related' has not been defined in the standard. The Appendix to IAS 39 provides lists of example of embedded derivative that are closely related to their host contracts and those that are not closely related. A degree of judgment is required when an embedded derivative does not fall in any of two lists. The assessment of whether an embedded derivative is closely related is primarily qualitative rather than quantitative and requires an understanding of the economic characteristics and risks of both instruments.

A Case study:

A company which is a power generation company, has a number of contracts that have prices linked to coal prices. Management believes that, from a qualitative perspective, the power price is linked to the price of coal, as coal is a major input required in generation of power. However, a quantitative analysis reveals that electricity prices are not directly correlated with coal prices. The point under consideration is weather derivative linked to the contracts should be considered closely related or not?

Solution

No, the derivative attached to the contract cannot be regarded as closely related, as a qualitative approach should be supported by quantitative analysis while determining whether the economic characteristics and risks of an embedded derivative are closely related to those of the host contract. In this case when quantitative analysis does support the fact that price of power is closely related to price of coal. Hence, the derivative should be separated from the host contracts.

An embedded derivative that modifies an instrument's inherent risk (such as a fixed to floating interest-rate swap embedded in a fixed rate debt instrument) would be considered closely related. Conversely, an embedded derivative that changes the nature of a contract's risks is not closely related. Commodity indexed interest or principal payments - in which the amount of the interest or principal is indexed to the price of a commodity - are not closely related to the host debt instrument or insurance contract because the risks inherent in the host contract and the embedded derivative are dissimilar.

A Case:

Entity X is a gold mining entity that operates in India. It issues bonds with a face value of Rs. 10,00,000, bearing interest at 8% annually. The terms require entity X to pay an additional 0.1% for every Rs. 100 increase in the gold price above Rs.10,000. The price of gold at the issue date was Rs. 10,000 per gram. The market rate for a fixed-interest loan is 8%. The point under consideration is should management account separately for an embedded derivative in a bond that has an interest rate that varies with the market price of a commodity?

Solution:

Yes. The embedded derivative should be accounted for separately. Entity X has issued a host debt instrument and has undertaken written call option to pay 0.1% interest for every Rs. 100 increase in the gold price above Rs. 10,000. The written call option is not closely related to the host contract, because its economic characteristics are linked to a commodity index rather than an interest-rate index. Entity X's management should initially recognise the embedded derivative at fair value and attribute the balance of the consideration received to the initial carrying amount of the bond. In subsequent periods, entity will measure the derivative at fair value through profit or loss and accrete interest on the bond, over its life, at the effective interest rate determined at inception.

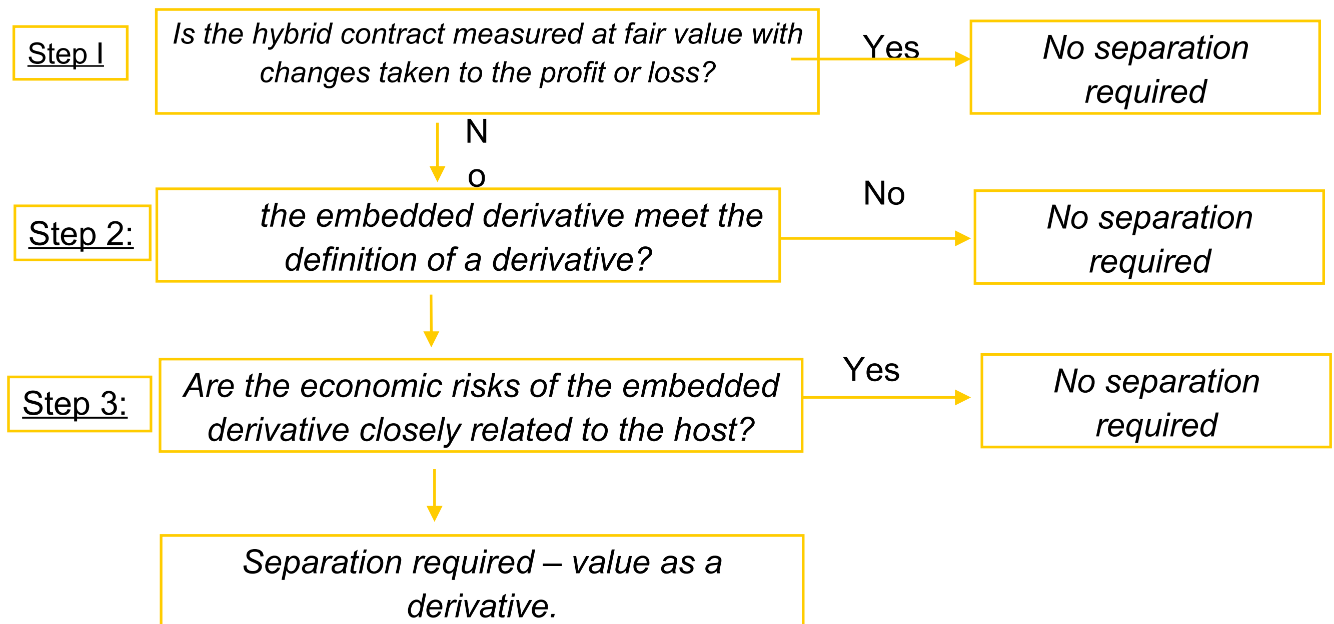
An embedded derivative that results in payments in a purchase or sale contract or a lease being denominated in a foreign currency is deemed closely related if foreign currency is any of the following:

- the functional currency of any substantial party to the contract

- the only currency in which contracts for a particular commodity are priced internationally, or

- a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (for example, a relatively stable and liquid currency that is commonly used in local business transactions or external trade). This last condition is particularly likely to apply in countries with high inflation rates or restricted currency markets where market participants generally prefer to transact in a stable currency

Embedded Derivatives



Measurement: Any embedded derivative which is not closely related to host contract will be accounted for as a standalone derivative and will be measured at fair value with any changes in fair value recognized in profit or loss. If the host contract is a financial instrument under this

standard it will be so accounted otherwise it will be dealt according to relevant accounting standard. Steps in valuation of components of hybrid contracts are:

- determine the fair value of embedded derivative
- find difference between consideration paid or acquired and value of embedded derivative to find value of host contract.

If entity in unable to find the value of separable embedded derivative then it should first find the fair value of whole contract and of the host contract and difference between them would represent the value of derivative. If entity is unable to do this also it must designate the whole contract as at FVTPL.

Chapter XIII

FAIR VALUE OF FINANCIAL INSTRUMENTS

The concept of fair value is centre to approach of IAS 32 & IAS 39. Most of the relevant information, required to be presented to users are based on Fair Value concept. Initial measurement for all financial assets and liabilities are to be done at Fair Value. Fair Value has been defined in the draft standard as the amount at which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. The fair value is viewed as an 'exit' and not as an 'entry' price, i.e. for an asset it is the amount that can be realized from its disposal and is not the cost to acquire it; and for liabilities it is the amount for settling it rather than amount to be received for taking it on.

One basic presumption while measuring Fair Value is that of a going concern. For determination of Fair Value maximum reliance has to be made on observable market data and minimum use of entity specific factors. Based on it a hierarchy can be formed, starting from those quoted in active market to those based on valuation technique requiring more subjectivity and judgment.

Whenever a **Quoted Market Price** is available for a financial asset or a liability it should be used for determining Fair Value. **Market** here is one in which quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency. A price quoted in such market represents actual prices of regularly happening transactions on arms length basis.

When there is more than one quote or more than one market, the Fair Value should be based on most advantageous market (i.e. where profit or net asset is maximum) to which entity has access. When there are several exit markets for a financial instrument following points are to be considered:

- Alternative prices of a market are to be considered only if there is no legal obstacle for entity to participate in the market.
- Where only portfolio of instruments is traded, entity has access only if it holds the portfolio.
- Adjustments for difference in counter party credit risks are to be done to price of most advantageous market.

'**Most Advantageous Market Price** 'here would mean price at which there is maximum profit. For an asset it is highest market exit price and for a liability it is lowest market exit price. For the purpose of comparison, transaction cost should be considered though price actually used as an estimate of Fair Value and should not be adjusted to include transaction cost.

Price to be considered for determining Fair Value would be the closing price at the end of last trading day of identical instrument. For listed stocks, options, futures and securities traded in public exchanges the published price quotation represents price for valuation. In dealer market (market for narrowly traded securities, corporate bonds, loans, securities) quotations are in form of bid and ask price. The difference between bid and ask price is 'bid-ask spread' which in normally treated as transaction cost. **Bid price** normally represent an exit price for an asset and entry price for a liability whereas **ask price** is exit price for a liability and entry price for an asset. Sometimes for assets and liabilities with offsetting market risk, mid price can be used. In such cases bid and ask price are still applicable for net open position.

E.g. if a company has an asset of 200 shares of another company and at a same time a liability of 150 shares of same company and the bid and ask price are Rs.50 and Rs. 54 respectively, it can value its financial instrument as follows:

Asset: 150 shares at mid price i.e. Rs. 52	Rs.7800
50 shares at bid price i.e. Rs. 50	Rs.2500
Liability: 150 shares at mid price Rs. 52	Rs.7800

The **mid price** can only be used for offsetting market risk. It cannot be used otherwise for presentation in financial statement even if required by some other regulation.

Other considerations for taking quoted market price:

- Where published price does not exist but the prices are obtained from industrial groups, pricing agency, regulatory agency, brokers etc., they represent actual and regular transaction price, such prices should be considered at their own merit.
- In case where published price is not available for financial instrument but published price for its ***component parts*** are available, then such price should be used.
- No adjustment for premium or discount should be made *for* ***large holding***. The Fair Value for such holdings must be product of Fair Value of individual holding and number of instruments.
- If certain ***restriction which limits*** the ability to sell a financial instrument exist as part of contractual arrangement of instrument itself, then it should be incorporated as Fair Value of the instrument.
- When quoted price is not available for financial instrument use of valuation technique has to be done.

VALUATION TECHNIQUES

Where active market for a financial instrument does not exist valuation techniques are used for ascertaining Fair Value. There are various techniques and selection of a particular technique would be based on following factors:

- Type and complexity of instrument
- Availability of input data
- Cash flow of equivalent alternative investment
- Frequently used and generally accepted technique used by others

Whenever Fair Value is determined using a technique, selection of formula, method and assumptions are done and there is **model risk** that any of these are incorrect. All valuation technique produces only a theoretical representation of market value. In order to access the validity of technique used, the entity should judge its technique by using prices from any current market transaction or on observable market data.

Valuation technique used should make **maximum use of market data** and minimum use of entity specific factors. Estimates and assumptions should be consistent with those used by other market participants. If a rate is quoted in market, use of that rate should be made. The other factors that influence Fair Value of financial instrument are:

- Credit risk
- Volatility
- Time value of money
- Interest rates
- Currency exchange rates
- Commodity prices
- Equity prices

- Service cost
- Prepayment or surrender risks
- Inflation rate
- Regulatory framework, e.t.c.

One of simpler and commonly used technique is the valuation on basis of **Recent Transaction Price.** The initial acquisition or origination of financial asset and incurrence of financial liability are market transaction for this purpose. If there is significant change in economic conditions after the transaction has taken place, Fair Value should be adjusted accordingly to reflect current price or rates for similar instruments. In absence of evidence to contrary, it can be assumed that no adjustments are required, provided entity takes reasonable steps to determine if there is evidence of change in factors. Adjustments need not be made for any changes occurring after the reporting date. Recent Transaction Price does not properly reflect the Fair Value in any of the following situations:

- If Recent Transaction is between related parties
- It is a sale of very large holding and involves discount or premium
- Price influenced because some other transaction, contract, agreement or arrangement between transacting parties.
- Recent transaction has occurred between parties, where one or both were experiencing severe financial crises.

Comparison to Similar Instrument is another way of establishing Fair Value and can be used where estimation of effect of difference between the instruments on Fair Value is possible. For using this technique it will be necessary to understand the instrument that is to be measured and then identify a similar instrument with quoted market price or recent transaction price that can be used for establishing its Fair Value. Once Fair Value of similar instrument is determined the effect of difference is identified and adjusted to arrive at the Fair Value of instrument requiring measurement. Two instruments are similar if amounts and timing of contractually specified cash

flow are similar and they are exposed to same kind of risks. Two instruments are said to have same risk attributes if prepayment expectations, credit risks and marketability are similar and if they are issued by entities in similar industry and geographical bases. Sometimes adjustment is to be made with regard to size of investments.

Sometimes Fair Value of a financial instrument cannot be determined by applying any of the above method. In such cases other technique like discounted cash flow, option-pricing models are used to determine Fair Value. When using **discounted cash flow** the discount rate equal to prevailing rates of return for financial instrument with same terms and characteristics like credit risk, term of interest payment and remaining term of repayment of the principle and currency in which payments are to be made. Short term receivables and payables with no stated interest rate may be measured at original invoice amount if effect of discounting is immaterial.

When valuation technique does not solely use observable market data, no gain or loss shall be recognized on initial recognition of financial instrument i.e. in **Day 1 P&L. S**ubsequently gain or loss is to be recognized only to the extend it arises from change in factor, including time, used in determining price.

In relation to liability that are payable on demand, the Fair Value of such liability is not less than the amount payable on demand, discounted from first date that amount could be required to be paid i.e. further discount on expectation that repayment will not be required to made on first date should not be done even if there is strong evidence of it.

Chapter XIV

MEASUREMENT OF FINANCIAL INSTRUMENT

Initial Measurement:

All financial assets and liabilities are initially measured at **Fair Value.** Fair Value is the amount for which an asset is exchanged or liability settled, between knowledgeable parties, willing parties in an arm's length transaction. Normally, in an arm's length transaction the fair value of consideration given or received should be the fair value. Therefore for initial recognition the

transaction price is best evidence of fair value of financial instrument. But in cases where there is strong market based evidence of the fair value of the instrument and fair value of the instrument is arrived by comparison with other observable current market transaction or based on valuation technique, an immediate gain or loss may arise on recognition of instrument.

Transaction Costs

In the case of a financial asset or a financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability are added or deducted from fair value on initial recognition. Transaction Costs are defined as incremental costs that are directly attributable to the acquisition, issue or disposal of a financial assets or liabilities. They include fees, commissions paid to advisers, agents etc., levies, taxes and duties. However, Transaction costs do not include debt premium or discount, financing costs, or allocations of internal administrative or holding costs.

Transaction costs that would arise on the sale of an asset are not recognised in measuring its fair value. To illustrate this: Company A acquires an equity security at a price of 100 and pays a purchase commission of 2. If the asset were sold, a sales commission of 3 would be payable. In this case, the initial measurement of the asset is 102; that is, the sum of the purchase price and the purchase commission. The commission payable on sale is not considered for the purposes of determining the initial measurement, nor is it deducted in measuring the fair value. As a result, if the value remained at 100, the purchase commission would be taken to the statement of comprehensive income when the asset was first revalued, but the sales commission would not be recognised until it was sold.

Subsequent Measurement

Subsequent measurement of financial assets would depend on their classification.

1. Financial assets as at Fair Value through Profit or Loss is measured at fair value on subsequent measurement also. Gain or Loss that arise on subsequent measurement are recognised in profit or loss. Gain/ loss that arise between date of last statement of financial position and date of de recognition of asset will be regarded as have arisen in period prior to disposal and would be recognised in profit or loss as they occur. Therefore, there will be no

gain/loss on disposal for such assets. Transaction costs that may be incurred on future disposal are not deducted from fair value and are recognised on disposal only.

2. Available-For-Sale financial assets are also measured at fair value subsequently. Any gain or loss on subsequent measurement at fair value, are recognised directly in equity except

- Interest calculated using effective interest method
- Impairment loss
- Foreign exchange gain or loss

On disposal accumulated amount earlier charged to equity is recognised in profit or loss. Such process is also called recycling. Such recycling has to be done even if an AFS asset is exchanged for another AFS asset.

Dividends on AFS asset are recognised in profit or loss when entities right to receive it is established.

3. Held to maturity and Loans and Receivables assets are subsequently measured at amortised cost using "effective interest method".

Amortised Cost

Amortised cost= Amount at initial recognition-principal repayments+/-cumulative amortisation-reduction for impairment or uncollectability.

Here cumulative amortisation is amortisation of difference between initial amount and maturity amount over the period of instrument using effective interest method.

Amortized cost method is required for financial assets classified as 'loans and receivables' and 'held to maturity' and financial liabilities other than those classified as at fair value through profit or loss. Besides this interest income or expense, calculated on amortised cost method, of interest bearing available for sale asset are recognised in profit or loss.

Effective interest method uses **effective interest rate** for amortisation of interest income or expense over the relevant period. Effective interest rate is rate that exactly discounts estimated

future cash payments or receipts through expected life financial instrument or where appropriate, a shorter period to the net carrying amount of financial asset or liability. Effective interest rate is uniformly applied through out the effective life of instrument and is not recalculated to reflect fair value changes.

Chapter XV

RECOGNITION AND DERECOGNITION OF FINANCIAL INSTRUMENTS

Introduction

In simple words, recognition is inclusion of financial asset or financial liability in the statement of financial position of the company and Derecognition of financial asset or liability implies the removal of previously recognised financial asset or financial liability from the statement of financial position of the company. The general criterion for recognition is that, the financial instruments are recognised when and only when entity becomes a party to the contractual provisions of the instrument. A previously recognised financial asset is derecognized when either the contractual right to the cash flow from the asset expires or the entity transfers the asset such that the transfer qualifies for the Derecognition. On the other hand, a financial liability is derecognized when and only when it is extinguished.

Recognition of financial instruments

General Principles of Initial Recognition

As discussed above an entity should recognize a financial asset or a financial liability on its statement of financial position when it becomes a party to the contractual provisions of the instrument. Owing to this principle, an entity recognizes all of its contractual rights and obligations under a derivative as assets and liabilities respectively, except for derivatives that prevent a transfer of financial assets from achieving derecognition as recognizing both derivative and the asset that fails derecognition would result in accounting for the same rights and obligation twice.

Illustrative Examples

Certain examples of arrangements that should be recognised as financial assets and liabilities are as follows:

- Unconditional receivables and payables are recognised as an asset or liability when the entity becomes party to the contract and thereby has legal right or obligation to receive or pay cash.
- A derivative except those to buy non financial items is recognised as an asset or a liability on the commitment date and not on date on which settlement takes place. In case, if the fair value of rights and obligation created by derivative is equal at time of inception, the fair value of derivative is taken to be zero.
- Issued debt is recognised as a liability when the entity that issues it becomes a party to the contractual terms of the debt and therefore has a legal obligation to pay cash to the debt holder.

In case of firm commitments, assets to be acquired and liabilities to be incurred are generally not recognised until at least one party has performed under the arrangement.

Planned future transactions are not recognised as assets or liabilities no matter how likely the contract is.

Special Situations

In case of linked transactions, two financial instruments relating to same risk, between the same counterparty should be recognised and measured as a single instrument if they are entered into at the same time and in contemplation of each other. However, sometimes there can be economic need or substantive business purpose, which requires the structuring of transactions separately, even if they are in substance single arrangement.

An entity may become a party to the contractual provisions of a financial instrument because of a substantive modification of an instrument that it already recognises in the statement of financial position.

Derecognition of Financial Asset

Derecognition in the context of financial assets is the removal of the financial asset from the statement of financial position through sale, payment, renegotiation, or default of the counter-party. Assessing whether or not a financial asset should be derecognised is normally straight forward. For example, when a manufacturer receives a payment from a customer for the delivery of goods the manufacturer no longer has any rights to further cash flows from the receivable. It should derecognise, i.e. remove receivables from the statement of financial position. However, the derecognition test is not always very simple and requires a lot of judgement. The decision weather a transfer qualifies for derecognition is made by applying dual tests for risk and reward and for control.

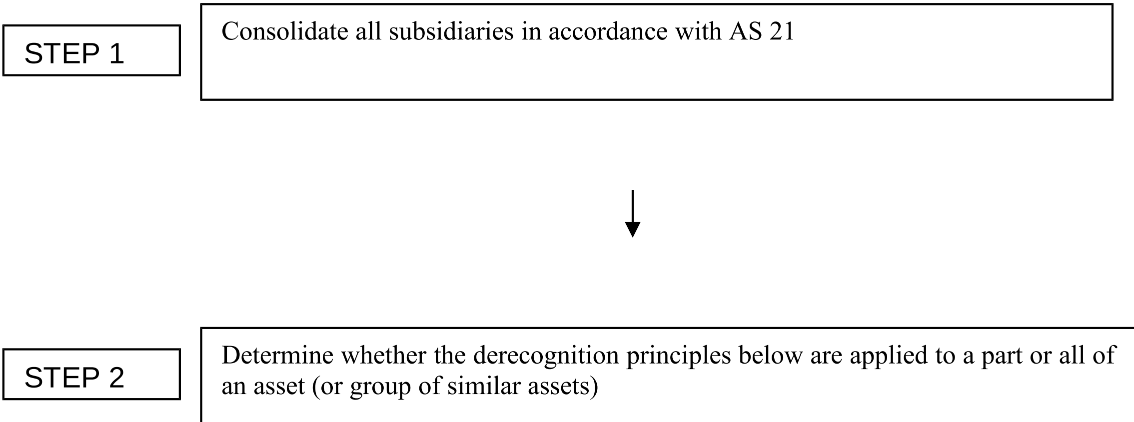
Dual Tests for Derecognition of Financial Assets

Risk and Reward Test: The risks and rewards tests seek to establish whether, having transferred a financial asset, the entity continues to be exposed to the risks of ownership of that asset or it continues to enjoy the benefit that it generates in future.

Control Tests: The control tests are designed with a view to understand which entity, transferor or the transferee, controls the asset. In other words, which entity can direct how benefits of those assets are realized.

Derecognition Decision Tree

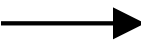
IAS 39 (AS 30) provides a flow chart representing the steps or hierarch of application of various derecognition tests. This chart has been reproduced below:



STEP 3

Have the rights to the cash flows from the asset expired?

Yes



Derecognise the asset

No

STEP 4

Has the entity transferred its rights to receive the cash flows from the asset?

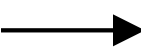
No

STEP 5

Has the entity assumed an obligation to pay the cash flows from the asset that meets the condition ?

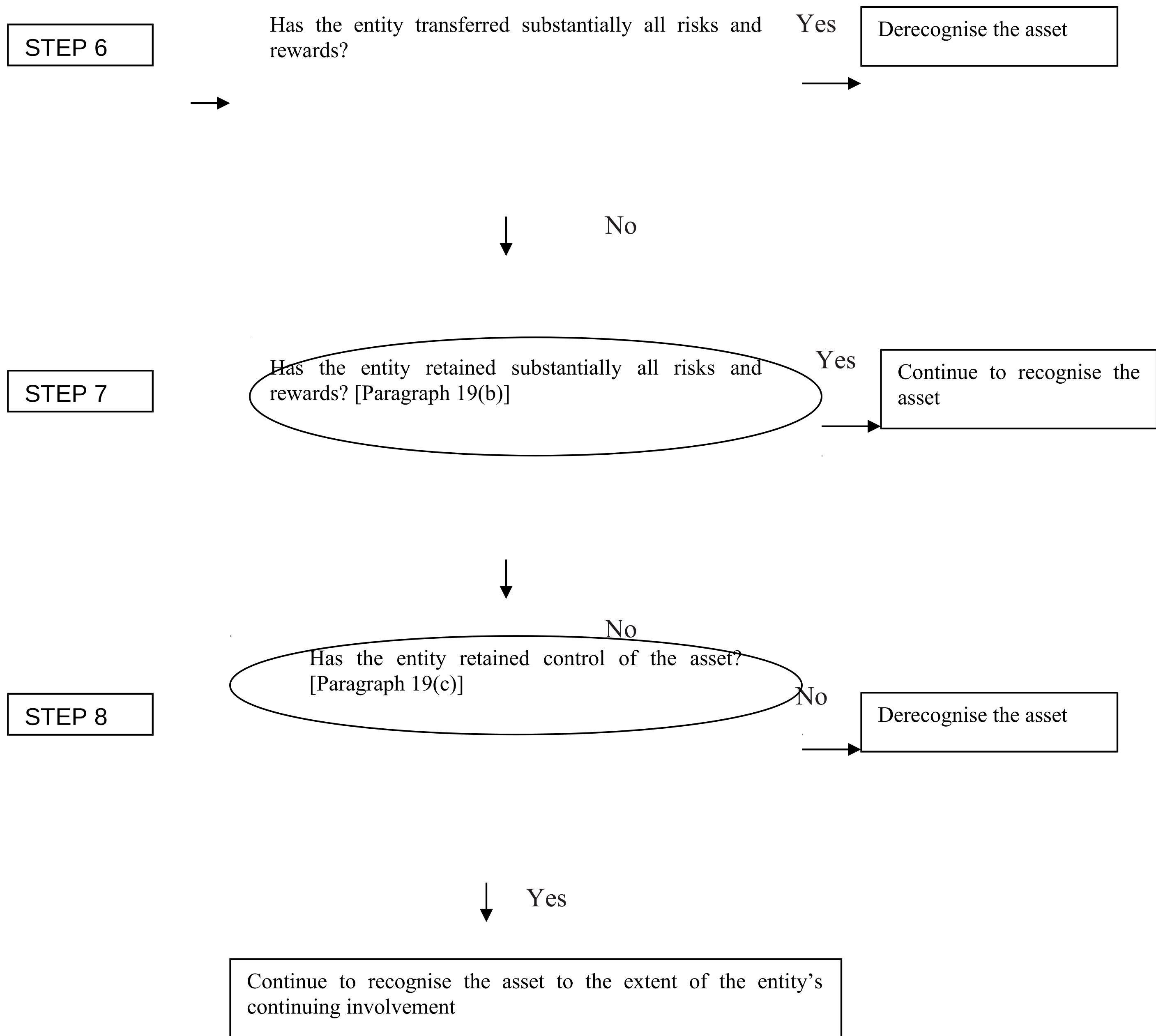
Yes

No



Continue to recognise the asset

Yes



Step 1 - Consolidation of all subsidiaries

This step is to define whether the derecognition principles are to be applied at company level only or consolidated level. Many derecognition structures use entities (e.g. trusts, partnerships, etc.) that have been specifically set up for the acquisition of the transferred assets. The transfer of

assets to such an entity might qualify as a legal sale. However, if the relationship between the transferor and the transferee suggests that the transferor controls the transferee the transferor needs to consolidate the transferee. The derecognition principles therefore have to be applied at a consolidated level. An entity first consolidates all subsidiaries and special purpose entities in accordance with IAS 27 and SIC-12 and then applies the derecognition principles to the resulting group. It ensures that the derecognition decision is consistent regardless of whether the transfer of the asset is directly for company or through a consolidated entity.

Step 2 - Identification of part that shall be derecognized

The next step is to identify the assets (or parts of assets) which should be tested for derecognition. The tests may be applied to any of the following:

- an entire financial asset (for example, an unconditional sale of a financial asset)
- a group of financial assets
- a part of financial assets; or
- a part of group of financial assets

Derecognition principles can be applied to a part of a financial asset or to a part of a group of similar financial assets, if it is one of the following:

- a fully proportionate share of the cash flows from an asset (for example, a sale of 10 percent of all principal and interest cash flows),
- specifically identified cash flows from an asset (for example, a sale of an interest-only strip of a loan), or
- a fully proportionate share of specifically identified cash flows from an asset (for example, a sale of 10% of an interest-only strip of a loan).

In all other cases, the derecognition tests are to be applied to a financial asset or group of similar financial assets in its entirety.

A case study:

An entity A the holder of a debt instrument of fair value of Rs. 100 crores, agrees to

i) transfer right to the first Rs. 70 crores of cash flows that are derived from the instrument to entity B.

ii) transfer 70% of the cash flow that are derived from the instrument to entity B.

Can the derecognition test be applied to the part of the financial asset in the above situations?

Solution:

i) in first case the entity A cannot apply the derecognition test to the part of the financial asset as the entity A has neither transferred specifically identifiable cash flows, nor a fully proportionate share of all or part of cash flows. In this case if there is a loss of any amount till Rs 30 crores it is bone by the entity A alone.

ii) in second situation the entity A can apply the derecognition test to the part of the financial asset as the entity A has transferred a fully proportionate share of the cash flows from the financial asset. In this case if there is a loss it will also be borne by entity B.

Step 3 - Expiry of contractual rights to receive cash flows from asset

A financial asset should be derecognized, if the contractual rights to the cash flows from the financial asset (or part of the asset) have expired or are forfeited. For example, when a debtor discharges its obligation by paying the holder of the financial asset or when the debtor's obligations to the holder have ceased, the contractual rights to the cash flow are said to have expired. The asset has no value and should be derecognized if there are no longer cash flows accruing to the entity. Other instance of derecognition would be when a financial asset reaches its maturity or a purchase option reaches its maturity unexercised, and there are clearly no further cash flows arising from the asset. Sometimes an entity may have a right to receive certain or all cash flows from a financial asset over a specified period of time that may be shorter than contractual maturity of that financial asset.

Step 4 - The Transfer of contractual rights to receive cash flows from asset

Some transactions clearly involve the transfer of rights to another party. An entity that has sold a financial asset has transferred its rights to receive the cash flows from the asset. An example of this is a legal sale of a bond. The transfer then has to be assessed to determine whether it meets the derecognition criteria. Sometimes an entity may transfer the contractual rights to cash flows of a financial asset or retain the contractual right to cash flows but assume a contractual obligation to pass on those cash flows to another entity, in what is referred to "pass through arrangements". The entity has to perform the tests for derecognition in Step 6 if the following requirements for pass through are met:

The entity has no obligation to pay cash flows to the transferee unless it collects equivalent cash flows from the transferred asset. In other words, entity does to benefit or suffer from the results of the financial asset.

- The entity is prohibited from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pass through cash flows. In other words, entity has no control over the future economic benefits from the transferred asset, and
- The entity is obliged to remit any cash flows without material delay and subject to certain investment restrictions. Here it should be noted that, without material delay does not imply instantaneously nor does it imply an extended length of time. The contractual arrangements will need to be considered in full in order to make assessment as to whether the timeframe between collection of cash flows from the assets and the point on which it passed to the recipient is material in context to the contractual arrangement. The investment, if any, done by the transferor should not be anything other than in cash or cash equivalent and interest if any, earned on it must be transferred to the eventual recipient.

Step 5- Assumption of obligation to remit cash flows from asset:

The financial assets remain on the statement of financial position if any of the above conditions are not met.

Step 6- The derecognition tests 1: Transfer of risk and reward of the asset

An entity derecognises an asset if it transfers substantially all the risks and rewards of ownership of the asset (for example, in an unconditional sale of a financial asset)

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

- An unconditional sale of a financial asset;
- A sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase; and
- A sale of a financial asset together with a put or call option that is deeply out of the money (an option so far out of the money it is highly unlikely to go into the money before expiry).

It will be clear in most cases whether the entity has transferred substantially all the risks and rewards without the need for a calculation. Where it will not be clear, the transfer of risks and rewards is evaluated on the entity's exposure, before and after the transfer, to the variability in amount and timing of the cash flows that are likely to occur. If the exposure to the present value of the future net cash flow from the asset does not change significantly because of transfer, then it means that entity has not transferred substantially all the risk and rewards of ownership. To do the comparison expected cash flow model should be used. Appropriate current market interest rate should be used as discount rate and all reasonably possible outcomes according to respective weight age should be considered to find present value of future cash flow.

Step 7- The derecognition tests 1: Retention of risk and reward of the asset

The entity continues to recognise the asset if it retains substantially all the risks and rewards of ownership of the asset. Derecognition requires the transferor's exposure to the risks and rewards of ownership to change substantially in respect to variability in the amount and timing of cash flows from the transferred asset, before and after the transfer. Examples of when an entity has retained substantially all the risks and rewards of ownership are:

A sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return: As the transferor is required to reacquire the asset for the fixed price, the transferor is exposed to the market risk of the asset even after the transfer.

A securities lending agreement: Here also transferor is exposed to the market risk of the asset even after the transfer.

A sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity: Under the terms of the total return swap, the transferor usually pays an amount equal to a borrowing rate to the transferee over time and transferee reimburse transferor for performance of the asset. The transferor continues to be exposed to the rise and fall in the cash flows even after the transfer and hence, retains substantially all of the risks and rewards of ownership of the asset

Sales of a financial asset together with a deep in-the-money put or call option (that is an option that is so far in the money that it is highly unlikely to go out of the money before expiry). When an entity sells an asset but retains an option to repurchase it at a price that is substantially lower than its fair value, this option is very likely exercised. Similarly, when entity sells an asset and gives the transferor the right to put it back to the entity at a very advantageous price, so that the option is likely to be exercised by the transferor, the entity retains substantially all the risk and reward of ownership.

A sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses those are likely to occur and thereby retains substantially all of the risk of ownership.

Step 8- The derecognition tests 2: the Control Test

It may happen that entity neither transfers nor retains substantially all the risks and rewards of the ownership of the asset. In such a case, it has to make an assessment as to whether or not it has retained control of the asset. If the entity does not retain the control of the financial asset, the entity shall derecognize the financial asset and create separately as assets or liabilities any right and obligation created or retained in the transfer. However if entity retains the control of the financial asset, the entity shall continue to recognize the financial asset to the extent of its

continuing interest in the financial asset. Control is based on the transferee's practical ability to sell the asset. The transferee has this ability if it can sell the asset in its entirety unilaterally to an unrelated third party without needing to impose further restrictions on the transfer. The key issue is what the transferee is able to do and not what contractual rights the transferee has. A transferee has the practical ability to sell the asset if it is traded in an active market because the transferee could purchase the asset in the market if it needs to return the asset to the transferor. The transferor has lost control if an asset subject to a call option can be readily obtained by the transferee in the market although he has retained some of the risks and rewards in relation to the asset. However, the contractual right to dispose of an asset is of little practical use if there is no market for the asset. The asset is derecognized if the entity has lost control. The entity continues to recognize the asset to the extent of its continuing involvement if it has retained control.

Transfers that qualify for derecognition

Where an entity concludes that derecognition of a financial asset is appropriate i.e either the rights to cash flow from asset has expired, or entity has transferred substantially all risks and rewards, or entity no longer retains the control of the asset, the asset is removed from the statement of financial position. Any new financial assets obtained or financial liabilities assumed are recognised at fair value. An entity that derecognises a financial asset in its entirety includes the difference between the carrying amount and the consideration received (including any cumulative gain or loss that had been recognised directly in equity) in the statement of comprehensive income. An entity that derecognises only a part of a financial asset allocates the previous carrying amount of the financial asset between the part that continues to be recognised and the part that is derecognised based on relative fair values at the date of transfer. The difference between the carrying amount allocated to the part derecognised (including any cumulative gain or loss relating to the part derecognised that had previously been recognised in equity) and the consideration received is included in the gain or loss on derecognition.

Accounting for servicing obligation undertaken

Often the transferor of the asset undertakes to service the transferred asset for a fee. An entity shall recognise either a servicing asset or a servicing liability for a servicing contract at fair value if it transfers a financial asset that qualifies for derecognition. A liability for the servicing

obligation shall be recognised if the fee to be received is not expected to compensate the entity adequately for performing the servicing. An asset shall be recognised for the servicing right if the fee to be received is expected to be more than adequate compensation for the servicing. When the benefit of servicing exactly compensate the service provider for performing the servicing but provide no additional benefits, the service provider has neither an asset nor a liability and fair value of servicing contract is taken to be nil.

Transfers that does not qualify for derecognition

If a financial asset does not qualify for derecognition in its entirety, i.e. when the transferor retains substantially all the risks and rewards of ownership or retains control over the transferred financial asset, the entity continues to recognise the asset in its entirety and recognises a financial liability for consideration received. If the transferee has the right to sell or repledge the collateral the asset is presented separately in the statement of financial position (for example, as a loaned asset, pledged securities, or repurchased receivable). The entity recognises income relating to the transferred assets and any expense incurred on the financial liability in subsequent periods. The asset and liability cannot be offset and similarly, any income from the asset cannot be offset against any expense on the liability.

Continuing involvement in the transferred asset

The entity continues to recognise the asset (to the extent of its continuing exposure) if the entity has neither transferred nor retained substantially all the risks and rewards of ownership and control has not passed to the transferee. Continuing involvement represents the extent to which transferor continues to be exposed to the changes in the value of the transferred asset, a liability must also be recognised in those circumstances. The combined presentation of the asset and liability should result in the recognition of the entity's net exposure to the asset on the statement of financial position either at fair value, if the asset was previously held at fair value, or at amortised cost, if the asset was accounted for on that basis. The treatment of the changes in the liability should be consistent with the treatment of changes in the asset. Consequently, when the transferred asset is classified as available-for-sale, gains and losses on both the asset and the liability are taken to equity. The asset and associated liability cannot be offset. Similarly, any

income from the asset cannot be offset against any expense on the liability nor can any change in fair value of that asset and related liability be offset against each other.

Derecognition of Liability

A financial liability (trading or other) is removed from the statement of financial position when it is extinguished, that is when the obligation is discharged, cancelled or expired. An obligation is said to be discharged when the entity is freed of its obligation either by paying amounts of cash or by delivering other goods or services to the counterparty. For example, an amount payable to the creditor is discharged when the entity pays back the dues. An obligation may expire with the expiry of time as in case of written option which lapses without being exercised by the counter party. However, there still are situations where a liability is considered unlikely to result in an outflow of economic resources. Such liability may be cancelled by the process of law or by negotiation with the counterparty. For example, entity may have distributed gift vouchers to its valued customers without an expiry date. Normally around 10% of such coupons are never redeemed. However, since there is no expiry date the company is obliged to honour the coupons whenever it is presented. Thus, this obligation may carry on indefinitely into future unless jurisdiction allows legal release from that obligation when a specified period of time has passed. This results in cancellation of liability.

Sometimes an entity may pay another person to assume its obligation under a contract in such cases the entity is not discharged from its obligation until a legal release from the obligation is obtained. Even after the legal release is obtained, the entity may concurrently assume a fresh obligation to a third party or the same creditor. In such cases, though the original liability is extinguished a fresh liability is assumed and brought to books.

The difference between the amount paid to extinguish the liability and the carrying amount of the liability is a gain or loss that is included in the statement of comprehensive income. Gains and losses arising from redemption, settlement or early payments are not extraordinary items but are included as a component of finance income or expense.

Chapter XVI

TRADE DATE AND SETTLEMENT DATE ACCOUNTING

Trade Date and Settlement Date Accounting

Regular way purchase and sale of financial assets are recognised either by applying trade date or settlement date accounting. An entity must choose between trade date and settlement date accounting for each category of financial asset. A 'regular way' purchase or sale is a transaction whose contractual terms require delivery of the asset within a timeframe established by the regulation or by market convention. Here, trade date refers to the date of commitment to buy or sell the financial asset and settlement date refers to date of actual delivery of the financial asset.

In trade date accounting, the entity recognises the financial assets to be received and corresponding liability to pay for it at the date of commitment. Similarly, the financial asset is removed from statement of financial position on the trade date. Contrary to this, under settlement date accounting, the asset is recognised on the day when it is received by the entity. Similarly, on disposal it continues to be recognised until it is delivered to the buyer. However, in settlement date accounting, even though the asset itself is not recognised in the statement of financial position between the trade date and settlement date, the entity is required to account for the changes in its fair value as if the assets were recognised at the trade date itself. Therefore, changes in fair value are recorded in profit or loss for assets to be classified as at fair value through profit or loss, in equity for assets classified as available for sale and not recognised for assets to be carried at cost or amortised cost.

An example: On 25/03/07, an entity commits itself to purchase an asset for Rs.1000, which is its Fair Value on that date. Fair Value of asset on 3/4/07 (settlement date) is Rs.1003 and on 31/3/07 is Rs1002

Solution using Trade Date Accounting		

		Type of Asset		
Balances as on		**FVTPL**	**HTM**	**AFS**
25/3/07	Financial Asset	1000	1000	1000
	Financial Liability	(1000)	(1000)	(1000)
31/3/07	Financial Asset	1002	1000	1002
	Financial Liability	(1000)	(1000)	(1000)
	Transferred to equity for fair value adjustment	-	-	(2)
	Recognised in profit or loss	(2)	-	-
2/4/07	Financial Asset	1003	1000	1003
	Financial Liability			
	Transferred to equity for fair value adjustment			(1)
	Recognised in profit or loss	(1)		

Solution using Settlement Date Accounting				
		Type of Asset		
Balances as on		**FVTPL**	**HTM**	**AFS**

25/3/07	Financial Asset	-	-	-
	Financial Liability	-	-	-
31/3/07	Financial Asset	-	-	-
	Financial Liability	-	-	-
	Receivables	2		2
	Transferred to equity for fair value adjustment	-	-	(2)
	Recognised in profit or loss	(2)	-	-
2/4/07	Financial Asset	1003	1000	1003
	Financial Liability	-	-	-
	Receivables	-	-	-
	Transferred to equity for fair value adjustment	-	-	(1)
	Recognised in profit or loss	(1)	-	-

Chapter XVII

IMPAIRMENT OF FINANCIAL ASSET

A financial asset is impaired if its carrying amount is greater than its estimated recoverable amount. An entity should assess at each reporting date for all financial assets except those measured at fair value through profit or loss, whether there is any objective evidence that a financial asset or group of assets may have been impaired. A financial asset or group of financial assets is impaired and impairment losses are incurred if there is objective evidence of impairment because of one or more events that occurred after the initial recognition of the asset. The event or events must also have an impact on the estimated future cash flows of the financial asset or group of financial assets. If any such evidence exists the entity should estimate the recoverable amount of that asset or group of assets and recognise impairment loss if any.

1. **Evidences of Impairment**

Objective evidence that a financial asset or group of assets is impaired or uncollectable includes:

- Significant financial difficulty of the issuer;
- An actual breach of contract, such as a default or delinquency in interest or principal payments;
- Granting by the lender to the borrower, for economic or legal reasons relating to the borrower's financial difficulty, of a concession that the lender would not otherwise consider;
- A high probability of bankruptcy or other financial reorganisation of the issuer;
- Recognition of an impairment loss on that asset in a prior financial reporting period;
- The disappearance of an active market for that financial asset due to financial difficulties; or
- A historical pattern of collections of accounts receivable that indicates that the entire face amount of a portfolio of accounts receivable will not be collected.

And, in addition, for equity investments:

- Significant changes in technological, market, economic or legal environment

- Significant prolonged decline in fair value

2. Impairment of Assets carried at Amortised Cost.

All assets in the categories of Loans and Receivables (except for short-term receivables and payables with no specified interest rate which are carried at invoice value) and Held to Maturity assets are carried at amortised cost. The assessment, measurement and reversal of impairment for such assets are done in following manner:

Assessment

The existence of objective evidence of impairment is assessed:

- Individually for individually significant financial assets
- Individually or collectively for financial assets that are not individually significant.

If no objective evidence of impairment at individual level - asset is grouped with assets of similar credit risk characteristics for collective assessment.

Measurement

Impairment loss is the difference between the carrying amount and present value of expected future cash flows discounted at original effective rate. Collateral must be taken into account when determining an asset's expected future cash flows. Where the terms of a loan are renegotiated due to financial difficulty of the borrower/issuer, whether a financial asset is impaired depends on the terms of the restructured loan. The amount of an impairment loss must be measured as the difference between the asset’s carrying amount and the present value of expected future cash flows under the restructured terms, discounted at the assets’ original effective interest rate. If the present value of the future principal and interest payments of the restructured loan is equal to, or greater than, the carrying amount, no impairment loss is recognised. Here it should be noted that, the timing of expected future cash flows, including the proceeds of any collateral, is crucial both in determining if impairment exists and measuring any impairment. Thus impairment has occurred, even if an entity expects to collect all interest and

principal payments due, where the timing of payments is expected to be delayed without full compensation for the delay calculated at the original effective interest rate for the asset

Recognition

- The carrying amount of the asset must be reduced to its estimated recoverable amount and the loss is included in profit or loss for the period
- Reversal of impairment through statement of comprehensive income is permissible only if change causing the reversal can be related objectively to an event occurring after write down

3. **Impairment of Assets carried at Cost**

Unquoted equity instruments and derivatives that results in delivery of unquoted equity instruments whose fair value cannot be reliably measured are shown at cost. For such instruments, impairment loss is the difference between the carrying amount and the present value of estimated future cash flow discounted at current rate of return for similar financial asset. Impairment losses once recognised cannot be reversed for such assets.

4. Impairment of Assets carried at Fair Value

All financial assets in category of assets as at fair value through profit or loss and available for sale are measured and carried at fair value. For assets as at fair value through profit or loss, impairment loss is recognised automatically as the fair value changes are carried in statement of comprehensive income. In case of available for sale assets, declines in value are recognised in equity as part of the normal measurement process. When there is objective evidence of impairment of such assets, the cumulative net loss that had been recognised directly in equity is removed from equity and recognised in profit or loss for the period.

Measurement

The amount is measured as the difference between acquisition cost (net of any principal repayment and amortisation) and current fair value less any impairment loss on that financial asset recognised earlier. The current fair value can be the quoted market price or determined fair value of the equity instrument. For debt instrument, it shall be the recoverable amount.

Recoverable amount of a debt instrument is the present value of expected future cash flows discounted at the current market rate of interest for a similar financial asset.

Reversal:

- for Available For Sale equity instruments impairment cannot be reversed
- For Available For Sale debt instruments impairment is reversed when the recoverable amount increases and the increase can be objectively related to an event occurring after the loss was recognised.

5. Distinction between impairment and non-performing loan

A non-performing loan is one that does not perform according to its original contractual terms. This is objective evidence of impairment, but there may not be an impairment loss to be recognised in income. Where the net present value of the expected cash flows on the impaired loan, discounted at the original effective interest rate, exceeds its carrying amount, the loan is considered to be non-performing, but not impaired. For example, if interest on a loan is 90 days overdue, it may be non-performing but it may be adequately secured and hence not impaired.

Chapter XVIII

HEDGE ACCOUNTING

1. Introduction

The word 'Hedge' literally means 'evade'. Most entities would like to evade risks. However, business cannot be disassociated with risk. Most entities therefore hedge risks, that is take action either to mitigate or offset the risks that arise from their activities. To offset financial risks like interest rate risks, currency fluctuation risk, equity/ commodity price risks, etc entities enter into hedging transaction so that they can reduce the variability in cash flow or the fair value of financial instrument that may arise from these risks. Hedge risks may be evident risks from item that are recognized in statement of financial position or they may be for future transactions that are yet to occur.

Hedge Accounting is method of accounting that may be applied voluntarily by an entity to reflect the results of hedging activity. Normally hedging involves use of derivatives, which are otherwise classified as at fair value through profit or loss and any gain or loss arising due to change in fair value are recognized in statement of comprehensive income. However, these derivatives may be used to hedge recognized assets or liabilities that are measured at cost or amortized cost or even though they are measured at fair value, the gain or loss on it may be recognized in equity rather than in profit or loss, as in the case of available for sale financial assets. This creates mismatch in the timing of gain or loss recognition in profit or loss. Hedge accounting seeks to correct this mismatch by changing the timing of recognition of gain or loss in either the hedged item or hedging instrument. The use of hedge accounting is not mandatory. There are onerous requirements to achieve hedge accounting. Management should always consider cost and benefit when deciding whether to use it or not. Sometimes the effect on statement of comprehensive income of applying hedge accounting may be substantially same as where hedge accounting is not applied for instance in case of hedge item being those classified as at fair value through profit or loss. Moreover, if an accounting mismatch exists, which results in profit or loss volatility, the entity may apply fair value option. However, though this option is simple it has disadvantage that it cannot be discontinued at any time like hedge accounting and if fair value option is used entire change in fair value of designated item must be recognized in profit or loss whereas hedge accounting allows the specific hedged risk to be designated.

2. Hedged Items

A hedged item is a recognized asset, liability, unrecognized firm commitment, highly probable forecast transaction or net investment in foreign operation that exposes the entity to risk of changes in fair value or future cash flow and is designated as being hedged. A hedged item may be:

- a single asset, liability, firm commitment, highly probable transaction or net investment in foreign operations or group of above having similar risk characteristics
- in a portfolio hedge of interest rate risk only a portion of the portfolio of financial assets or liabilities that share the risk being hedged.

Examples of hedged items:

i. Recognized assets and liabilities: equity investment

ii. Firm commitments: commitment to buy machinery at a specified date at a fixed Euro currency amount

iii. Highly probable future transactions: forecasted USD foreign currency sales of airline seats in the next month.

Designation of Financial Items:

If the hedged item is a financial asset or liability, it may be a hedged item with respect to the risks **associated with only a portion of its cash flows or fair value**, if effectiveness can be measured. It is also possible to hedge a proportion (i.e. percentage) of the cash flow or fair value of financial instrument. For example

An entity may have 10 thousand USD in variable rate debt, of which only USD 6 thousand of the debt is hedged.

- Part of the life of a bond may be hedged like the first 5 years of 10-year fixed rate debt issued by the entity or
- Only the risk-free interest rate on a loan by a bank to a customer can be hedged, or
- 75% of an available-for-sale equity security can be hedged, or
- 50% of the foreign exchange risk on a firm commitment to buy a machine in three months time for a fixed number of Euro.

Designation of Non-Financial Items:

Non Financial Items can only be hedged for foreign currency risks or in its entirety for all risks. This is so because generally it is difficult to isolate and directly measure the changes in cash flow or fair value associate with specific risk for non-financial asset other than foreign currency risk.

What cannot be hedged?

An unrecognized asset other than firm commitment cannot be hedged. Therefore, a contingent asset can never be a hedged item. Generally, transaction with external parties can be

designated as hedged. Therefore, transactions between entities of a group cannot be designed as hedged in consolidated financial statement. However, currency risk of forecast intragroup transaction and the foreign currency exposure of an intragroup monetary item that does not fully eliminate on consolidation can be hedged. The currency risk of forecast transaction can be a hedged item only if the transaction is denominated in currency other than functional currency of the entity and foreign currency risk affects the consolidated profit or loss. On designation of such transaction as hedged item, any gain or loss recognized in equity shall be reclassified into profit or loss in same periods in which foreign currency risk of external hedged transaction affects consolidated profit or loss. Foreign currency exposures of intragroup monetary items are not fully eliminated on consolidation when it is transacted between two entities within a group having different functional currencies.

Held-to-maturity financial assets cannot be a hedged item with respect to interest rate risk or prepayment risk. However, a HTM asset can be a hedged item in respect to foreign currency risk.

Overall business risk cannot be hedged because it cannot be specifically identified and measured.

Derivatives cannot be designated as a hedged item. However, a written option taken to offset purchase option can be a designated hedged item.

3. Hedging Instrument:

A Hedging Instrument is a designated derivative, or for a hedge of the risk of foreign currency exchange rates 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 flow of a designated hedged item.

Written Vs. Purchased Option

A derivative carried at fair value, unless a written option, can always de designated as a hedging instrument if it meets the effectiveness requirements and documents supporting hedging relationship are in place. A purchased option has potential gains equal to or more than the losses in hedged item. Therefore, it can qualify as hedged item. Whereas, loss on option that entity writes could be more than the potential gain in value of related hedged item. Therefore, a written

option does not qualify as hedging instrument unless it is designated as an offset to a purchased option.

Derivative linked to unquoted equity

Derivative that is linked to and must be settled by delivery of an unquoted equity instrument whose value cannot be reliably measured is measured at cost, and cannot be considered an effective hedging instrument. This is so because the hedge effectiveness cannot be determined when fair value of hedging instrument is not certain.

Designation of non derivative financial instrument

A non-derivative financial instrument may only be designated as a hedging instrument when hedging foreign currency risk. Example: a commitment for purchase of equipments at a future date from a company with different functional currency can be designated for its foreign currency risks. Similarly a held to maturity financial assets can be designated as hedging instrument only in hedge of foreign currency risk.

A case study:

Management of entity A wants to designate a bond issued by the entity as a hedge of an available-for-sale investment in a bond with same interest rate, which is measured at fair value. Can management use the bond issued by it which is a non-derivative instrument, as a hedging instrument to hedge the risk from the investment?

Solution:

No. The entity A cannot apply hedge accounting for interest-rate risk for the bonds as in above case since non derivate instrument can be used to hedge only foreign currency risks. Therefore, the issued bond will be measured at amortised cost, whereas the investment bond will be carried at fair value.

Instruments involving group companies

For hedge accounting, instrument involving any group company, segment or individual company that is being reported on, cannot be designated as hedging instrument in consolidated statements. However, such instrument may apply for hedge accounting in the individual or separate financial statements of individual entities within the group or in segment reporting if they are external to individual entity or segment that is being reported.

Splitting of derivative instrument

Normally there is a single fair value for a hedging instrument and factors causing variation in fair value of the instrument are co-dependent. Therefore, generally a hedging instrument is designated in hedging relationship in its entirety. However, splitting of instrument is permissible in following cases:

- Separation of intrinsic value and time value of an option is permissible for designation of only intrinsic element as hedging instrument. This exception is provided since the intrinsic value of option can generally be measured separately.

- Similarly, the interest and spot element of a forward contract may be separated, with only spot element designated as the hedging instrument.

Since splitting of a derivative for designation as hedging relationship is prohibited, a hedging relationship cannot be designated for only a portion of time that hedging instrument is outstanding.

Designation of portions or proportions of hedging instrument

A proportion of entire hedging instrument may be designated as the hedging instrument in a hedging relationship. For example, if a company has firm commitment for purchase of machinery for 10 million dollar and has deposit of 50 million dollar in foreign bank account which it wishes to use to meet this commitment, it can designate 20% of its deposit as hedging instrument.

Single instruments for hedging multiple risks

Though, a hedging instrument is often designated as hedging single risk, it can be used to designated more than one risk provided following conditions are met:

The risk being hedged is clearly identified

The effectiveness of hedge can be effectively demonstrated, and

It is possible to ensure that there is specific designation of the hedging instrument and different risk positions.

In such cases, if a different form of accounting is used; separate disclosure for each risk will be required. Moreover, if any of the above criteria's were not met for any of the risk being hedged no hedge accounting treatment would be allowed for the period.

A case study:

An entity X whose functional currency is the rupee has a highly probable forecast sale in US dollars and highly probable forecast purchases in euro. Entity X enters into an external foreign currency forward contract to sell US dollars and buy Euro. Entity X intends to designate the foreign currency forward contract as a hedge of both the exchange rate fluctuation risks pertaining to dollar / rupees foreign currency risk associated with the forecast sales and the euro/ rupees foreign currency risk associated with the forecast purchases.

The Euro/US dollar forward contract is theoretically divided into two different derivatives. The rupees is imputed as the base currency for the two derivatives creating an artificial US dollar/rupees foreign currency forward and an artificial rupees/Japanese yen foreign currency forward. The hedged item is designated as to mitigate two risks one the foreign currency cash flow risk associated with the forecast US dollar sales and other the foreign currency cash flow risk associated with the forecast Euro purchases. Is entity X which has two foreign currency risk exposures, justified in designating a single derivative as a hedge of a combination of these exposures?

Solution

Yes. The Entity X may designate the Euro/US dollar forward as a cash flow hedge of both the foreign currency cash flow risks associated with the forecast sales in US dollars and the forecasted purchases in Euro provided all of the other conditions for hedge accounting are met. It is essential that each hedging relationship must be tested for effectiveness separately and if one

of the two hedging relationships becomes ineffective (either because an effectiveness test is failed or because one of the forecast transactions is no longer highly probable to occur), hedge accounting will be discontinued prospectively for both hedge relationships.

Multiple derivatives designated as hedging instrument

Two or more offsetting derivatives or proportion thereof can be viewed in combination and can be jointly designated as hedging instrument provided none of them is written or net written option. Moreover, in case of hedging of foreign currency fluctuation risk, two or more non-derivative or proportion thereof can be jointly designated as hedging instrument.

4. Types of Hedging Relationships

Three types of hedging relationships are recognised based on the nature of the risk exposed in hedging relationship. These are

1. Fair Value Hedge
2. Cash Flow Hedge, and
3. Hedge of net investment in foreign operations

4.1 Fair Value Hedge

A fair value hedge is hedge of exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion thereof that is attributable to a particular risk and can affect profit or loss. Some examples of fair value exposures are:

- Investments in fixed rate bonds and liabilities like fixed rate loans
- Investment in equity
- Firm commitment to buy or sell non-financial items at a fixed price

Some example of fair value hedges are:

- Fixed-rate debt issued by the entity and hedged using a "receive fixed/pay floating" interest rate swap. This protects the fair value of the debt against changes in interest rates.
- Available-for-sale equity security hedged with a purchased put option. This protects against a decline in fair value of the security below a pre-determined level (the strike price of the option).
- Oil held in inventory and hedged using a six-month oil forward. This protects the fair value of the inventory against changes in the oil price during the six-month period.

Accounting for fair value hedges

The gain or loss from re-measuring the derivative hedging instrument at fair value or the foreign currency component of its carrying amount of non derivative hedging instrument is recognised immediately in profit or loss

For fair value hedges, the carrying amount of the hedged item is adjusted through profit or loss for the gain or loss on the hedged item attributable to the hedged risk. This applies even if the hedged item is otherwise carried at cost or is an available for sale asset. In case of fair value hedge of interest risks exposure of a portion of a portfolio of financial assets or financial liabilities the gain or loss in carrying amount of hedged item can be presented in a single line item within assets or liabilities for those time periods for which the hedged item is an asset or liability. This amount can be removed from statement of financial position on Derecognition of related asset or liability.

As a result of above entries the effect of changes in fair value of hedged item and hedging instrument is squared off to the extent risks are hedged. The net effect in profit or loss is nil.

A case study:

On 1st April 2004, an Indian entity A, whose functional currency is the Rupee, borrows USD 50,000 at a fixed-interest rate of 10% with a maturity of one year. Interest is payable semi-annually on 30th September and 31st March. Entity A immediately converts the USD 50,000 to Rupee at the spot rate. Simultaneously, Entity A enters into the following contracts:

a) a call option A to buy USD 2,500 that expires on 30th September at a strike price of Rs 40 and Premium of Rs. 1,000; and

b) a call option B to buy USD 52,500 that expires on 31st March, 2005 at a strike price of Rs 40 and a Premium of RS 10,000

The following USD/Rs exchange rates are relevant:

Date	**Spot rates**	**31 December 20X3forward rates**
1st April 2004	USD1.00 = Rs. 40	USD1.00 = Rs. 40
30th September 2004	USD1.00 = Rs 41	USD1.00 = RS 42
31 March 2005	USD1.00 = Rs.43	

The fair value of the 2nd call option for 31st March 2005 option as at 30th September 2004 is Rs. 50,000.

Management designates and documents the intrinsic value of the options as a hedge of the exposure to an increase in the fair value of the borrowing attributable to a weakening of the Rupees against the US dollar.

Solution

If we assume that all the conditions for hedge accounting are met the entity will pass the following entries in its book (in RS.)

On 1st April 2004	DR	CR
1. Cash (USD 50,000 x Rs. 40)	20,00,000	

To Loan A/c 20,00,000

(Being foreign currency borrowing recognised)

2. Call option A 1,000

To Cash 1,000

(being premium pd on purchase of call option A)

3. Call option B 10,000

To Cash 10,000

(being premium pd on purchase of call option B)

Entries on 30th September 2004

4. Interest expense (USD 2,500 x Rs 41) 1,02,500

`To Cash 1,02,500

(being the semi-annual interest paid at the current spot rate)

5. Cash (USD 2,500 x Rs[41-40]) 2,500

To Call option A 1,000

To Gain on option A 1,500

(Being the gain on the exercise of the call option A)

6. Call options B(Rs. 50,000- Rs. 10,000) 40,000

To Gain on options 40,000

(Being the change in the fair value of the call option B)

7. Exchange loss (USD 50,000 x Rs[41-40]) 50,000

To Loan a/c 50,000

(Being exchange loss on the foreign currency debt recognised)

31st March 2005

8. Interest expense (USD 2,500 x Rs. 43) 1,07,500

To Cash 1,07,500

(Being the semi-annual interest paid at the current spot rate)

9. Cash (USD 52,500 x Rs.[43-40]) 1,57,500

To Call option B 50,000

To Gain on options B 1,07,500

(being the gain on the exercise of the call option B)

10. Exchange loss (USD 50,000 x Rs[43-41]) 1,00,000

To Loan a/c 1,00,000

(being exchange loss on the foreign currency debt recognised)

11. Loan a/c (USD 50,000 x Rs.43) 21,50,000

To Cash 21,50,000

(being loan in US dollar paid back)

Accounting for Fair Value hedges of unrecognized firm commitment

A firm commitment is a binding agreement for exchange of a specified quantity of resources at a specified price on future date. For example, a company X signs a legally binding purchase agreement to take delivery of 100 tons of rice on 31st December, 2007 for Rs. 20 per kg. Normally, firm commitments are recognised in books only on fulfilment of the commitment. Hedges of firm commitments are generally fair value hedge except for the foreign exchange risk that can be accounted either as fair value hedge or cash flow hedge.

When risks relating to changes in fair value of an unrecognized firm commitment are designated in a hedging relationship, the cumulative changes in fair value of hedged item i.e. the firm commitment is recognised as asset or liability with corresponding gain or loss recognised I the profit or loss. The changes in the fair value of the hedging instrument also being recognised in profit or loss as in other cases.

On fulfilment of the firm commitment, the resulting initial carrying amount is adjusted to include the cumulative changes in fair value of the firm commitment attributable to hedged risk that is earlier recognised in statement of financial position

Discontinuing fair value hedge accounting

The fair value hedge accounting should be discontinued prospectively if:

The hedging instrument expires or is sold, terminated or exercised. Here it is to be noted that, the rollover or replacement of hedging instrument into another hedging instrument, if part of documented hedging strategy from inception will not be regarded as termination or expiration.

If hedging criteria as discussed below are no longer met, or

The hedging relationship is de-designated by the entity.

4.2. Cash Flow Hedge

A cash flow hedge is hedging the exposure to changes in the cash flows attributable to a particular risk associated with a recognised asset, liability, or highly probable forecasted transaction that could affect reported profit or loss. It aims to provide protection from the variability of cash flows arising from market price movements. Certain assets and liabilities that have exposure to cash flow variability are:

- Variable rate loan
- Variable rate investment in bonds
- Highly probable purchase or sale

Some examples of cash flow hedges are:

- Floating-rate debt issued by the entity and hedged using a "receive floating/pay fixed" interest rate swap. This protects the future interest cash flows to be paid on the debt against changes in interest rates.

- Forecasted USD foreign currency sales of airline seats in December hedged by a USD/euro forward contract. This protects the euro cash flows to be received from the sales against changes in exchange rates.

- A firm commitment to buy a machine in three months' time for a fixed USD foreign currency amount hedged by a USD/Rs. forward contract. This protects the future Rupees cash flows to be paid against changes in exchange rate

Accounting for cash flow hedges

A cash flow hedge is accounted as follows:

- 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 like Hedging Reserve Account

- The ineffective portion of the hedging instrument should be recognised in the statement of profit or loss

- In other words, the appropriate equity account associated with the hedged item is adjusted to the lesser of the following:

- The cumulative gain or loss on the hedging instrument from inception of the hedge

- The cumulative change in fair value of the expected future cash flow on the hedged item from inception of the hedge

- Remaining gain or loss on the hedging instrument that is designated in hedging relationship is recognised in the profit or loss. The undesignated portion, if any, of the

hedging instrument is recognised in accordance with the principles set for normal financial assets and liabilities according to the category in which they fall.

Hedging of Forecast Transaction

A forecast transaction is uncommitted but anticipated future transaction. For example, Company Y forecasts the purchase of 100 million tons of sugarcane to be used in manufacturing process of sugar in first quarter of year 2008. In contrary to firm commitments, they are always cash flow hedged. Cash flow hedge accounting can be applied to forecast transaction only if they are highly probable. Though what can be regarded as highly probable is not defined in accounting standards, the probability of occurrence should be significantly more than 50%. Moreover, if an entity has incidences of wrong forecasting, it will question the entities rights to use hedge accounting for similar transaction in future. Here it should be noted that, if the timing of a forecast transaction moves forward i.e. it is expected to occur sooner than originally forecasted, the forecast transaction continues to be highly probable and hence continues to qualify for hedge accounting. A hedged forecast transaction must be identified and documented with sufficient specificity. Therefore, a forecast transaction may be identified as sale of the first 1 thousand units but not for last 1 thousand units as the first 1 thousand units can be identified but last 1 thousand units cannot be clearly identified.

The cumulative gain or loss on the hedging instrument deferred in equity continues to be separately recognised in the equity until forecast transaction occurs. On occurrence of forecast transaction, it is removed from equity and transferred to profit or loss. If a forecast transaction though expected to occur, is not highly probable anymore, subsequent changes in fair value of the hedging instrument shall be recognised in profit or loss and not in equity whereas the cumulative gain or loss on hedging instrument already recognised in equity prior to its ceasing to be highly probable will remain in equity.

Discontinuing Cash Flow Accounting

The cash flow hedge accounting should be discontinued prospectively if:

The hedging instrument expires or is sold, terminated or exercised. Here it is to be noted that, the rollover or replacement of hedging instrument into another hedging instrument, if part of documented hedging strategy from inception will not be regarded as termination or expiration.

If hedging criteria as discussed below are no longer met,

The hedging relationship is de-designated by the entity, or

The forecast transaction is no longer expected to occur.

4.3. Net Investment Hedge

Net investment in non-integral foreign investment is defined in AS 11 as the reporting enterprise's share in the net assets of that operation. The net investment hedge is a hedge of foreign currency exposure to changes in the reporting entity's share in the net assets of its foreign operation. The accounting of hedges on net investment is similar to accounting of cash flow hedges. Therefore, the portion of the gain or loss on the hedging instrument that is determined to be effective hedge is recognised directly in appropriate equity account and the portion of the gain or loss on the hedging instrument that is determined to be ineffective hedge should be recognised in profit or loss.

On disposal of the foreign operation, the accumulated gain or loss on hedging instrument relating to effective portion of the hedge that has been earlier recognised in equity account, shall be transferred to statement of comprehensive income.

On 3rd July,2008 IFRIC issued IFRIC 16 *Hedges of a Net Investment in a Foreign Operation* which is effective from annual periods beginning on or after 1 October 2008 retrospectively or prospectively as entity chooses, however earlier adoption is also permitted. IFRIC 16 clarifies three main issues:

Whether risk arises from (a) the foreign currency exposure to the functional currencies of the foreign operation and the parent entity, or from (b) the foreign currency exposure to the functional currency of the foreign operation and the presentation currency of the parent entity's consolidated financial statements.

IFRIC 16 concludes that the presentation currency does not create an exposure to which an entity may apply hedge accounting. Consequently, a parent entity may designate as a hedged risk only the foreign exchange differences arising from a difference between its own functional currency and that of its foreign operation.

Which entity within a group can hold a hedging instrument in a hedge of a net investment in a foreign operation and in particular whether the parent entity holding the net investment in a foreign operation must also hold the hedging instrument.

IFRIC 16 concludes that the hedging instrument(s) may be held by any entity or entities within the group.

How an entity should determine the amounts to be reclassified from equity to profit or loss for both the hedging instrument and the hedged item when the entity disposes of the investment.

IFRIC 16 concludes that while IAS 39 must be applied to determine the amount that needs to be reclassified to profit or loss from the foreign currency translation reserve in respect of the hedging instrument, IAS 21 must be applied in respect of the hedged item.

5. Conditions for Hedge Accounting

A hedge accounting can be done for any type of hedging relationship only if certain conditions are fulfilled. The conditions are:

- The hedged item and the hedging instrument should be specifically identified
- There should be formal documentation and designation of hedging relationship and enterprise's risk management objective and strategy at inception of hedge.
- The documentation of the hedged relationship must also identify the hedged risk and how the effectiveness of the hedge will be assessed
- The hedge should be highly effective in offsetting the changes in cash flow or fair value attributable to hedged risk.

- The effectiveness should be reliably measurable.
- A forecast transaction that is subject to hedge must be highly probable
- The hedge should be assessed on ongoing basis for its hedging effectiveness. Effectiveness must fall within a range of 80 to 125% over the life of the hedge. This leaves some scope for short-term ineffectiveness, provided that overall effectiveness falls within this range.

6. Assessing Hedge Effectiveness

One of the essential condition for applying hedge accounting is that hedge should be highly effective. A hedge is said to be highly effective only if at inception of the hedge and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which hedge is designated and the actual results of hedge are within a range of 80-125. Any deviation of the results from 100% is partial ineffectiveness and should be recognised immediately.

There is no specific method prescribed for assessing effectiveness. However, entity must specify at inception the method it proposes to follow and follow in consistently for all similar hedges until some other method is justified. Some of the ways in which hedge expectations can be demonstrated are:

- comparison of past changes in cash flow or fair value of hedged item with those of changes in the cash flow or fair value of related hedging instrument. Eg. Ratio analysis or dollar offset method
- demonstrating high statistical correlation between the fair value or cash flow of the hedged item and those of hedging instrument. Eg. Regression analysis

There are two tests for hedge effectiveness:

i. Prospective effectiveness - the hedge is expected to be highly effective at inception and on an ongoing basis

ii. Retrospective effectiveness - the hedge has actually been highly effective in the period (within the range of 80% - 125%)

Hedge effectiveness must be measured every time the company issues interim or annual financial statements.

7. Documentation

Beside assessment of effectiveness, another important criterion for applying hedge accounting is proper documentation. Therefore, until the necessary documents are in place a company cannot apply hedge accounting. Specifically the documentation must set out the following key elements of a hedge relationship:

- The entity's risk management strategy and objective for undertaking the hedge
- Identification of the hedging instrument
- Identification of the hedged item and hedged risk
- Identification of the type of hedge relationship - cash flow, fair value of net investment
- How the entity plans to assess hedge effectiveness
- The date of designation

Chapter XIX

DISCLOSURES FOR FINANCIAL INSTRUMENTS

1. Introduction

IFRS 7 *Financial Instruments: Disclosures* provides the disclosure requirements for the financial instruments. The objective of the standard is to require entities to provide disclosures in financial reports that enable the users to evaluate the significance of the financial instruments for determining the entities financial position, results and cash flows, and the nature and extent of exposure to risks arising from the financial instruments. The entities are also required to report

regarding how the entity manages their exposures to risks. The disclosure requirements are such that it includes both the qualitative narrative descriptions and the specific quantitative data. A balance has to be reached such that, the level of disclosures should not over burden the users with excessive details, but at the same time, it should not obscure significant information due to excessive aggression.

2. Applicability

The disclosures requirements are applicable to all entities and to all risks arising from all types of financial instrument, unless specifically scoped out. Disclosures are also required to be made in respect of unrecognised financial assets like loan commitments that are not designated or required to be carried as fair value through profit or loss. Regular way purchase and sell accounted for using settlement date accounting policy also give rise to unrecognised liability. Moreover the contracts to buy or sell non-financial items which are recognised as financial instruments are also required to meet the disclosure requirements. However, disclosures prescribed do not apply to the following:

- Interests in subsidiaries, associates and joint ventures that are not held for trading and are covered by their own respective standards- However, those interests in subsidiary, associates and joint venture where investment has been made and held exclusively with a view to its subsequent disposal in the near future or where it operated under severe long term restrictions which significantly impair its ability to transfer funds to the parent are required to meet disclosure requirement for financial instruments.
- Employees benefit plan obligation
- Share based payments transactions
- Insurance contracts-However, all embedded derivatives in insurance contracts that are required to be presented separately will need to comply with the disclosure requirements.
- Contingent consideration in business combinations

3. Classes of financial instruments

Entities are required to group financial instruments into classes. Classes here should be distinguished from 'categories'. Categories refer to categories of financial assets and liabilities like fair value through profit or loss, held to maturity, loans and receivables, available for sale etc. Class on other hand is a lower level of aggregation than category. For example, equity securities, government debt security or asset backed securities can be called classes of financial instrument. Entity should group financial instrument into classes that are appropriate to nature of information disclosed after taking into account the characteristics of those financial instruments. The classes should be reconciled to the line items presented in the statement of financial position. The classes should be such that they at least distinguish between the financial instruments that are measured at cost from those that are measured at fair value. The financial instruments outside the scope of the standard should also be treated as separate class or classes. A number of disclosures like those for derecognition of financial assets, impairment losses recognised for financial assets in profit or loss, fair value of all financial instruments, day 1 profit or loss, credit risk, allowance account for credit losses, etc are required to be given by class of financial instruments.

4. Categories of financial instruments

Entities should disclose the carrying amount for each category of financial instruments either on the face of the statement of financial position or in the notes to the financial statements. As discussed earlier financial asset are categorized in four broad categories, which are:

i. Financial assets carried at fair value through profit or loss

ii. Held to maturity financial assets

iii. Loans and receivables financial assets, and

iv. Available for sale financial assets.

All Financial liabilities broadly falls into two categories, which are:

i. Financial liabilities carried at fair value through profit or loss, and

ii. Other financial liabilities.

Besides carrying amount, entities are also required to give disclosure of gains and losses made by each category of financial instruments. This information helps users to appraise management's decision to buy, sell or hold a financial asset and to incur, maintain or discharge a financial liability.

5. Significance of financial instruments

Financial Instruments are very important part of any entities financial statements. One of the purpose of these disclosure requirements are to enable the users of the financial statements to evaluate the significance of financial instruments held or issued by entity, in assessing its financial position and performance. Some of the terms used in the forthcoming discussions are explained below:

Credit Risk: Credit Risk refers to the risk that one party to the financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

Market Risk: This is the risk that the fair value or the future cash flow of the financial instrument will fluctuate because of the changes in the market price. It comprises of three types of risks, which are currency risk, interest rate risk and other price risk.

Currency Risk: It is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

Interest Rate Risk: It is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rate.

Other Price Risk: It is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in the market price other than those arising from interest rate risk and currency risk. These changes may be caused by the factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.

Disclosures requirement for financial instruments in the statement of financial position and statement of comprehensive income and equity are summarized below.

5.1 Financial instruments in statement of financial position

Certain minimum disclosures requirement has been prescribed by the standards. However, the location for the required statement of financial position disclosures has not been specified. The disclosures may be given at the face of the statement of financial position or by the way of notes to the financial statements.

5.1.1 Financial assets as at fair value through profit or loss

Entities are required to give extensive disclosures when it designates a loan or receivable as at fair value though profit or loss. This is because, applying fair value option to these instruments makes a significant impact on financial statements as fair value movements are recognised in the financial statements. The required disclosure include maximum amount of credit exposure, the impact of credit derivatives on the credit exposure, and changes in fair value of loans or receivables (or group of loans and receivables) and any related credit derivatives due to changes in credit risk, both during the period and cumulatively. Since it is difficult for many entities to identify and reliably measure changes in fair value of loans and receivables attributable to change in own credit risks, entities are allowed to calculate the amount of change in fair value that is not attributable to change in market condition that give rise to market risks. Entities are allowed to use other methods if it represents the effect of credit risks more faithfully. However, entities need to disclose the method used and if entity believes that the disclosures does not faithfully represent the changes in fair value of financial asset attributable to changes in its credit risk, it should give the reason for such conclusion and other relevant factors.

5.1.2 Financial liabilities at fair value through profit or loss

Extensive disclosures are required when an entity designates a financial liability as at fair value through profit or loss, particularly about the credit worthiness. The change in fair value of financial liability during the period and cumulative, due to change in the credit risk of that liability should be disclosed. Since it is difficult for many entities to identify and reliably measure changes in fair value of financial liabilities attributable to change in own credit risks, entities are allowed to calculate the amount of change in fair value that is not attributable to

change in market condition that give rise to market risks. Entities may use other methods, if they can demonstrate that it results in more faithful representation of change in fair value attributable to changes in credit risk of the liability. Entities need to disclose the method used and if entity believes that the disclosures does not faithfully represent the changes in fair value of financial asset attributable to changes. Moreover, entities are also required to disclose the carrying amount of the financial liability at fair value through profit or loss and the amount entity would contractually liable to pay at maturity to the holder of the instrument.

5.1.3 Other Disclosures in Statement of Financial Position

Reclassification: Entities are required to disclose the amount and reason for reclassification of financial assets from cost or amortised cost to fair value or vice versa, for each category of financial assets. As discussed earlier, reclassification into or out of financial asset or liability as at fair value through profit or loss is not permitted. Hence, in practice disclosure relating to reclassification into and out of available for sale category will be required.

Transferred assets not Derecognized: As discussed earlier, some transfers of financial assets do not qualify for derecognition. In such cases, it is important that user of the financial statements are able to evaluate the extent and nature of the risk and rewards entity continues to be exposed to and extent of its continuing involvement with the asset. The disclosures for derecognition are required for each class of financial assets, which can be either be according to type of financial asset or according to nature of risk and reward retained. The entities are required to disclose for each class of such financial assets:

- The nature of the assets
- The nature of the risk and rewards of ownership to which entity remain exposed
- The carrying amount of the assets and associated liabilities when entity continues to recognise all of the assets and in case entity continues to recognise to the extent of its continuing involvement, the total carrying amount of the original assets are also disclosed.

Collateral Received: An entity should disclose the fair value and terms and condition of use of financial or non financial assets received as collateral which the company has right to sell or repledge in the collateral in the absence of default. It should also disclose the fair value of any such collateral sold or repledged and whether the entity has an obligation to return it.

Collateral Given: In respect to collateral pledged by the entity it should disclose the carrying amount and terms and conditions of financial assets pledged as collateral. Moreover, in respect of collateral given, for which counterparty has, right to sell or repledge, it should be classified separately from other financial assets.

Allowance Account For credit losses: Entities are required to present a reconciliation of changes in allowance account, for credit losses due to impairment for each class of financial assets during the period. Such disclosures are useful for assessing the adequacy of the allowance for impairment losses. However, components of reconciliation have not been specified and preparer has flexibility of determining the most appropriate format.

Compound financial instruments with multiple embedded derivatives: If an entity issues a compound instrument i.e. an instrument with both liability and equity component, with multiple derivatives (as in the case of callable convertible debentures), it should disclose the existence of such features.

Defaults and Breaches: Entities are required to disclose details of any defaults of principal, interest, sinking fund, or redemption terms during the period of any financial liability that is loan payable by the entity. Moreover, the carrying amount of any such loans that are in default at the reporting date is required and whether the default was remedied or the terms of the loans payable were renegotiated before the issue of financial statements should also be stated. Similar disclosures are also required for breaches of other loan agreement if those breaches permit the lender to demand accelerated repayment. However, disclosure need not be given if the breaches are remedied or terms of loan are renegotiated on or before the reporting date. This information is relevant to users for determining the entities credit worthiness and affects the future fund raising prospects of the company.

5.2 Financial Instruments in statement of profit or loss and equity

As in the case of minimum statement of financial position related disclosures, an entity is permitted to present the required statement of comprehensive income disclosures on either the face of the statement of comprehensive income or in the notes to financial statements. Disclosures in respect to following item of income, expense, gains and losses should be disclosed by the entity:

Net gains or losses for each financial instrument category of financial instrument as defined earlier. The financial assets and liabilities held for trading has to be shown separately from those designated as at fair value through profit or loss on initial recognition.

Total interest income and total interest expense, calculated using effective interest method for financial assets or financial liabilities other than not at fair value through profit or loss, should be disclosed.

Fee income and expense, other than those included in determining effective interest rate, arising from financial assets and liabilities other than financial assets and liabilities as at fair value -through profit or loss. Moreover, the disclosure shall be provided of trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions. Such information is useful in assessing the level of such activities by entity and in estimating probable future income of the entity.

Interest income on impaired financial assets that is determined using the rate of interest used to discount the future cash flows for measuring impairment loss.

The amount of any impairment loss for each class of financial asset

As stated earlier, the class is generally lower level of aggregation than a category. For example an entity may disclose impairment of available for sale debt securities separately from available for sale equity securities, if the classes are significant.

5.3 Other Disclosures

5.3.1 Accounting Policies

Normally, measurement bases and accounting policies used in preparation and understanding of financial statements are disclosed. For financial instruments these requirement would include the following:

- Criteria for designating financial assets and financial liabilities as at fair value through profit or loss
- Nature of financial assets or liabilities that have been designated as at fair value through profit or loss
- Narrative description of justification of designation of financial asset or financial liability as at fair value through profit or loss
- Criteria for designating financial asset as available for sale
- Determining when the carrying amount of impaired financial assets are reduced directly and when allowance account has to be used.
- Criteria for writing off the amount charged to allowance account against the carrying amount of impaired financial assets.
- Whether trade date or settlement date accounting model is used for accounting of regular way purchases and sales of financial assets.
- Method of determining net gains or net losses on each category of financial instrument. For example, whether the net gains or net losses on items at fair value through profit or loss includes interest or dividend income.
- The criteria for determining the objective evidence of impairment loss.
- When the terms of financial assets that would otherwise be past due or impaired have been renegotiated, the accounting policy for financial assets that are subject to renegotiation.

5.3.2 Hedge Accounting Disclosures

Hedging activities are integral and a very significant part of many entities. These activities are integral to entity's financial risk management policy. Hedge accounting is not mandatory for an enterprise. It is adopted to remove the difference in timing of recognition of gains and losses on exposure that is being hedged and the hedging instrument. This accounting choice can have significant effect on the financial statement.

For all hedges, entity must disclose a description of each type of hedge, description and fair values at reporting date of the financial instruments designated as hedging instruments date and nature of the risks being hedged. Since, in cash flow hedges, entity has to make significant judgments about expectation of the cash flow and these hedges also requires recognition of gains and losses directly in equity which are recycled to profit or loss, greater transparency is required. Therefore, some additional disclosures are required for cash flow hedges, which are:

- The expected period of cash flows and timing of their effect in profit or loss
- Description of any forecast transaction which was hedged previously, but no longer expected to occur
- The amount recognised in appropriate equity account during the period
- Amount recycled from equity to profit or loss for the period
- The amount removed from appropriate equity account and included in the initial cost or other carrying amount of non-financial asset or non-financial liability whose acquisition or incurrence was a hedged highly probable forecast transaction.
- The ineffectiveness recognised in profit or loss that arises from cash flow hedges.

In case of fair value hedges the gain or loss on the hedging instrument and gain or loss on the hedged item are immediately recognised in profit or loss in all periods. The net of these represents the effective portion of the fair value hedge. Therefore, the gain or loss on the hedging instrument and gain or loss on the hedged item attributable to hedged risk are separately disclosed either on the face of the financial statement or in the notes to financial statements.

The ineffectiveness recognised in profit or loss that arises from hedges of net investment in foreign operation is also disclosed.

The disclosure requirement relating to hedge accounting, mentioned above can be summarized as follows:

Disclosures	Cash Flow Hedge	Fair Value Hedge	Net Investment Hedge
Description of hedged risk and hedging instrument with related fair values	√	√	√
When hedged cash flows are expected to occur	√		
Whether forecast transactions are no longer expected to occur	√		
Gains and losses recognised in equity and their recycling in profit or loss	√		
Gain or loss from hedging instrument and hedging items separately		√	
Ineffectiveness recognised in profit or loss during the period	√		√

5.3.3 Disclosures relating to Fair Value

For disclosing fair values of financial instrument, financial assets and liabilities should be grouped into appropriate classes and fair value for each class should be provided in such a way that they could be compared to their carrying amount in the statement of financial position. The fair values of a financial instrument cannot be offset against far value of anther financial instrument if their carrying amounts are not offset in the statement of financial position. Some financial instruments are carried at fair value and so there fair value need not be disclosed in the notes. Fair value disclosures are required for instruments accounted for at cost or amortised cost. Moreover, fair value disclosures are not required also for financial instruments whose carrying amount reasonably approximates fair value as in the case of most short-term receivables and payables. Exception to fair value disclosures also extent to investment in unquoted equity instruments whose fair value cannot reliably be measured and derivative linked to such instruments and to contracts with discretionary participation feature if the fair value of the feature cannot be reliably measured. However, wherever entity does not provide fair value of a financial instrument because of its inability to measure it reliably, it should supplement it with such disclosures so as to enable the users to make their own judgment of difference between the carrying amount and fair values of the instrument. These disclosures would include description of the instrument, its carrying amount, the fact that the fair value cannot be reliably measured with reasons thereof, information regarding its market and information on whether and how entity wants to dispose such instruments. Moreover, at the time of derecognition of such instrument, entity should disclose the fact that fair value of it was not reliably measurable with carrying amount of the instrument at time of derecognition and gain or loss on derecognition.

Disclosures are also required to be given of the methods and significant assumptions used in determining fair values of financial instrument. These disclosures would include the following:

- Whether fair value is based on quoted price or valuation technique
- Whether the fair value is based on assumptions that includes assumptions not supported by market prices or rates, and if so, the amount of change in fair value recognised in statement of profit or loss that arise from use of valuation technique
- The effect of reasonably possible alternative assumption used in valuation technique.

ABN AMRO group, which applies IFRS for the reporting purpose, gives following disclosures regarding fair value measurement on financial instruments.

Extract from ABN AMRO Annual Report, 2006. pg 136

Fair value of financial instruments

For financial instruments that are actively traded and have quoted market prices or parameters readily available, there is little to no subjectivity to determine fair value. When observable market prices and parameters do not exist, management judgement is necessary to estimate fair value.

Where no active market exists, or quoted prices are unobtainable, the fair value is estimated using a variety of valuation techniques, including discounted cash flow and other pricing models. Input to pricing models is generally taken from reliable external data sources. The models used are validated prior to use by staff independent to the initial selection or creation of the model. The degree of management judgement involved in determining the fair value of a financial instrument is dependent upon the availability of quoted market prices or observable market parameters. Other factors that could affect estimates are incorrect model assumptions, market dislocations and unexpected correlation. We believe our estimates of fair value are adequate. However, the use of different models or assumptions could result in changes in our reported results. For a further discussion on the use of fair values and the impact of applying reasonable possible alternative assumptions as inputs, see note 38 to our consolidated financial statements.

6. Nature and Extent of Risks from Financial Instruments

As mentioned earlier, one of the most important objectives of prescribing the disclosures for financial instruments is to enable the users to evaluate the nature and extent of risk arising from financial instruments to which entity is exposed on the reporting date. Entity needs to disclose both qualitative and quantitative disclosures about the risks that arise from financial instruments.

Such disclosures should be given in the financial statements or incorporated by clear cross reference from the financial statements to some other statement, such as management risk report or commentary. Such management risk report or commentary should be available to the users of the financial statement at the same terms and time as financial statement.

6.1 Qualitative Disclosures

The qualitative disclosures of the risks are intended to complement the required quantitative disclosures to enable the users of the financial statements to understand the entities risk management activities. For each type of risk arising from financial instrument, entity should disclose exposures to the risk, explanation of how it arose, entity's objectives, policies and processes for managing the risks and method used to manage the risks. The information may be provided on a gross basis or net of risk transferred or mitigated, if any. Moreover, entities are also required to disclose any changes in these from previous period. Such changes may result from changes in the risk exposure or change in way of management of risks. This information is important as it enables the user to understand the effect such change has on the nature, timing and uncertainty of future cash flows. The policies and processes for managing the risks would normally include the following:

- The structure and organization of entity's risk management function
- The scope and nature of risk reporting or measurement system
- Policies for hedging or mitigating risks, including policies and procedures for taking collateral
- The entity's processes for monitoring the continuing effectiveness of such hedges or mitigating devices
- Disclosure of the policies and procedures that are undertaken to avoid excessive concentrations to risk.

6.2 Quantitative Risks Disclosures

The quantitative disclosures are intended to provide the extent to which the entity is exposed to the risks based on the information available to the key management personnel. The entities are required to provide the quantitative information about exposures to each type of risks. Where an entity uses several methods to manage risks exposures, it should disclose information using the methods that are most relevant and reliable. Beside this, the entities are required to disclose

information regarding the credit, liquidity and market risks if these are material and not covered in information provided to key management personnel.

The entity should also disclose all risks concentration to which it is exposed, in relation to financial instruments, based on the financial instruments that have similar characteristics and amount of risks concerns. The identification of concentrations of risks requires judgement and must take into account the specific circumstances of the entity. Such disclosures should include:

- a description of how management determines concentrations;
- a description of the shared characteristic that identifies each concentration (eg counterparty, geographical area, currency or market); and
- the amount of the risk exposure associated with all financial instruments sharing that characteristic.

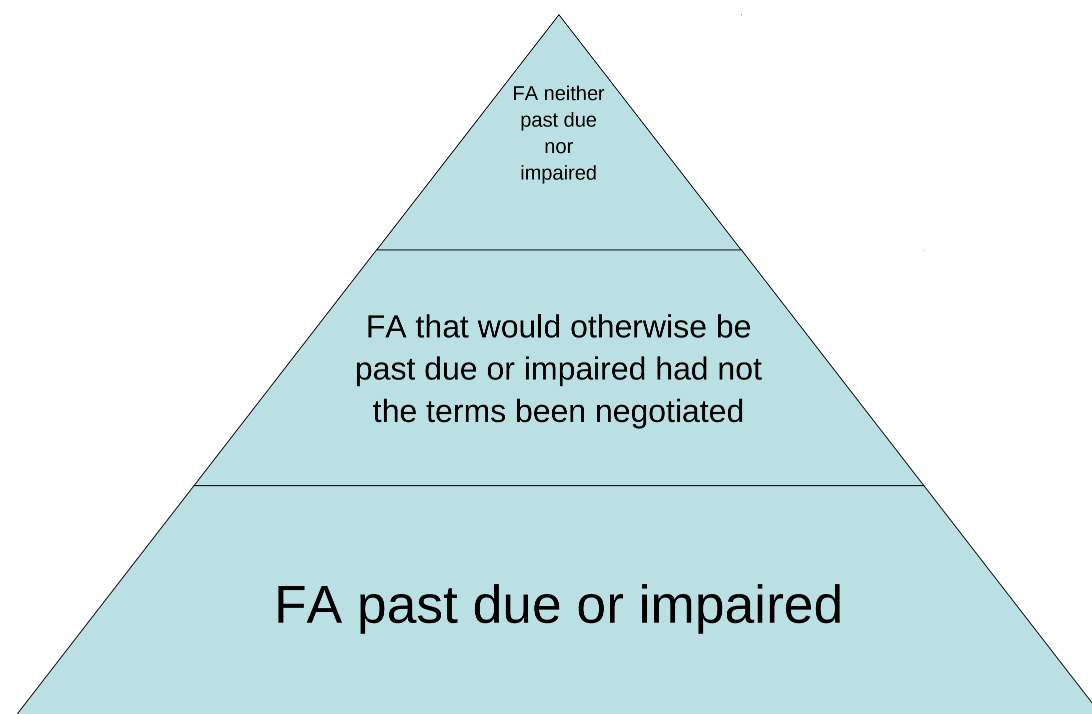
When the quantitative data disclosed at the reporting date in not representative of entity's exposure to the risks during the period, the entity should provide further disclosures so that fair representation may be done. Such further information may include the highest, lowest and average amount of the risk to which entity was exposed during the period.

6.2.1 Credit Risk

The Credit Risk has been defined as the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation. The disclosures requirement relating to the credit risks are extensive and intended to provide the users of the financial statement with the net risk exposures of financial assets at all stages. This gives an insight to extent of financial assets that have likelihood of becoming impaired in the future.

For each class financial asset the entity is required to disclose the amount that best represents its maximum exposure to credit risk at the reporting date without taking into account any collateral held or other credit enhancements that do not qualify for offset. The objective of such a disclosure is to enable the users to assess the risk exposures to which an entity is exposed during the year, and just at the reporting date.

The disclosures for credit risks are given relating to financial instrument classified in hierarchy of the increasing exposures to credit risk.



Disclosure of maximum exposure to credit risk and description of security and other credit enhancements.

The maximum credit exposures for loans and receivables granted and deposits placed would be the carrying amount net of impairment loss if any. For the derivatives it would be the fair value and for the financial guarantees, it would be the amount the entity could have to pay if the guarantee is called on, which may be significantly greater than the amount recognised as liability.

The maximum to credit risk for making a loan commitment that is irrevocable over the life of the facility or is revocable only in response to a material adverse change, is the full amount of the commitment. This is because it is uncertain whether the amount of any undrawn portion may be drawn upon in the future. This may also be significantly greater than the amount recognised as a liability.

6.2.1.1 Information on the credit quality of financial assets neither past due nor impaired

A financial asset is past due when a counterparty has failed to make a payment of interest or principal, when contractually due. Therefore, a financial asset is considered not past due where the debtor has not missed any contractual obligation for payment and a financial asset is not impaired where there is no objective evidence of impairment. Standard requires disclosures on the credit quality of financial assets neither past due nor impaired. Such disclosures provide insight into the credit risks of assets and thereby enabling the users to assess the likelihood of assets getting impaired. In disclosing the information regarding credit quality of financial assets with credit risk that are neither past due nor impaired, an entity might disclose the following information:

- An analysis of credit exposures using an external or internal credit grading system;
- the nature of the counterparty;
- historical information about counterparty default rates; and
- any other information used to assess credit quality.

The credit ratings on which credit quality are monitored and managed can be internally generated or accepted from external credit agency. When the entity considers external ratings when managing and monitoring credit quality, the entity might disclose information about:

- the amounts of credit exposures for each external credit grade;
- the rating agencies used;
- the amount of an entity's rated and unrated credit exposures; and
- the relationship between internal and external ratings.
- When the entity considers internal credit ratings when managing and monitoring credit quality, the entity might disclose information about:
- the internal credit ratings process;

- the amounts of credit exposures for each internal credit grade; and
- the relationship between internal and external ratings.

6.2.1.2 Information on the credit quality of financial assets that would otherwise be past due or impaired whose terms has been renegotiated.

For financial assets which would have been past due or impaired, had not there terms been renegotiated, the entities are required to disclose the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated.

6.2.1.3 Information on the credit quality of financial assets that are either past due or impaired

A financial asset is past due when counterparty has failed to make a payment of interest or principal, when contractually due whereas a financial asset is impaired when it's carrying value is more than its recoverable amount. There should be objective evidence of impairment. When an asset is past due, various actions can be taken such as renegotiation, enforcement of covenants, or legal proceedings but it does not mean that the counterparty will never pay. When the terms and conditions of financial assets that have been classified as past due are renegotiated, the terms and conditions of the new contractual arrangement apply in determining whether the financial asset remains past due.

The following disclosure of financial information for such assets should be made by entity for each class of financial asset:

An analysis of the age of financial assets that are past due as at the reporting date but not impaired: Such an analysis enables the user of the financial statement to understand the extent of financial assets that are more likely to be impaired because they are past due for longer time. An entity uses its judgement to determine an appropriate number of time bands. For example, an entity might determine that the following time bands are appropriate:

- not more than three months;
- more than three months and not more than six months;

- more than six months and not more than one year; and
- More than one year.

An analysis of financial assets that are individually determined to be impaired at the reporting date, including the factors the entity considered in determining that they are impaired. This analysis is important as it allows the readers to evaluate the amount of financial assets actually impaired. Such an analysis might include the carrying amount, before deducting any impairment loss, the amount of any related impairment loss, and the nature and fair value of collateral available and other credit enhancements obtained.

A description of collateral held by the entity as security and other credit enhancements for above and, unless impracticable, an estimate of their fair value. Such disclosure of fair value of collateral held for such debts provide an insight to net risk position of such financial assets.

6.2.1.4 Disclosure of Collateral and other credit enhancements obtained

For each class of financial assets the entity should disclose the description of collateral obtained. This can be done by disclosing the following:

- the policies and processes for valuing and managing collateral and other credit enhancements obtained;
- a description of the main types of collateral and other credit enhancements (examples of the latter being guarantees, credit derivatives, and netting agreements that do not qualify for offset);
- the main types of counterparties to collateral and other credit enhancements and their creditworthiness; and
- information about risk concentrations within the collateral or other credit enhancements.

When an entity obtains financial or non-financial assets during the period by taking possession of collateral it holds as security or calling on other credit enhancements (eg guarantees), and such assets meet the recognition criteria in other Standards, an entity should disclose the nature and

carrying amount of the assets obtained and when the assets are not readily convertible into cash, its policies for disposing of such assets or for using them in its operations.

6.2.2 Liquidity Risk

The Liquidity Risk has been defined as risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities. Such risks arise because an entity may be required to pay its liability earlier than the expected time. Entities are required to disclose a maturity analysis for financial liabilities that shows the remaining contractual maturities and a description of how it manages the liquidity risk inherent in them. In preparing the contractual maturity analysis for financial liabilities, an entity uses its judgement to determine an appropriate number of time bands. For example, an entity might determine that the following time bands are appropriate:

- not later than three month;
- later than three month and not later than six months;
- later than six months and not later than one year; and
- later than one year and not later than five years.

When counterparty has a choice of when an amount is paid, the liability is included on the basis of the earliest date on which the entity can be required to pay. For example, financial liabilities that an entity can be required to repay on demand (eg demand deposits) are included in the earliest time band. When an entity is committed to make amounts available in instalments, each instalment is allocated to the earliest period in which the entity can be required to pay. For example, an undrawn loan commitment is included in the time band containing the earliest date it can be drawn down.

When the amount payable is not fixed, the amount disclosed is determined by reference to the conditions existing at the reporting date. For example, when the amount payable varies with changes in an index, the amount disclosed may be based on the level of the index at the reporting date.

The amounts disclosed in the maturity analysis are the contractual undiscounted cash flows. Such undiscounted cash flows differ from the amount included in the statement of financial position because the amount in the statement of financial position is based on discounted cash flows.

Preferably, an entity should disclose the analysis of derivative financial instruments separately from that of non-derivative financial instruments in the contractual maturity analysis for financial liabilities.

If an entity manages liquidity risk on the basis of expected maturity dates, it might disclose a maturity analysis of the expected maturity dates of both financial liabilities and financial assets. If an entity discloses such an expected maturity analysis, it might clarify that expected dates are based on estimates made by management, and explain how the estimates are determined with the principal reasons for differences from the contractual maturity analysis.

To describe how an entity manages the liquidity risk inherent in the maturity analysis of financial liabilities it might consider the following factors in providing this disclosure, whether the entity:

- expects some of its liabilities to be paid later than the earliest date on which the entity can be required to pay (as may be the case for customer deposits placed with a bank);
- expects some of its undrawn loan commitments not to be drawn;
- holds financial assets for which there is a liquid market and that are readily saleable to meet liquidity needs;
- has committed borrowing facilities (eg commercial paper facilities) or other lines of credit (eg stand-by credit facilities) that it can access to meet liquidity needs;
- holds financial assets for which there is not a liquid market, but which are expected to generate cash inflows (principal or interest) that will be available to meet cash outflows on liabilities;
- holds deposits at central banks to meet liquidity needs;
- has very diverse funding sources; or

- has significant concentrations of liquidity risk in either its assets or its funding sources.

Liquidity risk

Measurement and control

Liquidity risk arises in any bank's general funding of its activities. For example, a bank may be unable to fund its portfolio of assets at appropriate maturities and rates, or may find itself unable to liquidate a position in a timely manner at a reasonable price. The Group holds capital to absorb unexpected losses, and manages liquidity to ensure that sufficient funds are available to meet not only the known cash funding requirements, but also any unanticipated ones that may arise. At all times, the Group maintains what we believe to be adequate levels of liquidity on a Group-wide basis to meet deposit withdrawals, repay borrowings and fund new loans, even under stressed conditions.

We manage liquidity on a daily basis in all the countries in which we operate. Each national market is unique in terms of the scope and depth of its financial markets, competitive environment, products and customer profile. Therefore local line management is responsible for managing our local liquidity requirements under the supervision of Group Asset and Liability Management on behalf of the Group Asset and Liability Committee.

On a day-to-day basis our liquidity management depends on, among other things, the effective functioning of local and international financial markets. As this is not always the case, we have Group-wide contingency funding plans. These plans are put into effect in the event of a dramatic change in our normal business activities or in the stability of the local or international financial markets. The Group Strategic Funding Committee has full authority to manage such a crisis. As part of this liquidity management contingency planning, we continually assess potential trends, demands, commitments, events and uncertainties that could reasonably result in increases or decreases in our liquidity. More specifically, we consider the impact of these potential changes on our sources of short-term funding and long-term liquidity planning.

As we have entered into committed credit facilities, our liquidity management process also involves assessing the potential effect of the contingencies inherent in these types of transactions on our normal sources of liquidity and finance.

Liquidity gap

The following table provides an analysis that categorises the statement of financial position of the Group into relevant maturity groupings based on the remaining contractual periods to repayment.

Maturity for the year ended 31 December 2006:

	On demand	< 1 year	≥ 1 year < 5 years	≥ 5 years	Total
Assets					
Cash and balances at central banks	16,657	-	-	-	16,657
Financial assets held for trading **1**	202,055	-	-	-	202,055
Financial Investments	12,366	12,047	35,425	63,936	123,774
Loans and receivables – banks	7,251	80,091	5,922	15,371	108,635
Loans and receivables – customers	24,101	171,824	84,497	99,826	380,248
Other assets **1**	3,213	21,268	4,341	20,613	49,435

Total	265,643	285,230	130,185	199,746	880,804
Liabilities					
Financial liabilities held for trading **1**	148,588				148,588
Due to banks	30,905	117,150	8,349	11,417	167,821
Due to customers	147,846	138,630	14,481	16,126	317,083
Due to customers	1,495	100,873	34,548	33,703	170,619
Subordinated liabilities	–	1,156	5,101	12,815	19,072
Other liabilities **1**	4,712	15,335	2,771	10,651	33,469
Total	333,546	373,144	65,250	84,712	856,652
Net liquidity gap	(67,903)	(87,914)	64,935	115,034	24,152

1 *Financial assets and liabilities held for trading and hedging derivatives are shown as on demand which management believes most accurately reflects the short-term nature of the trading and derivative activities.*

6.2.3 Market Risk

This is the risk that the fair value or the future cash flow of the financial instrument will fluctuate because of the changes in the market price. It comprises of three types of risks, which are currency risk, interest rate risk and other price risk. Each of these risks are defined as follows:

Currency Risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

Interest Rate Risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rate.

Other Price Risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in the market price other than those arising from interest rate risk and currency risk. These changes may be caused by the factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market. Equity price risk, commodity price risk, prepayment risk etc. are some of the entity specific risks.

All financial instruments are subject to market risk. However, the required market risk quantitative disclosures are restricted to sensitivity of profit or loss and equity to changes in market risk.

Market risk sensitivity may be disclosed in two ways:

i. a separate sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date, based on the relevant risk variable that are reasonably possible at that date

ii. an analysis such as value-at-risk (VoR), that considers interdependencies between risk variables (eg interest rates and exchange rates) and is used by management to manage financial risks.

Sensitivity Analysis

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. Moreover, disclosure should also be given for the methods and assumptions used in preparation of market risk sensitivity analysis and changes with reason for any change from the previous period in such methods and assumptions.

The sensitivity analysis provides useful information as it highlights the nature and extent of risks that arise from financial instruments. Moreover, it is suitable for all entities and is relatively easy to calculate.

No fixed format has been prescribed for presentation of sensitivity analysis. If an entity has exposure to only one type of market risk in only one economic environment, it would not show disaggregated information. Otherwise, an entity decides how it aggregates information to display the overall picture, although exposures to risks from significantly different economic environments should not be combined. For example, an entity that trades financial instruments might disclose this information separately for financial instruments held for trading and those not held for trading.

Since the factors affecting market risk vary depending on the specific circumstances of each entity, the appropriate range to be considered in providing a sensitivity analysis of market risk varies for each entity and for each type of market risk.

When the sensitivity analysis disclosed is unrepresentative of a risk inherent in financial instrument additional disclosures should be made. For example, this can occur when:

A financial instrument contains terms and conditions whose effects are not apparent from the sensitivity analysis, eg options that remain out of (or in) the money for the chosen change in the risk variable. In such cases additional information can be given about the terms and conditions of the financial instrument (eg the options), the effect on profit or loss if the term or condition were met (i.e. if the options were exercised); and a description of how the risk is hedged.

Financial assets are illiquid, eg when there is a low volume of transactions in similar assets and an entity finds it difficult to find counterparty. In such cases, additional information might include the reasons for the lack of liquidity and how the entity hedges the risk.

An entity has a large holding of a financial asset that, if sold in its entirety, would be sold at a discount or premium to the quoted market price for a smaller holding. In such cases, additional disclosure might include the information about the nature of the security, the extent of holding, the effect on profit or loss and how the entity hedges the risk.

Recent Amendments to IFRS 7 *Financial Instruments: Disclosures*

Reclassification

In October 2008 the Board amended IAS 39 to permit reclassification of particular financial assets in some circumstances. The amendments introduce into IFRSs the same possibility of reclassifications that is already permitted under US GAAP in limited circumstances. The amendments would permit reclassification of some financial instruments out of the fair-value-through-profit-or-loss category and out of the available-for-sale category

The Board decided to require additional disclosures about the situations in which any such reclassification is made, and the effects on the financial statements. . The Board regards such information as useful because the reclassification of a financial asset can have a significant effect on the financial statements.

If the entity has reclassified a financial asset out of the fair value through profit or loss category in accordance with paragraph 50B or 50D of IAS 39 or out of the available-for-sale category in accordance with paragraph 50E of IAS 39, it shall disclose:

(a) the amount reclassified into and out of each category;

(b) for each reporting period until derecognition, the carrying amounts and fair values of all financial assets that have been reclassified in the current and previous reporting periods

(c) if a financial asset was reclassified in accordance with paragraph 50B, the rare situation, and the facts and circumstances indicating that the situation was rare;

(d) for the reporting period when the financial asset was reclassified, the fair value gain or loss on the financial asset recognised in profit or loss or other comprehensive income in that reporting period and in the previous reporting period;

(e)in the period of reclassification and in subsequent periods until the financial asset is derecognised, the gain or loss that would have been recognised in profit or loss or OCI had the financial asset not been reclassified, and the actual gain, loss, income and expense recognised in profit or loss;

(f) the effective interest rate and estimated amounts of cash flows the entity expects to recover, as at the date of reclassification of the financial asset.

. The amendments are effective 1 July 2008.

March 2009: IASB enhances the IFRS 7 financial instruments disclosures

On 5 March 2009, the IASB has issued *Improving Disclosures about Financial Instruments (Amendments to IFRS 7)*. The amendments require enhanced disclosures about fair value measurements and liquidity risk. Among other things, the new disclosures:

clarify that the existing IFRS 7 fair value disclosures must be made separately for each class of financial instrument

And disclosure of any change in the method for determining fair value and the reasons for the change

establish a three-level hierarchy for making fair value measurements:

1. Quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1);
2. Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices) (Level 2); and
3. Inputs for the asset or liability that are not based on observable market data (unobservable inputs) (Level 3).

Add disclosure, for each fair value measurement in the statement of financial position, of which level in the hierarchy was used and any transfers between levels, with additional disclosures whenever level 3 is used including a measure of sensitivity to a change in input data

Clarify that the current maturity analysis for non-derivative financial instruments should include issued financial guarantee contracts

Add disclosure of a maturity analysis for derivative financial liabilities

Entities are required to apply the amendments for annual periods beginning on or after 1 January 2009, with earlier application permitted. However, an entity will not be required to provide comparative disclosures in the first year of application.

Financial Instruments Disclosures Check List

	Yes/ NO/ N.A
AS PER IAS 39 : FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT	
For classification of financial assets	
In case, the entity use categories for its financial assets other than those defined in paragraph 9 of IAS 39 when presenting information on the face of the financial statements, is information required by IFRS 7 presented in notes?	
Fair value hedges	
For a fair value hedge of the interest rate exposures of a portion of a portfolio of financial assets or financial liabilities, are the requirement in paragraph 89(b) of IAS 39 (relating to the accounting of the gain or loss on hedged item attributable to hedged risk) met by presenting the gain or loss attributable to the hedged item either:	
in a single separate line item within assets, for those repricing time periods for which the hedged item is an asset? or	
in a single separate line item within liabilities, for those repricing time periods for which the hedged item is a liability.	
AS PER IAS 32: FIANCIAL INSTRUMENTS: PRESENTATION	

For liabilities and equity	
On initial recognition, does the issuer of a financial instrument classify the instrument or its component parts as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement rather than the legal form, and in accordance with the definitions of a financial liability, a financial asset and an equity instrument?	
When an issuer applies the definitions in paragraph 11 of IAS 32 to determine whether a financial instrument is an equity instrument rather than a financial liability, are both conditions (a) and (b) below met?	
the instrument includes no contractual obligation:	
to deliver cash or another financial asset to another entity: or	
to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer; and	
if the instrument will or may be settled in the issuer's own equity instruments, it is:	
a non-derivative instrument that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or	
a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments.	
For compound financial instruments	
Does the issuer of a non-derivative financial instrument evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component.	
Are such components classified separately as financial liabilities, financial assets or equity instruments	
For treasury shares	
If an entity has reacquired the entities own equity instruments are those treasury shares deducted from equity?	

Are gains or losses recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments?	
Are considerations paid or received recognised directly in equity?	
Is the amount of treasury shares held is disclosed separately, either on the face of the statement of financial position or in the notes?	
Does the entity make appropriate disclosures in accordance with IAS 24 *Related Party Disclosures* in case it reacquires its own equity instruments from related parties?	
For Interest, dividends, losses and gains	
Are interests, dividends, losses and gains relating to a financial instrument or a component of a financial instrument that is a financial liability recognised as income or expense in profit or loss?	
Are distributions to holders of an equity instrument debited by the entity directly to equity, net of any related income tax benefit?	
Is transaction costs of an equity transaction accounted for as a deduction from equity, net of any related income tax benefit?	
Are the costs of an equity transaction that is abandoned recognised as an expense?	
Weather the transaction costs related to the issue of a compound financial instrument allocated to the liability and equity components of the instrument in proportion to the allocation of the proceeds?	
In case, the transaction costs relate jointly to more than one transaction, are they allocated to the transactions using a basis of allocation that is rational and consistent with similar transactions?	
Are the amount of transaction costs accounted for as a deduction from equity in the period disclosed?	
Are the dividends that are classified as an expense, presented in the statement of comprehensive income either with interest on other liabilities or as a separate item?	

Are gains and losses related to changes in the carrying amount of a financial liability recognised as income or expense in profit or loss even when they relate to an instrument that includes a right to the residual interest in the assets of the entity in exchange for cash or another financial asset?	
For offsetting a financial asset and a financial liability	
Are both the conditions as mentioned below are met before financial asset and a financial liability are offset and the net amount presented in the statement of financial position,	
Does entity currently has a legally enforceable right to set off the recognised amounts? And	
Does the entity intend either to settle on a net basis, or to realise the asset and settle the liability simultaneously?	
AS PER IFRS 7: FINANCIAL INSTRUMENT: DISCLOSURES	
For classes of financial instruments and level of disclosure	
When AS 32 requires disclosures by class of instrument, has the entity grouped 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?	
When IFRS 7 requires disclosure by class of instrument, has the entity provided sufficient information to permit reconciliation to the line items presented in the statement of financial position?	
Significance of financial instruments for financial position and performance	
Does the entity disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance?	
Statement of financial position	
For categories of financial assets and financial liabilities	
Are the carrying amounts of each of the following categories, as defined in IAS 39 *Financial Instruments: Recognition and Measurement*, disclosed either on the face of	

the statement of financial position or in the notes?	
financial assets at fair value through profit or loss, showing separately:	
those designated as such upon initial recognition; and	
those classified as held for trading in accordance with IAS 39;	
held-to-maturity investments;	
loans and receivables;	
available-for-sale financial assets;	
financial liabilities at fair value through profit or loss, showing separately:	
those designated as such upon initial recognition; and	
those classified as held for trading in accordance with IAS 39; and	
financial liabilities measured at amortised cost.	
For financial assets or financial liabilities at fair value through profit or loss	
Where the entity designates a loan or receivable (or group of loans or receivables) as at fair value through profit or loss, does it disclose:	
the maximum exposure to credit risk of the loan or receivable (or group of loans or receivables) at the reporting date;	
the amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk;	
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:	
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	
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; and	
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 at fair value through profit or loss.	
Where the entity has designated a financial liability as at fair value through profit or loss in accordance with IAS 39, does it disclose:	
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:	
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	
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; and	
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.	
Does the entity disclose:	
the methods used to determine the amount of change that is attributable to changes in credit risk in compliance with the requirements in paragraphs 9(c) and 10(a) of IFRS 7 (see above); and	
if the entity believes that the disclosure it has given to comply with the requirements in paragraphs 9(c) or 10(a) of IFRS 7 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.	
For reclassification	
In case the entity has reclassified a financial asset as one measured at cost or amortised cost, rather than at fair value; or at fair value, rather than at cost or amortised cost, does it disclose the amount reclassified into and out of each category and the reason for that reclassification?	
For derecognition	

Where the entity has transferred financial assets in such a way that part or all of the financial assets do not qualify for derecognition, does the entity disclose the following for each class of such financial assets:	
the nature of the assets not derecognised;	
the nature of the risks and rewards of ownership to which the entity remains exposed;	
when the entity continues to recognise all of the assets, the carrying amounts of the assets and of the associated liabilities; and	
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?	
For collateral	
Does the entity disclose:	
the carrying amount of financial assets it has pledged as collateral for either liabilities or contingent liabilities, including amounts that have been reclassified in the statement of financial position separately from other assets as the transferee has the right to sell or repledge, in accordance with AS 30; and	
the terms and conditions relating to its pledge?	
When the 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, does it disclose:	
the fair value of such collateral held;	
the fair value of any such collateral sold or repledged, and whether the entity has an obligation to return it; and	
the terms and conditions associated with its use of the collateral?	
For allowance account for credit losses	
When financial assets are impaired by credit losses and the entity records the impairment in a separate account rather than directly reducing the carrying amount of the asset, does it disclose a reconciliation of changes in that account during the period	

for each class of financial assets?	
For compound financial instruments with multiple embedded derivatives	
In case where the 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, does it disclose the existence of those features?	
For defaults and breaches	
Does the entity disclose the following for loans payable recognised at the reporting date:	
details of any defaults during the period of principal, interest, sinking fund, or redemption terms of those loans payable;	
the carrying amount of the loans payable in default at the reporting date; and	
whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue?	
Where during the period, there were breaches of loan agreement terms other than those described in paragraph 18 of IFRS 7 (see above), does entity shall disclose the same information as required by paragraph 18 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)?	
For statement of comprehensive income and equity	
For items of income, expense, gains or losses	
Does the entity disclose the following items of income, expense, gains or losses either on the face of the financial statements or in the notes:	
net gains or net losses on:	
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;	
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 profit or loss for the period;	
held-to-maturity investments;	
loans and receivables; and	
financial liabilities measured at amortised cost;	
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;	
fee income and expense (other than amounts included in determining the effective interest rate) arising from:	
financial assets or financial liabilities that are not at fair value through profit or loss; and	
trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions;	
interest income on impaired financial assets accrued in accordance with AS 30; and	
the amount of any impairment loss for each class of financial asset?	
For other disclosures	
For Accounting policies	
Does the entity discloses, in the summary of significant accounting policies, the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements?	
For hedge accounting	
Does the entity disclose the following separately for each type of hedge (i.e. fair value hedges, cash flow hedges, and hedges of net investments in foreign operations):	
a description of each type of hedge;	
a description of the financial instruments designated as hedging instruments and their fair values at the reporting date; and	
the nature of the risks being hedged?	

Does the entity disclose the following in respect of cash flow hedge	
the periods when the cash flows are expected to occur and when they are expected to affect profit or loss;	
a description of any forecast transaction for which hedge accounting had previously been used, but which is no longer expected to occur;	
the amount that was recognised in equity during the period;	
the amount that was removed from equity and included in profit or loss for the period, showing the amount included in each line item in the statement of comprehensive income; and	
the amount that was removed from equity during the period and included in the initial cost or other carrying amount of a non-financial asset or non-financial liability whose acquisition or incurrence was a hedged highly probable forecast transaction?	
Does the entity disclose separately:	
in fair value hedges, gains or losses:	
on the hedging instrument; and	
on the hedged item attributable to the hedged risk;	
in cash flow hedges, the ineffectiveness recognised in profit or loss; and	
for hedges of net investments in foreign operations, the ineffectiveness recognised in profit or loss?	
For fair value	
Except as set out in paragraph 29 of IFRS 7 (see below), for each class of financial assets and financial liabilities, does the entity disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount?	
Does the entity disclose:	
the methods and, when a valuation technique is used, the assumptions applied in determining fair values of each class of financial assets or financial liabilities;	
whether fair values are determined, in whole or in part, directly by reference to published price quotations in an active market or are estimated using a valuation	

technique ;	
whether the fair values recognised or disclosed in the financial statements are determined in whole or in part using a valuation technique based on assumptions that are not supported by prices from observable current market transactions in the same instrument (i.e. without modification or repackaging) and not based on available observable market data; and	
if paragraph 27(c) of IFRS 7 applies (see above), the total amount of the change in fair value estimated using such a valuation technique that was recognised in profit or loss during the period?	
In the circumstances described in paragraph 27(c) of AS, for fair values that are recognised in the financial statements, if changing one or more of those assumptions to reasonably possible alternative assumptions would change fair value significantly does the entity state this fact and disclose the effect of those changes?	
If a difference exists between the fair value at initial recognition and the amount that would be determined at that date using a valuation technique, does the entity disclose, by class of financial instrument:	
its accounting policy for recognising that difference in profit or loss to reflect a change in factors (including time) that market participants would consider in setting a price; and	
the aggregate difference yet to be recognised in profit or loss at the beginning and end of the period together with a reconciliation of changes in the balance of this difference?	
In the cases described in paragraphs 29(b) and (c) of IFRS 7 where fair value need not be given as they cannot be determined, does the entity disclose information to help users of the financial statements make their own judgements about the extent of possible differences between the carrying amount of those financial assets or financial liabilities and their fair value, including:	
the fact that fair value information has not been disclosed for these instruments because their fair value cannot be measured reliably;	

a description of the financial instruments, their carrying amount, and an explanation of why fair value cannot be measured reliably;	
information about the market for the instruments;	
information about whether and how the entity intends to dispose of the financial instruments; and	
if financial instruments whose fair value previously could not be reliably measured are derecognised, that fact, their carrying amount at the time of derecognition, and the amount of gain or loss recognised?	
For nature and extent of risks arising from financial instruments	
Does the entity 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	
Does the entity disclose the following for each type of risk arising from financial instruments:	
the exposures to that risk and how they arise;	
its objectives, policies and processes for managing the risk and the methods used to measure the risk; and	
any changes in 33(a) or (b) from the previous period?	
Quantitative disclosures	
For each type of risk arising from financial instruments, does the entity disclose:	
summary quantitative data about its exposure to that risk at the reporting date based on the information provided internally to key management personnel of the entity	
the disclosures required by paragraphs 36 to 42 of IFRS 7 , to the extent not provided in paragraph 34(a), unless the risk is not material; and	
concentrations of risk if not apparent from 34(a) and (b)?.	
Does entity give disclosure of concentrations of credit risk which includes:	
a description of how management determines concentrations;	

a description of the shared characteristics that identifies each concentration; and	
the amount of the risk exposure associated with all financial instruments sharing that characteristic?	
If the quantitative data disclosed as at the reporting date are unrepresentative of an entity's exposure to risk during the period, does the entity provide further information that is representative?	
For credit risks	
Does the entity disclose by class of financial instrument:	
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;	
in respect of the amount disclosed in 36(a), a description of collateral held as security and other credit enhancements;	
information about the credit quality of financial assets that are neither past due nor impaired; and	
the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated.	
For financial assets that are either past due or impaired, does the entity disclose by class of financial asset:	
an analysis of the age of financial assets that are past due as at the reporting date but not impaired;	
an analysis of financial assets that are individually determined to be impaired as at the reporting date, including the factors the entity considered in determining that they are impaired; and	
for the amounts disclosed in 37(a) and (b), a description of collateral held by the entity as security and other credit enhancements and, unless impracticable, an estimate of their fair value?	
When the entity obtains financial or non-financial assets during the period by taking possession of collateral it holds as security or calling on other credit enhancements (e.g. guarantees), and such assets meet the recognition criteria in other Standards,	

does the entity disclose:	
the nature and carrying amount of the assets obtained; and	
when the assets are not readily convertible into cash, its policies for disposing of such assets or for using them in its operations?	
For liquidity risk	
Does the entity shall disclose:	
a maturity analysis for financial liabilities that shows the remaining contractual maturities; and	
b) description of how it manages the liquidity risk inherent in above?	
For Market risk	
Unless the entity complies with paragraph 41 does it disclose:	
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;	
the methods and assumptions used in preparing the sensitivity analysis; and	
changes from the previous period in the methods and assumptions used, and the reasons for such changes?	
If the entity prepares a sensitivity analysis, such as value-at-risk, that reflects interdependencies between risk variables (e.g. interest rates and exchange rates) and uses it to manage financial risks, does it disclose	
an explanation of the method used in preparing such a sensitivity analysis, and of the main parameters and assumptions underlying the data provided; and	
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.	
When the sensitivity analyses disclosed in accordance with paragraphs 40 or 41 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), does the entity	

disclose that fact and the reason it believes the sensitivity analyses are unrepresentative?	

Chapter XX

TERMINOLOGY

Amortised Cost: 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

Associates: an associate is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor.

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

Call Option: Call Option is right to buy at a fixed price, on or before a fixed date, a fixed quantity.

Cash flow hedge: A cash flow hedge is hedging the exposure to changes in the cash flows attributable to a particular risk associated with a recognised asset, liability, or highly probable forecasted transaction that could affect reported profit or loss.

Compound instrument: Compound Instruments are financial instruments, which has the component of both equity and liability.

Credit risk: Credit Risk refers to the risk that one party to the financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

Currency Risk: Currency Risk is the risk that fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

Currency swap: Currency Swaps are contracts that require exchange of currencies at a future date at a fixed rate

*Derecognition****: It is the removal of a previously recognised financial asset or financial liability from an entity's statement of financial position.***

*Derivatives****: A derivative is a financial instrument or other contract 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.

*Effective interest method****: 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.***

Effective interest rate: 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

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

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

*Fair value**: 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.***

Fair value hedge: A fair value hedge is hedge of exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion thereof that is attributable to a particular risk and can affect profit or loss

Financial asset: A financial asset is any asset that is:

(a) cash;

(b) an equity instrument of another entity;

(c) a contractual right:

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

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

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

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

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

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

Financial Instrument: A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

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

It is classified as held for trading

Upon initial recognition it is designated by the entity as at fair value through profit or loss.

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

(a) a contractual obligation:

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

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

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

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

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

Financial Risk: ***Financial risk is the risk of possible future change in one or more of 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 case of non-financial variable that variable is not specific to the party to the contract.***

Firm commitment: 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.

Forecast transaction: A forecast transaction is an uncommitted but anticipated future transaction.

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

Foreign currency risk: Foreign currency risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

Hedge accounting: Hedge accounting is the method of presentation of hedging transaction, which ensures that the gain or loss in hedging instrument is recognised in profit or loss in the same period when the item that is being hedged affects profit or loss.

Hedge effectiveness: Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument

Hedge item: A hedged item is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that exposes the entity to risk of changes in fair value or future cash flows and is designated as being hedged

Hedging instrument: A hedging instrument is a designated derivative or for a hedge of the risk of changes in foreign currency exchange rates only, a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item

Held for trading financial instruments: held for trading financial asset or financial liability are those that are:

(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; or

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

*Held-to-maturity investments**: Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity (see Appendix A paragraphs A36-A45) 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.

Impairment: Impairment is decrease in the recoverable amount of financial assets below its carrying value.

Interest rate risks: Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rate.

Joint venture: A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.

Liquidity risks: Liquidity risk is risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities.

Loans and receivables financial assets: 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.

Market risk: Market risk is the risk that the fair value or the future cash flow of the financial instrument will fluctuate because of the changes in the market price. It comprises of three types of risks, which are currency risk, interest rate risk and other price risk.

Measurement: Measurement is the process of determining the monetary amounts at which the elements of financial statements are to be recognised and carried in the statement of financial position and statement of comprehensive income.

Net investment hedge: A hedge of net investment in a foreign operation is a hedge of the foreign currency exposure to changes in reporting entity's share in the net assets of that foreign operation.

Options: Option is a contract which gives the holder the right to purchase (call option) or to sell (put option) the underlying future contract or security at a specified price within a specified period of time.

Option pricing models: Option pricing models are valuation technique used for determining the value of an option.

Perpetual debt instruments: Perpetual Debt instruments are financial instruments which normally provide the holder with the contractual rights to receive payments on account of interest at fixed dates extending into the indefinite future, either with no right to receive a return of principal or a right to a return of principal under terms that make it very unlikely or very far in the future.

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

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

Settlement date accounting: Settlement date accounting refers to the recognition of an asset on the day it is received by the entity, and the derecognition of an asset and recognition of any gain or loss on disposal on the day that it is delivered by the entity.

Swap: A Swap is a simultaneous buying and selling of the same security or obligation.

Trade date: The trade date is the date that an entity commits itself to purchase or sell an asset

Trade date accounting: Trade date accounting refers to the recognition of an asset to be received and the liability to pay for it on the trade date, and 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.

Transaction costs: Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. In other words, it is the cost that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

Underlying: An underlying is the variable that along with either a notional or a payment provision determines the settlement amount of a derivative

Weather derivatives: Weather derivatives are contracts requiring payments based on climatic variable

Top

PART C

GUIDE TO FIRST TIME ADOPTION OF IFRS- IFRS 1

Chapter XXI

INTRODUCTION TO IFRS 1

ORIGIN OF IFRS 1

Companies listed on the European Stock Exchange were required to present their separate and consolidated accounts in accordance with IFRS 1 from 2005.Therefore The International Accounting Standards Board initiated a project for providing guidance and assistance to the first time adopters and published its first IFRS 1 First-time Adoption of International Financial Reporting Standards on 19th June 2003. The new standard provides guidance in difficult areas such as the use of hindsight and the application of successive versions of the same standards.

Prior to the adoption of IFRS 1 as stated above , the guidance related to first time adoption of accounting standards was detailed in SIC-8 First-Time Application of IASs However there were

inherent difficulties faced by the first time adopting entities in complying with the provisions in SIC -8

Under SIC 8, in the period of first-time application of IASs as the primary accounting basis, the financial statements of an enterprise, including comparative information, should be prepared and presented as if the financial statements had always been prepared in accordance with the IASs effective for the period of first-time application. Therefore, the Standards and Interpretations should be applied retrospectively except when Standards or Interpretations require or permit a different transitional treatment or when the amount of the adjustment relating to prior periods cannot be reasonably determined. Adjustment amounts should be treated as an adjustment to the opening balance of retained earnings of the earliest period presented in accordance with IASs. If adjustments relating to prior periods or comparative information cannot be determined, the fact should be disclosed

These difficulties faced by the enterprises led to the replacement of SIC-8 by IFRS-1 as the standard for first time transition by the IASB. IFRS 1 has significant improvements over SIC-8 which is detailed out below:

1. IFRS- 1 requires an entity to follow all the accounting standards in the preparation and presentation of its financial statements which are effective at the reporting date thus ignoring previous superseded versions of standards which were effective some time earlier, but have become redundant on the date of transition.

For eg an entity which carries out the transition in 2009 has to comply with the standards effective 31st December 2009.

IFRS 1 also permits an entity to apply a new IFRS that is not yet mandatory if that standard allows early application.

2. In its basis for conclusions, the Board mentioned that IFRS 1 is drafted to give priority to achieving comparability over time within a first-time adopter's first IFRS financial statements and between different entities adopting IFRS for the first time at a given date and that achieving comparability between first-time adopters and entities that already apply IFRS is a secondary objective. On the other hand SIC-8 gave priority to ensuring comparability between a first-time adopter and entities already adopting IFRS.

On 27 November 2008, the International Accounting Standards Board (IASB) issued a revised version of IFRS 1 First-time Adoption of International Financial Reporting Standards. The objective of the revision was to restructure the Standard to improve its readability and clarity – no new or revised technical material was introduced. The November 2008 revisions (exposed as part of the 2007 improvements project) are designed to make the Standard clearer and easier to follow by reorganizing and moving to appendices most of the Standard's numerous exceptions

and exemptions. The improved structure was also intended to accommodate future changes to the Standard.

The Material has been reorganized within appendices as follows:

- exceptions to the retrospective application of other IFRSs (new Appendix B);
- exemptions for business combinations (new Appendix C);
- Exemptions from other IFRSs (new Appendix D).
- Interestingly, the Board has created another appendix (Appendix E) which could be used for future possible short-term exemptions from IFRSs on first-time adoption.

The revised version is effective for entities applying IFRSs for the first time for annual periods beginning on or after 1 January 2009. Earlier application is permitted.

STRUCTURE OF IFRS 1

IFRS 1 is set out in Paras 1-47 and Appendices A-C

- Appendix A- Defined Terms
- Appendix B- Business combinations
- Appendix C- Amendments to other IFRS (now incorporated in the relevant IFRS)
- Appendix D- Exemptions from other IFRSs
- Appendix E - Short-term exemptions from IFRSs

KEY DEFINTIONS as set out in Appendix A

1. **First time Adopter:** An entity that presents its first IFRS financial statements
2. **First IFRS financial Statements:** The First annual financial statements in which an entity adopts IFRS by an explicit and unreserved statement of compliance with IFRS
3. **First IFRS reporting period**: The latest reporting period covered by an entity's first IFRS financial statements
4. **Opening IFRS statement of financial position**: An entity's statement of financial position at the date of transition to IFRSs
5. **Date of transition to IFRSs**: The beginning of the earliest period for which an entity presents full comparative information under IFRSs in its first IFRS financial statements

OBJECTIVE OF IFRS 1

The objective of IFRS 1 is to ensure that an entity's first IFRS financial statements and its first IFRS interim financial statements contain high quality financial information that:

(a) Is transparent for users and comparable over all periods presented;

(b) Provides a suitable starting point for accounting under IFRS; and

(c) Can be generated at a cost that does not exceed the benefits to users.

SCOPE OF IFRS 1

An entity shall apply this IFRS 1 in:

(a) Its first IFRS financial statements; and

(b) each interim financial report, if any, that it presents in accordance with IAS 34 *Interim Financial Reporting* for part of the period covered by its first IFRS financial statements.

The first IFRS statements are the first annual financial statement in which the entity makes an explicit and unreserved statement of compliance with IFRS. . This means IFRS-1 does not apply to entities that already apply IAS /IFRS.

Most companies will apply IFRS 1 when they move from local GAAP to IFRS. In India, all public interest entities will be required to adopt IFRS for all accounting periods beginning on or after 1st April 2011. IFRS 1 must also be applied when a company's previous financial statements:

i. Was prepared under national GAAP not consistent with IFRS in all respect. included a reconciliation of some items from a previous GAAP to IFRS;

ii. complied with some, but not all, IFRS in addition to a previous GAAP – for example, in areas where there is no previous GAAP guidance; or

iii. complied with IFRS in all respects in addition to a previous GAAP, but did not include an explicit and unreserved statement of compliance.

An entity can also be a first-time adopter if, in the preceding year, its published financial statements asserted:

I. Compliance with some but not all IFRSs.

II. Included only a reconciliation of selected figures from previous GAAP to IFRSs. (Previous GAAP means the GAAP that an entity followed immediately before adopting to IFRSs.)

An entity may be a first-time adopter if, in the preceding year, it prepared IFRS financial statements for internal management use, as long as those IFRS financial statements were not and given to owners or external parties such as investors or creditors. If a set of IFRS financial statements was, for any reason, given to an external party in the preceding year, then the entity will already be considered to be on IFRSs, and IFRS 1 does not apply.

However, an entity **is not a first-time adopter** if, in the preceding year, its published financial statements asserted:

- Compliance with IFRSs even if the auditor's report contained a qualification with respect to conformity with IFRSs.
- Compliance with both previous GAAP and IFRSs.

Some situations to explain when IFRS 1 can be applied

1. Can an offering document contain the first IFRS financial statements?

Yes, if the financial statements included in the offering document contains an explicit and unreserved statement of compliance with IFRS it will be the first IFRS financial statements provided complete set is presented with comparative previous year information as required by IAS 1. The context in which the financial statements are prepared is not relevant to deciding whether or not they are the first IFRS financial statements. IFRS 1 should not be applied to the financial statements issued after the offering.

2. Can management of an existing IFRS reporter apply the exemptions of IFRS 1 to an entity's financial statements by dropping an explicit and unreserved statement of compliance with IFRS from its financial statements?

Yes. Deleting the statement of compliance with IFRS means that the financial statements will not be IFRS financial statements, even though entity has been preparing IFRS financial statements for several years. Entity's subsequent financial statements will therefore be entity's first IFRS financial statements.

3. Can an entity use a new holding company to create the first IFRS financial statements?

No. The creation of a new parent entity just to hold the group is a transaction that has no substance. The transaction should be ignored, and the first financial statements of the new parent entity should be prepared on the basis that the original parent continues as the preparer of the group financial statements.

4. Can management apply IFRS 1 when an entity's previous financial statements were qualified?

No. IFRS 1 is not applied when an entity previously prepared financial statements that contained an explicit statement of compliance with IFRS, but for which the auditors' report was qualified.

5. Can IFRS 1 be applied when an entity previously complied with some, but not all, IFRSs?

Yes. IFRS 1 is applied when an entity's previous financial statements did not contain an explicit and unreserved statement of compliance with IFRS. The statement that the financial statements complied with some, but not all, IFRSs is not an explicit and unreserved statement of compliance.

TRANSITION DATE FOR IFRS AND PREPARING OPENING STATEMENT OF FINANCIAL POSITION AT DATE OF TRANSITION

For Indian companies transiting to IFRS from 2011 and required to make comparative statements for one preceding year and having financial year from April to March, the date of transition would be 1st April 2010 and for companies having financial year from January to December date of transition would be 1st January 2010.

An entity's first IFRS financial statements must include at least one comparative period, but an entity may elect or be required to provide more than one comparative period. The beginning of the earliest comparative period for which the entity presents full comparative information under IFRS will be treated as its date of transition to IFRS.

The opening IFRS statement of financial position is the starting point for all subsequent accounting under IFRS. Companies should prepare an opening IFRS statement of financial position at 'the date of transition to IFRS'. This statement of financial position forms the basis for preparation of financial statements for eg opening statement of financial position is required for, and integral to an equity reconciliation that has to be presented in an entity's first IFRS financial statements.

The opening statement of financial statement has to be prepared as on this date however, the same need not be published in the first IFRS financial statements**.**

In preparing opening statement of financial position entity must: follow the ***Recognition & Measurement principles of IFRS 1***

Chapter XXII

RECOGNITION & MEASUREMENT PRINCIPLES OF IFRS 1

IFRS 1 requires a first-time adopter to use the same accounting policies including general principle of retrospective application, optional exemptions and mandatory exceptions in its opening IFRS statement of financial position and all periods presented in its first IFRS financial statements The selection of accounting policy among diverse existing alternatives as per IFRS standards should be done carefully , fully understanding its implication on both the opening IFRS statement of financial position and the financial statements of future periods.

A number of standards allow companies to choose between alternative policies. Companies should select the accounting policies to be applied to the opening IFRS statement of financial position carefully, with a full understanding of the implications on both the opening IFRS statement of financial position and the financial statements of future periods.

A company may apply a standard that has been issued at the reporting date, even if that standard is not mandatory, as long as the standard permits early adoption.

As a first time adopter is required to comply with all IFRS standards effective at the reporting date, it is evident that the transitional provisions of individual IFRS do not apply to first .time adopter. Instead the opening statement of financial position is prepared by a first time adopter only in accordance with IFRS-1. The IASB has stated that it will provide specific guidance for first-time adopters in all new standards.

Therefore for a first-time adopter, the requirements in IFRS 1 override the transitional provisions in other IFRS. There are limited exceptions [IFRS 1.9] to this general rule relating to

(1) Insurance contracts and

(2) Assets classified as held for sale and discontinued operations

(3) IFRIC relating to *determining whether an Arrangement contains a Lease*.

(4) Financial assets or intangible assets accounted for in accordance with IFRIC12

(5) Provisions relating to Borrowing costs (IAS 23).

In these cases IFRS 1 specifically requires application of the transitional rules in the relevant IFRS. It is important to note that the transition rules for first-time adopters and entities that already report under IFRS may differ significantly.

OPENING STATEMENT OF FINANCIAL POSITION

Generally a first time adopter shall comply with the following requirements of IFRS-1 in its opening statement of financial position:

(a) recognise all assets and liabilities whose recognition is required by IFRSs;

i. IAS 39 requires recognition of all derivative financial assets and liabilities, including embedded derivatives. These were not recognised under many local GAAPs.

ii. IAS 19 requires an employer to recognise its liabilities under defined benefit plans. These are not just pension liabilities but also obligations for medical and life insurance, vacations, termination benefits, and deferred compensation. In the case of "over-funded" plans, this would be a defined benefit asset.

iii. IAS 37 requires recognition of provisions as liabilities. Examples could include an entity's obligations for restructurings, onerous contracts, decommissioning, remediation, site restoration, warranties, guarantees, and litigation.

iv. Deferred tax assets and liabilities would be recognised in conformity with IAS 12.

A Case Study

Entity X occupies its factory shed on a 30-year lease. The useful life of the shed is estimated to be 35 years and the net present value of the minimum lease payments at the inception of the lease amounted to 90% of the fair value of the shed. Entity X has accounted for the lease arrangements as an operating lease under Indian GAAP. If Entity x has to transit to IFRS what adjustments should be made on the opening IFRS statement of financial position?

Solution

The management of entity X should recognise the building as property, plant and equipment and should recognise a finance lease liability instead of operating lease in accordance with IAS 17as the lease is for over 85% of the useful life of the building and the net present value of the minimum lease payments is equivalent to substantially all of the fair value of the property at the inception of the lease. Therefore Entity X should record the building as an asset at the net present value of the minimum lease payments at the inception of the lease, less appropriate depreciation. Entity X should also record a finance lease liability at the net present value of the minimum lease payments at the inception of the lease; less capital repayments calculated using the rate of interest implicit in the lease.

The difference between the amounts recorded as property, plant and equipment and the amount recorded as finance lease liability should be

included in retained earnings

(b) Not recognise items as assets or liabilities if IFRSs do not permit such recognition;

For example:

IAS 38 does not permit recognition of expenditure on any of the following as an intangible asset:

- research
- start-up, pre-operating, and pre-opening costs
- training
- advertising and promotion
- moving and relocation

If the entity's previous GAAP had allowed accrual of liabilities for "general reserves", restructurings, future operating losses, or major overhauls that do not meet the conditions for recognition as a provision under IAS 37, these are eliminated in the opening IFRS statement of financial position.

If the entity's previous GAAP had allowed recognition of reimbursements and contingent assets that are not virtually certain, these are eliminated in the opening IFRS statement of financial position.

Treasury shares are not recognized as assets in the IFRS.

Deferred tax assets, when recovery is not probable are derecognized as per IFRS.

A Case Study
An Entity manufactures textile weaving machines. The machines require installation, which is done by entity's own employees and takes nearly four weeks. An additional charge is added to the sales invoice to cover the costs of installation. Entity recognizes revenue from the sale of the machines when they are delivered to the customer's premises. There are always a number of installations in progress at the end of each financial year. In entity has to converge to IFRS what adjustments should be made for the opening IFRS statement of financial position?
Solution The entity should exclude from the opening IFRS statement of financial position any receivables recorded previously in connection with machines that have not been installed as IAS 18 requires that revenue is recognised when the buyer accepts delivery and installation and inspection are complete. Revenue cannot be recognised in connection with machines that have not been installed, so any receivable recorded should be excluded from the opening IFRS statement of financial position. The revenue should be recognised in subsequent year when installation is complete and customer has accepted the product. The machines delivered but not yet installed and accepted should be recognised as inventory at cost. The corresponding adjustment is made to reduce retained earnings.

(c) reclassify items that it recognised in accordance with previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity in accordance with IFRSs;

i. IAS 10 does not permit classifying dividends declared or proposed after the balance sheet date as a liability at the balance sheet date. In the opening IFRS statement of financial position these would be reclassified as a component of retained earnings.

ii. If the entity's previous GAAP had allowed treasury stock (an entity's own shares that it had purchased) to be reported as an asset, it would be reclassified as a component of equity under IFRS.

iii. Items classified as identifiable intangible assets in a business combination accounted for under the previous GAAP may be required to be classified as goodwill under IAS 22 because they do not meet the definition of an intangible

asset under IAS 38. The converse may also be true in some cases. These items must be reclassified.

iv. Some offsetting (netting) of assets and liabilities or of income and expense items that had been acceptable under previous GAAP may no longer be acceptable under IFRS

(d) Apply IFRSs in measuring all recognised assets and liabilities.

The general measurement principle is to apply IFRS in measuring all recognised assets and liabilities. Therefore, if an entity adopts IFRS for the first time in its annual financial statements for the year ended 31 December 2011, in general it would use the measurement principles in IFRSs in force at 31 December 2011.

Financial instruments are valued at fair value or amortised cost under IAS 39.

Pension liabilities are valued as per IAS 19 and involves detailed and complex calculations

Provisions are calculated using the best estimate as per IAS 37

Impairment of assets is checked as per the detailed complex calculation as per IAS 36.

All items like receivables (IAS 18), employee benefit obligations (IAS 19), deferred taxation (IAS 12), financial instruments (IAS 39), provisions (IAS 37), impairments of property, plant and equipment and intangible assets (IAS 36), assets held for disposal (IFRS 5), share-based payments, etc. are measured in accordance with IFRS

Resulting Adjustments required on account f moving from previous GAAP to IFRS at the time of first-time adoption.

The transition to IFRS could result in an entity having to change its accounting policies on recognition and measurement. The effect of this is recognized

- Directly in retained earnings or other appropriate category of equity in the opening IFRS balance sheet prepared at the date of transition to IFRSs,

For example, an entity that applies the IAS 16 – Property, Plant and Equipment – revaluation model in its first IFRS financial statements would recognize the difference between cost and the revalued amount of property, plant and equipment in a revaluation reserve. Conversely, an entity that had applied a revaluation model under its previous GAAP, but decided to apply the cost model under IAS 16 would reallocate the revaluation reserves to retained earnings.

There are significant disclosure requirements relating to changes in accounting policies on transition to IFRS. The information gathering and reporting systems of the entities should be

suitably modified to deliver correct presentation and disclosure requirements as per IFRS in the opening and subsequent period statement of financial positions of the first time adopters.

EXCEPTIONS TO THE PRINCIPLE THAT AN ENTITY'S OPENING STATEMENT SHALL COMPLY WITH EACH IFRS

1. Exceptions from other IFRS

2. Exceptions to retrospective application of other IFRSs

Optional Exemption to retrospective application

Fourteen exemptions are designed to allow companies some relief from full retrospective application so as to simplify the task of convergence. However, the application of the exemptions is also not very straightforward. Some exemptions allow for alternative ways of applying the relief and others have conditions attached an entity may elect to use one or more of the following 14 exemptions:

a) business combinations

b) *fair value* or revaluation as *deemed cost*

c) employee benefits

d) cumulative translation differences

e) compound financial instruments

f) assets and liabilities of subsidiaries, associates and joint ventures

g) designation of previously recognised financial instruments

h) share-based payment transactions

i) insurance contracts

j) decommissioning liabilities included in the cost of property, plant and equipment

k) leases

l) fair value measurement of financial assets or financial liabilities at initial recognition;

m) a financial asset or an intangible asset accounted for in accordance with IFRIC 12 *Service Concession Arrangements* and

n) borrowing costs

An entity shall not apply these exemptions by analogy to other items.

Now we shall look into each of this optional exemption one by one:

a) BUSINESS COMBINATION- APPENDIX C

Exemptions for business combinations

The IASB issued the latest revised version of IFRS 3 – Business Combinations in January 2008. which comes into effect for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1st July 2009. The standard permits earlier application, provided that IAS 27 as amended in 2008 is applied at the same time.

For all transactions qualifying as business combinations under IFRS 3, an entity being a first time adopter has three choices viz.

i. Not restate business combinations before the date of transition.

ii. Restate all business combinations before the date of transition.

iii. Restate a particular business combination, in which case all subsequent business combinations must also be restated and the IAS 36 impairment guidance must be applied.

The entity applying IFRS 3 as stated above has to comply with the following provisions of the standard:

Applying the acquisition method i.e. retrospective application

- A business combination must be accounted for by applying the acquisition method.
- An acquirer shall be identified for all business combinations.
- The cost of the business combination must be calculated.
- The IFRS establishes principles for recognising and measuring the identifiable assets acquired, including any additional intangible assets under IAS 38 Intangible Assets and the liabilities assumed, including any contingent liabilities and any non-controlling interest in the acquiree.
- Each identifiable asset and liability is measured at its acquisition-date fair value. Any non-controlling interest in an acquiree is measured at fair value or as the non-controlling interest's proportionate share of the acquirer's net identifiable assets.
- The IFRS requires the acquirer, having recognised the identifiable assets, the liabilities and any non-controlling interests, to identify any difference between:

- the aggregate of the consideration transferred, any non-controlling interest in the acquiree and, in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree; and
- the net identifiable assets acquired.

The difference will, generally, be recognised as goodwill. If the acquirer has made a gain from a bargain purchase that gain is recognised in profit or loss.

- Not amortise goodwill thus determined as per previous clause.
- Carry out an impairment test of assets as per IAS 36 Impairment of Assets during each annual period subsequent to the date of acquisition.

The retrospective application of IFRS 3 by a first time adopter could be onerous and in many cases impracticable because it requires an entity to review all the business combinations since its incorporation and to recreate every information that was not collected at the time of business combination but is required for retrospective application at the date of transition to IFRS. Moreover, from the date that a company applies IFRS 3 to its business combinations, it must also comply with IAS 27 and IAS 36.

To ease the burden of restating following retrospective application of IFRS3, IFRS1 includes an optional exemption. The exemption provides that an entity that chooses to apply exemption provided in IFRS 1 is not required to restate business combinations to comply with IFRS 3, *Business Combinations*, where control was obtained before the transition date. The exemption is available to all transactions that meet the definition of a business combination under IFRS 3. The classification under Indian GAAP is not relevant for determining whether the exemption can be applied. The exemption also applies to acquisitions of investments in associates and joint ventures.

However, application of the exemption is complex and certain adjustments must be made.

If a first-time adopter restates any business combination to comply with IFRS 3 (as amended in 2008), it shall restate all later business combinations and shall also apply IAS 27 (as amended in 2008) from that same date. For example, if a first-time adopter elects to restate a business combination that occurred on 30 June 20X6, it shall restate all business combinations as per IFRS 3 that occurred between 30 June 20X6 and the date of transition to IFRSs, and it shall also apply IAS 27 (amended 2008) from 30 June 20X6. The optional exemption will however be available for all the business combinations before 30 June 20X6. as per IFRS1.

The adjustments to recognized goodwill, other assets and liabilities under previous GAAP and reversal of goodwill amortization under previous GAAP related to business combination are

treated retrospectively in accordance with IFRS 3 and effect is directly recognized in retained earnings.

Reversal of previously amortised goodwill and testing of the goodwill for impairment is done from the date the IFRS 3 is followed retrospectively by a first time adopter. If from the date of transition, such restatement as per IFRS 3 is made, the reversal and impairment testing is done in the retained earnings as on date of transition or if from an earlier date such restatement is done, then the reversal and impairment is carried out for all the intervening periods i.e. from the date of retrospective restatement to the date of transition.

Application of optional exemption

Under the previous GAAP, an entity may have followed some other method for accounting for business combination

For eg :

- Acquisition method as prescribed by IFRS 3
- Uniting of interests method
- Reverse Acquisition method

If optional exemption is elected by a first time adopter, then it shall retain the same classification as was under previous GAAP, On the other hand, if an entity elects to apply IFRS 3 retrospectively, it shall comply with the provisions of IFRS 3 which permits only acquisition method for accounting business combinations.

The first-time adopter shall recognise all its assets and liabilities at the date of transition to IFRSs that were acquired or assumed in a past business combination, other than:

(i) some financial assets and financial liabilities derecognised in accordance with previous GAAP (paragraph B2); and

(ii) assets, including goodwill, and liabilities that were not recognised in the acquirer's consolidated statement of financial position in accordance with previous GAAP and also would not qualify for recognition in accordance with IFRSs in the separate statement of financial position of the acquiree

Most assets or liabilities will be adjusted through retained earnings except for the following two cases where adjustment is made in goodwill:

Goodwill is increased/decreased for an intangible asset recognized/ not recognised under Indian GAAP that does not qualify/qualify for recognition as an asset under IAS 38, or

Goodwill is impaired at the transition date after applying IAS 36.

Goodwill

The goodwill shall be adjusted at the date of transition for the following items only in case optional exemption for business combination is used:

(a) Intangible assets

Previous GAAP	**IFRS**	**Treatment to Goodwill**
Recognised	Not Recognised	Carrying amount at the date of transition of intangible assets (less deferred tax and non controlling interests) is added to goodwill
Not Recognised i.e. *intangible assets subsumed within goodwill*	Recognised	The amount at which the intangible assets would have been recognized in the separate IFRS financial statements of the subsidiary at the date of transition less (deferred tax and non controlling interests) is deducted from goodwill.

Goodwill shall also be adjusted on account of the following:

(b) Contingency affecting the amount of purchase consideration:

If the contingency has been settled and resolved before the date of transition although the effect has not been shown in the goodwill under previous GAAP then , goodwill as at the date of transition is adjusted for the amount of contingency.

Goodwill adjustment is also done when payment of the contingent amount is considered probable based on the reliable estimate calculated by the entity.

Impairment of Goodwill

Any resulting impairment of goodwill carried out at the date of transition is reflected as adjustment to goodwill. This requirement for testing impairment is compulsory as per IAS 36 without regard to any indication about impairment and based on the conditions existing at the transition date and in any resulting impairment loss is recognized in retained earnings (or, if so required by IAS 36, in revaluation surplus).

No other adjustments shall be made to the carrying amount of goodwill at the date of transition to IFRS. IFRS 1 highlights the following examples for which goodwill is not adjusted

- to exclude in process research and development acquired in that business combination (unless the related intangible asset would qualify for recognition in accordance with IAS 38 in the statement of financial position of the acquiree);
- to adjust previous amortisation of goodwill;
- to reverse adjustments to goodwill that IFRS 3 would not permit, but were made in accordance with previous GAAP because of adjustments to assets and liabilities between the date of the business combination and the date of transition to IFRSs.

Goodwill deducted directly from equity

If the first-time adopter recognised goodwill in accordance with previous GAAP as a deduction from equity then that goodwill is neither shown as an asset under the opening statement of financial position nor is it shown as a separate component of equity. Instead it is deducted directly from retained earnings.

Furthermore, on disposal of the subsidiary or if the investment in the subsidiary becomes impaired. which gave rise to goodwill previously deducted from equity, the amount recognized in the retained earnings at the date of transition is not transferred to profit or loss as part of net gain or loss on disposal.

Subsequent adjustments to goodwill previously deducted from equity resulting from the subsequent resolution of a contingency affecting the purchase consideration shall be recognised in retained earnings

Negative goodwill

Any negative goodwill recognised under previous GAAP is derecognized with corresponding adjustment to retained earnings at the date of transition.

To summarise the provisions relating to exemption with respect to business combination, it is evident that application of the exemption is complex, and certain adjustments to transactions may still be required. The following points should be kept in mind when exemption is availed of:

- Classification of the combination as an acquisition or a pooling of interests does not change.
- Assets and liabilities acquired or assumed in the business combination are recognized in the acquirer's opening IFRS statement of financial position, unless IFRS does not permit recognition.

- Deemed cost of assets and liabilities acquired or assumed is equal to the carrying value under Indian GAAP immediately after the business combination.

- Assets and liabilities that are measured at fair value under IFRS are restated to fair value in the opening IFRS statement of financial position, with the offset being recorded in equity

- Assets and liabilities that were not recognized under Indian GAAP immediately after the business combination are recognized on the opening IFRS statement of financial position only if they would be recognized in the acquired entity's separate IFRS statement of financial position.

- Goodwill must be tested for impairment at the date of transition to IFRS, using the impairment testing method required by IAS 36

b) FAIR VALUE OR REVALUATION AS DEEMED COST

Normally under IFRS property, plant and equipment are measured using either cost model or revaluation model. Under cost model they are carried at cost less accumulated depreciation and accumulated impairment. Under revaluation model they are valued at each reporting date. As per IFRS 1, for property, plant and equipment, an entity can choose to measure the value using:

- Cost in accordance with IFRS.

- Fair value at the date of transition as deemed cost.

A revaluation carried out at a previous date (such as an IPO) as deemed cost, subject to certain conditions

This exemption is very beneficial to entities as they need not dig in the records of previous year to remeasure depreciation and amortization amounts in previous years. It should be noted that an entity that applies the fair value as deemed cost exemption at the IFRS transition date is not required to revalue these assets in subsequent periods. When the exemption is applied, deemed cost is the basis for subsequent depreciation and impairment tests. The "fair value as deemed cost" exemption may be applied on an asset-by-asset basis. Moreover, this exemption can also be applied to investment property if an entity elects to use the cost model in IAS 40, *Investment Property,* or to intangible assets that meet both the recognition and revaluation criteria in IAS 38, *Intangible Assets.* However, it cannot be applied to any other assets or liabilities.

c) EMPLOYEE BENEFITS

The objective of IAS 19 is to prescribe the accounting and disclosure for employee benefits (that is, all forms of consideration i.e. wages and salaries profit sharing plans ,bonuses etc given by an enterprise in exchange for service rendered by employees

Types of Post-employment Benefit Plans

The accounting treatment for a post-employment benefit plan will be determined according to whether the plan is a

- defined contribution or
- a defined benefit plan

Under a defined contribution plan, the enterprise pays fixed contributions into a fund but has no legal or constructive obligation to make further payments if the fund does not have sufficient assets to pay all of the employees' entitlements to post-employment benefits. In these plans, the cost to be recognised in the period is the contribution payable in exchange for service rendered by employees during the period.

A defined benefit plan is a post-employment benefit plan other than a defined contribution plan. These would include both formal plans and those informal practices that create a constructive obligation to the enterprise's employees.

Under these plans, the present value of the defined benefit obligation should be determined using the Projected Unit Credit Method.

The employee benefits will be treated in accordance with the general principle of retrospective application i.e. any changes in the accounting policies are made retrospectively and the effect is shown in the retained earnings. There is no exemption in this area.

The relevant provisions of IAS 19 are summarized below in table format:

Relevant category	**Treatment in the financial statements**
Calculation under IAS 19 For defined benefit plans,	Projected Unit Credit Method The amount recognised in the statement of financial position should be the present value of the defined benefit obligation (that is, the present value of expected future payments required to settle the obligation resulting from employee service in the current and prior periods), as adjusted for unrecognised actuarial gains and losses and less unrecognised past service cost, and reduced by the fair value of plan assets at the balance sheet date.
Actuarial valuations , actuarial gains and losses	***Possibility to roll forward or back*** Measurements of employee benefit obligations at three dates: the end of the first IFRS reporting period, the date of the comparative statement of financial position and the date of transition to IFRSs is cumbersome. So an actuary can be engaged to carry out a detailed actuarial valuation at one or

	two of these dates and roll the valuation(s) forward or back to the other date(s). Any such roll forward or roll back reflects any material transactions and other material events (including changes in market prices and interest rates) between those dates (IAS 19 paragraph 57).
Estimates	***Apply guidance on estimates as per IFRS -1*** After adjustments to reflect any difference in accounting policies, the first time adopter shall make actuarial assumptions at the date of transition to IFRSs that are consistent with actuarial assumptions made for the same date in accordance with previous GAAP, unless there is objective evidence that those assumptions were in error .If certain assumptions were not made under previous GAAP then IFRS 1 requires that the estimates reflect market conditions at the date of transition (eg of discount rates and fair value of plan assets at the date of transition to IFRSs).The impact of any later revisions to those assumptions is an actuarial gain or loss of the period in which the entity makes the revisions and are not reflected in the calculation of pension liabilities at the date of transition.
Past service cost	Is the term used to describe the change in the obligation for employee service in prior periods, arising as a result of changes to plan arrangements in the current period. Past service cost may be either positive (where benefits are introduced or improved) or negative (where existing benefits are reduced). Past service cost should be recognised immediately to the extent that it relates to former employees or to active employees already vested. Otherwise, it should be amortised on a straight-line basis over the average period until the amended benefits become vested

Actuarial gains and losses – The corridor approach

The provisions for Valuations in respect of defined benefit plans are calculated on the basis of a large number of actuarial assumptions such as employee turnover, discount rates, inflation, future salary increase, expected long term return on plan assets and are carried out with sufficient regularity such that the amounts recognised in the financial statements do not differ materially from those that would be determined at the balance sheet date. The assumptions used for the purposes of such valuations should be unbiased and mutually compatible. The rate used to discount estimated cash flows should be determined by reference to market yields at the balance sheet date on high quality corporate bonds.

On an ongoing basis, actuarial gains and losses arise that comprise

- Experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred)
- Effects of changes in actuarial assumptions.
- The difference between the expected return and actual return on plan assets.

Over a long time period, actuarial gains and losses may offset one another and therefore the enterprise is not required to recognise all such gains and losses immediately. The Standard specifies that if the accumulated unrecognised actuarial gains and losses exceed 10% of the greater of the defined benefit obligation or the fair value of plan assets, a portion of that net gain or loss is required to be recognised immediately as income or expense. The portion recognised is the excess divided by the expected average remaining working lives of the participating employees. Actuarial gains and losses that do not breach the 10% limits described above (the 'corridor') need not be recognised - although the enterprise may choose to do so. Over the life of the plan, changes in benefits under the plan will result in increases or decreases in the enterprise's obligation.

The retrospective application of the corridor approach would require cumulative actuarial gains and losses from the inception of each pension plan to be split into recognized and unrecognized gains and losses at each balance sheet date. This would be impracticable for a first time adopter unless the entity has data readily available under previous GAAP by following similar accounting practice as in IAS 19 for employee benefits. Thus IFRS 1 applies optional exemption to retrospective application of the corridor approach.

Thus through this optional exemption a first-time adopter is allowed to recognise all cumulative actuarial gains and losses at the date of transition to IFRSs in retained earning without requiring them to be recycled through profit or loss account subsequently. This election, however does not preclude it from using the corridor approach for later actuarial gains and losses.

This exemption may result in a significant charge to equity at the date of transition, however this is compensated by avoiding the amortizing the accumulated losses in profit and loss account over a period. Thus those actuarial gains and losses which arise subsequent to the date of transition will be recognized in the profit and loss account.

d) CUMULATIVE TRANSLATION DIFFERENCES

Retrospective application of IAS 21, *The Effects of Changes in Foreign Exchange Rates,* would require a company to determine the foreign currency translation differences in accordance with IFRS from the date on which a foreign operation was formed or acquired. This would mean restating the currency translation reserve to what it would have been had IFRS always been applied. Restatement requires an entity to recreate the IFRS financial statements of every subsidiary since each one was acquired or created and to calculate currency adjustments for each

year through to transition date. The cost of restating is likely to outweigh the benefit for most entities. However, the exemption allows a company to apply IAS 21 prospectively. All cumulative translation gains and losses as of the transition date are reset to zero through an adjustment to opening retained earnings and gains or losses on subsequent disposals of foreign operations will exclude translation differences that arose before the transition date. Translation differences arising after the transition date are recorded in other comprehensive income.

e) COMPOUND FINANCIAL INSTRUMENTS

IAS 32 requires a company to split a compound financial instrument at inception into separate liability and equity components according to substance of the contract. Two entries remain in equity when the liability component of a compound financial instrument has been repaid - the original equity component and the interest on the liability component that is part of retained earnings. However, IFRS 1 exemption provides that if the liability component is no longer outstanding at the transition date, a first-time adopter does not have to separate it from the equity component in the equity. If the liability component is outstanding at the transition date, companies will need to bifurcate the two elements of equity and measure the components in accordance with IAS 32.

f) ASSETS AND LIABILITIES OF SUBSIDIARIES, ASSOCIATES, AND JOINT VENTURES

A parent and its subsidiaries 9or associate or joint venture) might adopt IFRS at different dates. For instance, an Indian parent company might prepare its first IFRS financial statements at December 31, 2014, while its subsidiary in U.S might not adopt IFRS for statutory reporting till 2014. In such cases, the exemption under IFRS 1 allows a subsidiary to measure its assets and liabilities either at the carrying amounts included in its parent's consolidated IFRS financial statements or on the basis of IFRS 1 as applied to its statutory financial statements at its own date of transition. However, when a subsidiary (joint venture or associates) elects to use the carrying amounts in its parent's consolidated financial statements, those carrying amounts are adjusted to exclude consolidation and acquisition adjustments.

Moreover, when a parent adopts IFRS after a subsidiary, the parent must measure the subsidiary's assets and liabilities in the consolidated financial statements using the subsidiary's existing IFRS carrying values. Most of the IFRS 1 voluntary exemptions cannot be used on an existing IFRS-reporting subsidiary. However, the subsidiary's carrying values are adjusted to include consolidation and acquisition adjustments.

A Case Study
Entity X, an Indian company, has a subsidiary in China that has already adopted

IFRS and filed its IFRS financial statements. The subsidiary opted to use fair value as deemed cost for certain property, plant and equipment as allowed by the IFRS 1 optional exemptions while adopting IFRS for the first time. Can entity X again avail of the exemption to fair value Chinese subsidiary's property, plant and equipment when transiting to IFRS?
Solution When Entity X converts to IFRS, it must carry over the value of the Chinese subsidiary's property, plant and equipment at the deemed cost less depreciation currently on the subsidiary's books. Therefore, Entity X cannot use the fair value as deemed cost exemption again for the Chinese subsidiary at the time of its own transition date.

g) DESIGNATION OF PREVIOUSLY RECOGNIZED FINANCIAL INSTRUMENTS

Entities will have to classify their financial assets and liabilities as if they had always applied IFRS. IAS 39 permits a financial instrument to be designated on initial recognition as a financial asset or financial liability at fair value through profit or loss (provided it meets certain criteria) or as available for sale. As per IAS 32 the choice is irrevocable i.e. a financial asset cannot be reclassified in and out of fair value through profit or loss account category. However, IFRS 1 allows an exemption from retrospective application by permitting such designations to be made at the date of transition.

This exception of designation at the date of transition instead of the designation at the initial recognition as required by IAS 39 is allowed because the first time adopter might have applied the provisions of previous GAAP at the date of initial recognition and has not been able to take the advantage of election available to the entities that already report under IFRS. .

Accordingly, an entity may choose to designate a financial instrument as a financial asset or financial liability "at fair value through profit or loss" or may designate a financial asset as available-for-sale at its transition date.

If the entity shall uses this exception it shall disclose the fair value of financial assets or financial liabilities designated into each category at the date of designation and their classification and carrying amount in the previous financial statements.

An entity shall treat an adjustment to the carrying amount of a financial asset or financial liability as a transition adjustment to be recognised in the opening balance of retained earnings at the date of transition to IFRSs only to the extent that it results from adopting IAS 39.

h) SHARE-BASED PAYMENT TRANSACTIONS

The share-*based payment transaction* are accounted for in accordance with IFRS 2.The standard requires an entity to reflect in its profit or loss and financial position the effects of share-based payment transactions, transactions with employees or other parties to be settled in cash, other assets, or equity instruments of the entity including expenses associated with transactions in which *share options* are granted to employees.

For equity-settled share-based payment transactions, the IFRS requires an entity to measure the goods or services received, and the corresponding increase in equity, directly, at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If the entity cannot estimate reliably the fair value of the goods or services received, the entity is required to measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted. This amount is recognized at the grant date or allocated over the vesting period if any attached to the scheme.

An entity need only apply IFRS 2, Share-based payments, to equity instruments granted before 7 November 2002 (i.e. the date when IFRS 2 was issued) and to those granted after 7 November 2002 which were not vested by the later of transition date. However, share based payment granted after 7 November 2002 which has not vested till the date of transition entities would be required to apply IFRS 2. Similarly only liabilities arising from cash-settled share-based payments arising after 7 November 2002 and not settled by the later of transition date are captured. A first-time adopter may choose to apply IFRS 2 to other instruments but only if the entity has previously disclosed publicly the fair value of the instruments, determined at the measurement date.

The relevant provisions of IFRS 2 relating to first time adopter are summarized below in table format:

Grant date	**Application of IFRS 2**	**Conditions to be complied with**
Granted on or before 7 November 2002.**	A first-time adopter is encouraged, but not required, to apply IFRS 2 *Share-based Payment* to these equity instruments	A first-time adopter shall

Granted after 7 November 2002 and vested before the later of (a) the date of transition to IFRSs and (b) 1 January 2005.**	A first-time adopter is encouraged, but not required, to apply IFRS 2 to these equity instruments.	nevertheless disclose the information required by paragraphs 44 and 45 of IFRS 2.in all these cases without regard to grant and vesting dates
Granted after 7 November 2002 and vested after1 January 2005.	IFRS 2 must be applied retrospectively with changes to comparative information.	

* * However, if a first-time adopter elects to apply IFRS 2 to such equity instruments, it may do so only if the entity has disclosed publicly the fair value of those equity instruments, determined at the measurement date, as defined in IFRS2.

The relevant provisions of IFRS 2 relating to liabilities arising from share-based payment are summarized below in table format:

Date of settlement of liabilities	**Application of IFRS 2**
Liabilities arising from share-based payment transactions that were settled before the date of transition to IFRSs. **AND** Liabilities that were settled before 1 January 2005.	A first-time adopter is encouraged, but not required, to apply IFRS 2 to liabilities arising from share-based payment transactions that were settled before the date of transition to IFRSs and to those liabilities that were settled before 1 January 2005..
Other liabilities	IFRS 2 must be applied retrospectively with changes to comparative information. However comparative information need not be restated to the extent that the information relates to a period or date that is earlier than 7 November 2002

(i) INSURANCE CONTRACTS

The objective of this IFRS 4 on Insurance Contracts is to specify the financial reporting for *insurance contracts* by any entity that issues such contracts (described in this IFRS as an *insurer*) until the Board completes the second phase of its project on insurance contracts. In particular, this IFRS requires:

(a) Limited improvements to accounting by insurers for insurance contracts.

(b) Disclosure that identifies and explains the amounts in an insurer's financial statements arising from insurance contracts and helps users of those financial statements understand the amount, timing and uncertainty of future cash flows from insurance contracts.

An insurance contract is a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

In contrast to the general principle of retrospectively application in IFRS 1, the provisions in IFRS 4 (para 40 of IFRS 4) as well as the Para D4 of Appendix D to IFRS 1 states that a first-time adopter issuing Insurance Contracts (Issuer) may apply the transitional provisions in IFRS 4 *Insurance Contracts* prospectively for reporting periods on or after 1st January 2005 with optional application earlier.

IFRS 4 restricts changes in accounting policies for insurance contracts, including changes made by a first-time adopter.

j) CHANGES IN EXISTING DECOMMISSIONING, RESTORATION, AND SIMILAR LIABILITIES INCLUDED IN THE COST OF PROPERTY, PLANT AND EQUIPMENT

IFRIC 1 requires that changes made to a decommissioning liability, for which an asset is recognised, are recognised against the cost of the asset. This treatment assumes that changes relate to the discount rate or changes in the estimated cash flows to settle the liability and the IAS 16 cost model are used. The adjusted asset value is depreciated over the remaining useful life of the asset in accordance with IAS 16. Retrospective application of IFRIC 1 would require identification of all the revisions to the discount rate and estimated cash flows that would have been recognised since the inception of the decommissioning obligation. IFRS 1 provides an exemption from full retrospective application. IFRS 1 allows first time adopters to apply a shortcut method for measuring the decommissioning liability and related depreciated asset cost at the transition date. Entities can elect to measure the decommissioning liability at the transition date in accordance with IAS 37 and then "back into" the amount of the decommissioning liability that would have been included in the cost of the related asset at the time the liability first arose by discounting the liability to that date using historic risk-adjusted rates. The entity would then calculate the accumulated depreciation on that discounted amount as of the transition date using the current estimate of the useful life and the depreciation policy adopted under IFRS.

k) LEASES

IFRIC 4, *Determining Whether an Arrangement Contains a Lease,* requires an assessment of whether a contract or arrangement contains a lease at the inception of the contract or arrangement. However, as per IFRS 1 first-time adopters must apply IFRIC 4, but can elect to make this assessment as of the date of transition based on the facts at that date instead of inception date of the arrangement.

l) FAIR VALUE MEASUREMENT OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES AT INITIAL RECOGNITION

IAS 39 contains guidance to determine fair value of financial instruments. Normally, the transaction price of a financial instrument is the best evidence of fair value, unless fair value is evidenced by comparison with other observable current market transactions in the same instrument or based on a valuation technique whose variables include only data from observable markets. At initial recognition, a company may recognize day one gain or loss I.e. a gain or loss on the difference between this fair value measurement and the transaction price only if the measurement of fair value is based entirely on observable market inputs without modification. Otherwise recognition of a day one gain or loss is prohibited and requires transaction price to be taken as fair value. Subsequent measurement and recognition follows the guidance as provided in IAS 39. A first time adopter may measure these financial instruments at initial recognition either:

- Prospectively for transactions entered into after October 25, 2002; or
- Prospectively for transactions entered into after January 1, 2004.

m) SERVICE CONCESSION ARRANGEMENTS

IFRIC 12, *Service Concession Arrangements,* applies to contractual arrangements between grantor and operator in which a private sector operator participates in the development, financing, operation, and maintenance of infrastructure for public sector services. First-time adopters may elect to use the transitional provisions of IFRIC 12 rather than full retrospective application. Paragraph 30 of IFRIC 12 provides that when it is impractical for an operator to apply IFRIC 12 retrospectively the operator may:

- Recognize financial and intangible assets that existed at the start of the earliest period presented.
- Use the previous carrying amounts as the carrying amount at that date (however previously classified).
- Test the financial and intangible assets recognized at that date for impairment

n) Borrowing Cost

IFRS 1 allows first time adopter to apply transitional provision provided in paragraphs 27 and 28 of IAS 23 *Borrowing Costs*. If the accounting treatment for capitalized interest required by IAS 23 is different than a company's previous accounting policy, the company should apply IAS 23 to borrowing costs related to qualifying assets capitalized on or after January 1, 2009, or the date of transition to IFRS, if later. Alternatively, companies can designate any date before January 1, 2009 and apply the standard to borrowing costs relating to all qualifying assets capitalized on or after that date.

APPLYING MANDATORY EXCEPTIONS TO RETROSPECTIVE APPLICATIONS

There are three mandatory exceptions to full retrospective application. They apply in areas where retrospective application would be inappropriate. These exemptions are:

a) derecognition of financial assets and financial liabilities

b) hedge accounting and

c) non-controlling interests

1. Derecognition of financial assets and financial liabilities

IAS 39 is applied retrospectively to the derecognition of non-derivative financial assets and non-derivative financial liabilities. Such financial assets and liabilities derecognised before 1 January 2004 under previous GAAP are not recognised on the opening IFRS statement of financial position. In other words, first-time adopter shall apply the derecognition requirements in IAS 39 *Financial Instruments: Recognition and Measurement* prospectively for transactions occurring on or after 1 January 2004.

Notwithstanding the provisions mentioned above, an entity may choose to apply the IAS 39 derecognition requirements from an earlier date. However, it must have obtained the necessary information at the time of initially accounting for the transactions concerned.

2. Hedge Accounting

In contrast to the general principle of retrospective application in IFRS-1, the provisions relating to hedge accounting need not be applied retrospectively as doing the same would call for using the entity's perception in order to achieve a predetermine specific result which would make the

financial statements misleading. The exception therefore requires that hedge accounting may be applied prospectively by a first time adopter.

As required by IAS 39, at the date of transition to IFRSs, an entity shall:

(a) measure all derivatives at fair value; and

(b) eliminate all deferred losses and gains arising on derivatives that were reported in accordance with previous GAAP as if they were assets or liabilities. Recognise the effect in retained earnings.

If, before the date of transition to IFRSs, an entity had designated a transaction as a hedge but the hedge does not meet the conditions for hedge accounting in IAS 39 the entity shall apply paragraphs 91 and 101 of IAS 39 to discontinue hedge accounting and recognise the effect in retained earnings.

This exception requires entities to recognize hedging relationships in the opening Statement of financial position (i.e., at the transition date) if the hedging instrument is of a type that would qualify for hedge accounting under IFRS. However, hedge accounting can be applied to those hedging relationships subsequent to the transition date only if all of hedge accounting criteria as stated in IAS 39 are met. Entities should first consider whether their hedge qualifies for hedge accounting under IAS 39. If they qualify, entities must follow the detailed guidance in IFRS 1 to recognize the hedging instrument and the hedging relationship in the opening statement of financial position. Hedge accounting after the transition date may be applied only if all the IAS 39 hedge accounting criteria are met. If the criteria are not met the entity should apply IAS 39 guidance for discontinuing hedge accounting until the criteria are met. If hedges are of a type that does not qualify for hedge accounting under IAS 39, the hedging relationship must not be reflected in the opening statement of financial position.

3. Non Controlling Interest

A first-time adopter shall apply the following requirements of IAS 27 *Consolidated and Separate Financial Statements* (as amended in 2008) prospectively from the date of transition to IFRSs:

- the requirement in paragraph 28 of IAS 27 that the total comprehensive income is attributed to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance; because as per the amendments to IAS 27 in the Jan 2008 the non controlling interests are a part of equity and hence an entity should attribute total comprehensive income to the non controlling interest even if it results in a deficit balance

- the requirements in paragraphs 30 and 31 for accounting for changes in the parent's ownership interest in a subsidiary that do not result in a loss of control; In Jan 2008 the Board decided to amend substantively IAS 27 thereby incorporating this provision of accounting for all transactions which change the ownership interest of the parent without resulting in a loss of control are accounted for as equity transactions. Equity transactions mean transactions wherein the carrying amount of the controlling and non controlling interests are adjusted to reflect the changes in their relative interests in the subsidiary, without disturbing profit or losses account, or any assets (including goodwill) or liabilities of the subsidiary and

- the requirements in paragraphs 34–37 for accounting for a loss of control over a subsidiary. A parent loses control when it loses the power to govern the financial and operating policies of an investee so as to obtain economic benefits from its activities. The loss of control ceases the parent – subsidiary relationship. The parent no longer controls the assets and liabilities of the subsidiary and hence derecognizes the same and also derecognizes the carrying amount of any non controlling interests.

However, if a first-time adopter elects to apply IFRS 3 (as revised in 2008) retrospectively to past business combinations, it shall also apply IAS 27 (as amended in 2008) in accordance with paragraph C1 of IFRS1.

IAS 36 -Impairment of Assets

IAS 36 as revised in March 2004 requires an entity to test for impairment in some cases when there is an indication that asset has been impaired, or in other cases annually, Irrespective of any

indication whether an asset has been impaired or not. This impairment testing without any indication is done in the following cases:

- The recoverable amount of an intangible asset with an indefinite useful life is to be measured annually whether any indication for impairment exists or not.
- The recoverable amount of an intangible asset which is not yet available for use is to be measured annually whether any indication for impairment exists or not.
- The goodwill acquired in a business combination is to be tested for impairment annually whether any indication for impairment exists or not.

An impairment loss is recognized in the profit and loss account when an asset's recoverable amount is less than carrying amount. Recoverable amount is the lower of an asset's fair value less costs to sell and its value in use.

An entity applies IAS 36 in:

(a) Determining whether any impairment loss exists at the date of transition to IFRSs; and

(b) Measuring any impairment loss that exists at that date, and reversing any impairment loss that no longer exists at that date.

The first time adopter shall recognize any impairment loss arising on the date of transition to IFRS as a result of change in accounting policies in retained earnings.

An entity's first IFRS financial statements include the disclosures that IAS 36 would have required if the entity had recognized those impairment losses or reversals in the period beginning with the date of transition to IFRSs (paragraph 24(c) of the IFRS).

The estimates used to determine whether an entity recognises an impairment loss or provision (and to measure any such impairment loss or provision) at the date of transition to IFRSs are consistent with estimates made for the same date in accordance with previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were in error (paragraphs 14 and 15 of the IFRS). The entity reports the impact of any later revisions to those estimates (both under previous GAAP and under IFRS) as an event of the period in which it makes the revisions i.e. in profit and loss account.

A first time adopter is not permitted to reverse any impairment loss on goodwill subsequent to the date of transition.

IAS 29 Financial Reporting in Hyperinflationary Economies

An entity complies with IAS 21 the Effects of Changes in Foreign Exchange rates in determining its functional currency and presentation currency. When the entity prepares its opening IFRS

statement of financial position, it applies IAS 29 to any periods during which the economy of the functional currency or presentation currency was hyperinflationary.

Retrospective application of IAS 29 is required to present true and fair results in the financial statements, even when the currency at present no longer hyperinflationary

An entity which elects to use the fair value of an item of property, plant and equipment at the date of transition to IFRSs as its deemed cost at that date, as per paragraphs D5–D8 of the IFRS 1 and therefore gives the disclosures required by paragraph 30 of the IFRS 1, is required to apply IAS 29 to periods after the date for which the revalued amount or fair value was determined

IAS 18 -Revenue

If an entity has received amounts that do not yet qualify for recognition as revenue in accordance with IAS 18 (for example, the proceeds of a sale that does not qualify for revenue recognition), the entity recognises the amounts received as a liability in its opening IFRS statement of financial position and measures that liability at the amount received.

IAS 12- Income Taxes

An entity applies IAS 12 to temporary differences between the carrying amount of the assets and liabilities in its opening IFRS statement of financial position and their tax bases.

In accordance with IAS 12, the measurement of current and deferred tax reflects tax rates and tax laws that have been enacted or substantively enacted by the end of the reporting period. An entity accounts for the effect of changes in tax rates and tax laws when those changes are enacted or substantively enacted.

If the previous GAAP measurement of deferred tax is based on an accounting policy which is largely on the basis of IFRS accounting policy, then the estimate of deferred tax already calculated is not adjusted unless there is objective evidence that the estimate is in error.

Reconciliations

The first IFRS financial statements shall be presented in accordance with the presentation and disclosure requirements in IAS 1 Presentation of Financial statements and other standards and interpretation under IFRS.

Comparative information

To comply with IAS 1, an entity's first IFRS financial statements shall include at least three statements of financial position, two statements of comprehensive income, two separate income

statements (if presented), two statements of cash flows and two statements of changes in equity and related notes, including comparative information.

An entity shall explain how the transition from previous GAAP to IFRSs affected its reported financial position, financial performance and cash flows.

Thus as per the provisions of IFRS 1, an entity's first IFRS financial statements shall include:

reconciliations of its equity reported in accordance with previous GAAP to its equity in accordance with IFRSs for both of the following dates:

(i) the date of transition to IFRSs; and

(ii) the end of the latest period presented in the entity's most recent annual financial statements in accordance with previous GAAP*, which is the same as beginning of the current reporting period.*

(b) a reconciliation to its total comprehensive income in accordance with IFRSs for the latest period in the entity's most recent annual financial statements. The starting point for that reconciliation shall be total comprehensive income in accordance with previous GAAP for the same period or, if an entity did not report such a total, profit or loss under previous GAAP.

(c) if the entity recognised or reversed any impairment losses for the first time in preparing its opening IFRS statement of financial position, the disclosures that IAS 36 *Impairment of Assets* would have required if the entity had recognised those impairment losses or reversals in the period beginning with the date of transition to IFRSs.

If an entity presented a statement of cash flows under its previous GAAP, it shall also explain the material adjustments to the statement of cash flows

The reconciliations as stated above shall:

- Give sufficient detail to enable users to understand the material adjustments to the statement of financial position and statement of comprehensive income. *And*
- Shall distinguish the correction of the errors made under previous GAAP, from changes in accounting policies.

IAS 8 does not deal with changes in accounting policies that occur when an entity first adopts IFRSs. Therefore, IAS 8's requirements for disclosures about changes in accounting policies do not apply in an entity's first IFRS financial statements.

If an entity did not present financial statements for previous periods, its first IFRS financial statements shall disclose that fact.

<u>IAS 34 -Interim Financial Reporting</u>

IFRS does not require an entity to publish interim reports in compliance with IAS 34. Due to industry and government regulations entities generally prepare interim financial reports.

IAS 34 applies only if an entity is required, or elects, to present an interim financial report in accordance with IFRSs. Accordingly, neither IAS 34 nor the IFRS requires an entity:

(a) to present interim financial reports that comply with IAS 34; or

(b) to prepare new versions of interim financial reports presented in accordance with previous GAAP. However, if an entity does prepare an interim financial report in accordance with IAS 34 for part of the period covered by its first IFRS financial statements, the entity restates the comparative information presented in that report so that it complies with IFRSs.

The entity which prepares interim financial reports for part of the period as stated above shall satisfy the following requirements in addition to the requirements of IAS 34:

(a) Each such interim financial report shall, if the entity presented an interim financial report for the comparable interim period of the immediately preceding financial year, include:

- a reconciliation of its equity in accordance with previous GAAP at the end of that comparable interim period to its equity under IFRSs at that date; and
- a reconciliation to its total comprehensive income in accordance with IFRSs for that comparable interim period (current and year to date). The starting point for that reconciliation shall be total comprehensive income in accordance with previous GAAP for that period or, if an entity did not report such a total, profit or loss in accordance with previous GAAP.

(b) In addition to the reconciliations required by (a), an entity's first interim financial report in accordance with IAS 34 for part of the period covered by its first IFRS financial statements shall include the reconciliations described in paragraph 24(a) and (b) (supplemented by the details required by paragraphs 25 and 26) or a cross-reference to another published document that includes these reconciliations.

The following reconciliations are mentioned in the paragraph 24(a) and (b) (supplemented by the details required by paragraphs 25 and 26,

(a) Reconciliations of its equity reported in accordance with previous GAAP to its equity in accordance with IFRSs for both of the following dates:

(i) the date of transition to IFRSs; and

(ii) the end of the latest period presented in the entity's most recent annual financial statements in accordance with previous GAAP. *This is the same as beginning of the current reporting period.*

(b) a reconciliation to its total comprehensive income in accordance with IFRSs for the latest period in the entity's most recent annual financial statements. The starting point for that reconciliation shall be total comprehensive income in accordance with previous GAAP for the same period or, if an entity did not report such a total, profit or loss under previous GAAP.

(c) if the entity recognised or reversed any impairment losses for the reconciliations required by paragraph 24(a) and (b) shall give sufficient detail to enable users to understand the material adjustments to the statement of financial position and statement of comprehensive income. If an entity presented a statement of cash flows under its previous GAAP, it shall also explain the material adjustments to the statement of cash flows.

For eg : Entity A's first IFRS financial statements are for a period that ends on 31 December 20X5, and its first interim financial report in accordance with IAS 34 is for the quarter ended 31 March 20X5. Entity A prepared previous GAAP annual financial statements for the year ended 31 December 20X4, and prepared quarterly reports throughout 20X4.

Application of requirements

In each quarterly interim financial report for 20X5, entity A includes reconciliations of:

(a) its equity in accordance with previous GAAP at the end of the comparable quarter of 20X4 i.e. 31st March 2004 to its equity in accordance with IFRSs at that date 31st March 2004; and

(b) its total comprehensive income (or, if it did not report such a total, profit or loss) in accordance with previous GAAP for the comparable quarter of 20X4 (current and year to date) to its total comprehensive income in accordance with IFRSs. (1st Jan 2004 to 31st March 2004)

In addition to the reconciliations required by (a) and (b) and the disclosures required by IAS 34, entity A's interim financial report for the first quarter of 20X5 includes reconciliations of (or a cross-reference to another published document that includes these reconciliations):

(a) Reconciliations of its equity reported in accordance with previous GAAP to its equity in accordance with IFRSs for both of the following dates:

(i) the date of transition to IFRSs; 1 January 20X4 being date of transition and

(ii) the end of the latest period presented in the entity's most recent annual financial statements in accordance with previous GAAP. *which is the same as beginning of the current reporting period.* 31 December 20X4 or 1st Jan 2005.

(b) its total comprehensive income (or, if it did not report such a total, profit or loss) for 20X4 in accordance with previous GAAP to its total comprehensive income for 20X4 in accordance with IFRSs. Ie 1st January 2004 to 31st December 2004.

If an entity becomes aware of errors made under previous GAAP, the reconciliations required by paragraph 24(a) and (b) shall distinguish the correction of those errors from changes in accounting policies.

Each of the above reconciliations gives sufficient detail to enable users to understand the material adjustments to the statement of financial position and statement of comprehensive income. The first time adopter also explains the material adjustments to the statement of cash flows.

IAS 34 requires minimum disclosures, which are based on the assumption that users of the interim financial report also have access to the most recent annual financial statements. However, IAS 34 also requires an entity to disclose 'any events or transactions that are material to an understanding of the current interim period'. Therefore, if a first-time adopter did not, in its most recent annual financial statements in accordance with previous GAAP, disclose information material to an understanding of the current interim period, its interim financial report shall disclose that information or include a cross-reference to another published document that includes it.

If the first time adopter becomes aware of errors made in accordance with previous GAAP, the reconciliations distinguish the correction of those errors from changes in accounting policies.

Chapter XXIII

PRESENTATION AND DISCLOSURES

This IFRS does not provide exemptions from the presentation and disclosure requirements in other IFRSs.

Non-IFRS comparative information and historical summaries

The recognition and measurement requirements of this IFRS are not applicable to those entities which present historical summaries of selected data for periods before the first period for which they present full comparative information in accordance with IFRSs. This IFRS does not require such summaries to comply with the provisions of IFRSs.

Also, some entities present comparative information in accordance with previous GAAP as well as the comparative information required by IAS 1. In any financial statements containing historical summaries or comparative information in accordance with previous GAAP, an entity shall:

(a) label the previous GAAP information prominently as not being prepared in accordance with IFRSs; and

(b) disclose the nature of the main adjustments that would make it comply with IFRSs. An entity need not quantify those adjustments.

Disclosures

The IFRS requires disclosures that explain how the transition from previous GAAP to IFRSs affected the entity's reported financial position, financial performance and cash flows.

IAS 8 does not deal with changes in accounting policies that occur when an entity first adopts IFRSs. Therefore, IAS 8's requirements for disclosures about changes in accounting policies do not apply in an entity's first IFRS financial statements.

Use of fair value as deemed cost

If an entity uses fair value in its opening IFRS statement of financial position as *deemed cost* for an item of property, plant and equipment, an Investment property or an intangible asset the entity's first IFRS financial statements shall disclose, for each line item in the opening IFRS statement of financial position:

- the aggregate of those fair values; and
- the aggregate adjustment to the carrying amounts reported under previous GAAP.

Designation of financial assets or financial liabilities

The entity shall disclose the fair value of financial assets or financial liabilities designated into each category at the date of designation and their classification and carrying amount in the previous financial statements.

Use of deemed cost for investments in subsidiaries, jointly controlled entities and associates

If an entity uses a deemed cost in its opening IFRS statement of financial position for an investment in a subsidiary, jointly controlled entity or associate, the entity's first IFRS separate financial statements shall disclose:

(a) the aggregate deemed cost of those investments for which deemed cost is their previous GAAP carrying amount;

(b) the aggregate deemed cost of those investments for which deemed cost is fair value; and

(c) the aggregate adjustment to the carrying amounts reported under previous GAAP.

Chapter XXIV

FIRST TIME ADOPTION OF IFRS: CHECKLIST- IFRS -1

Sr. No.	Particulars	Yes/NO/NA
(A)	**General Requirements**	
1	What are the key impacts on the organisation and its financial reporting arising from the implementation of IFRS?	
2	What are the key changes to accounting policies?	
3	What level of resource is required to successfully manage the transition?	
4	What IFRS staff training is required?	
5	What actions are required to ensure that bodies that are consolidated into the financial statements will successfully implement IFRS?	
6	What role do internal audit have in aiding the transition?	
7	What is the potential budgetary impact of the move to IFRS?	
8	How and when will engagement with the external auditor take place?	
9	What implications to the configuration of financial systems arise as a result of the transition to IFRS?	
10	For what balances and disclosures is there a need to capture new and revised data with regard to IFRS?	
11	How do management accounting processes need to be re-engineered to ensure they are compatible with IFRS?	
12	Are parallel systems needed for initial years of transition, for IFRS and FRS based information, to ensure that comparative information can be accurately produced?	
(B)	**Requirements of IFRS -1**	

1	**Compliance with IFRS: Explicit and unreserved**	
	Whether an entity has adopted IFRS for the first time by an explicit and unreserved statement of compliance with IFRS?	
2	**Accounting Policies**	
	Whether same accounting policies are used in its opening IFRS statement of financial position and throughout all periods presented in its first IFRS financial statements? Whether the correction of errors is distinguished from changes in accounting policies in reconciliation?	
3	**Presentation of first time financial statements**	
4	**Exemptions (optional) and Exceptions (Mandatory) available for first time adoption of IFRS**	
4 (A)	**EXEMPTIONS: (Optional)** **(Indicate for each exemption whether it is opted for?)**	
1	**Fair value or revaluation as deemed cost**	
	An entity may elect to apply:- - Fair value at the date of transition to IFRSs or - A previous GAAP revaluation at, or before, the date of transition (if the revaluation broadly comparable to fair value or cost or depreciated cost in accordance with IFRSs)	
2	**Employee benefits (IAS 19)**	
	If corridor approach is used, than entity may elect to recognise all cumulative actuarial gains and losses at the date of transition to IFRSs (If uses this election, apply it to all plans)	
3	**Business Combinations**	
	(a) IFRS 3 need not be applied to combinations before date of transition BUT, if one combination is restated, all subsequent combinations are restated	

	When the exemption is used No change in classification Post combination carrying amount deemed cost for assets and liabilities measured at cost Assets and liabilities measured at fair value restated at date of transition – adjust retained earnings (b) Goodwill is recognised at the carrying amount under previous GAAP and adjusted for Intangibles that are not recognised under IFRS Intangibles that must be recognised under IFRS Contingent consideration not recognised; and Tested for impairment	
4	**Cumulative translation differences (IAS 21)**	
	The entity may elect: (a) the cumulative translation differences for all foreign operations are deemed to be zero at the date of transition to IFRSs; and (b) the gain or loss on a subsequent disposal of any foreign operation shall exclude translation differences that arose before the date of transition to IFRSs and shall include later translation differences. *IAS 21:* (a) to recognise some translation differences in other comprehensive income and (b) on disposal of a foreign operation, to reclassify the cumulative translation difference for that foreign operation from equity to profit or loss as part of the gain or loss on disposal.	
5.	**Assets and liabilities of subsidiaries, associates and joint ventures.**	
	(A) **Prepares separate financial statements** Accounting for investments in subsidiaries, jointly controlled entities and associates either:	

	(a) at cost (cost- IAS27 or fair value or carrying value as per previous GAAP) or (b) in accordance with IAS 39. (B) **If a subsidiary/associate/joint venture becomes a first-time adopter later than its parent (1st)**, the subsidiary shall, in its financial statements, measure its assets and liabilities at either: (a) the carrying amounts that would be included in the parent's consolidated financial statements, based on the parent's date of transition to IFRSs, or (b) the carrying amounts based on the subsidiary's date of transition to IFRSs. (C) **if an entity becomes a first-time adopter later than its subsidiary (or associate or joint venture) (1st)** the entity shall, in its consolidated financial statements, measure the assets and liabilities of the subsidiary (or associate or joint venture) at the same carrying amounts as in the financial statements of the subsidiary (or associate or joint venture), after adjusting for consolidation and equity accounting adjustments and for the effects of the business combination in which the entity acquired the subsidiary. (D) **If a parent becomes a first-time adopter for its separate financial statements earlier or later than for its consolidated financial statements**, it shall measure its assets and liabilities at the same amounts in both financial statements, except for consolidation adjustments.	
6	**Designation of previously recognized financial instruments**	
	IAS 39 permits (A) a financial asset to be designated on initial recognition as available for sale or (B) a financial instrument (provided it meets certain criteria) to be designated as a financial asset or financial liability at fair value through	

	profit or loss.	
7	**Share based payment transactions**	
	(1) A first-time adopter is encouraged, but not required, to apply IFRS 2 *Share-based Payment* to **equity instruments** that were granted on or before 7 November 2002. A first-time adopter is also encouraged, but not required, to apply IFRS 2 to equity instruments that were granted after 7 November 2002 and vested before the later of (a) the date of transition to IFRSs and (b) 1 January 2005. However, if a first-time adopter elects to apply IFRS 2 to such equity instruments, it may do so only if the entity has disclosed publicly the fair value of those equity instruments, determined at the measurement date, as defined in IFRS 2. For all grants of equity instruments to which IFRS 2 has not been applied (eg equity instruments granted on or before 7 November 2002), a first-time adopter shall nevertheless disclose the information required by paragraphs 44 and 45 of IFRS 2. If a first-time adopter modifies the terms or conditions of a grant of equity instruments to which IFRS 2 has not been applied, the entity is not required to apply paragraphs 26–29 of IFRS 2 if the modification occurred before the date of transition to IFRSs. (2) A first-time adopter is encouraged, but not required, to apply IFRS 2 to **liabilities** arising from share-based payment transactions that were settled before the date of transition to IFRSs. A first-time adopter is also encouraged, but not required, to apply IFRS 2 to liabilities that were settled before 1 January 2005. For liabilities to which IFRS 2 is applied, a first-time adopter is not required to restate comparative information to the extent that the information relates to a period or date that is earlier than 7 November 2002.	
8	**Compound financial instruments (IAS 32)**	
	The entity need not separate two portions (retained earning –cumulative interest, equity) of compound financial instruments, if the liability component is no longer outstanding at the date of transition to IFRSs. *IAS 32*: To split compound financial instrument at inception into separate	

	liability and equity components. If the liability component is no longer outstanding, retrospective application of IAS 32 involves separating two portions of equity. The first portion is in retained earnings and represents the cumulative interest accreted on the liability component. The other portion represents the original equity component.	
9	**Decommissioning liabilities included in the cost of property, plant and equipment.**	
	If a first-time adopter the exemption from IFRIC 1, it shall: (a) measure the liability as at the date of transition to IFRSs in accordance with IAS 37; (b) to the extent that the liability is within the scope of IFRIC 1, estimate the amount of liability to be included in the cost of the related asset when the liability first arose (by discounting the liability to that date using discount rate) and (c) **calculate the accumulated depreciation on that amount, as at the** **date of transition to IFRSs,** on the basis of the current estimate of the useful life of the asset, using the depreciation policy adopted by the entity in accordance with IFRSs. *IFRIC 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities* requires specified changes in a decommissioning, restoration or similar liability to be added to or deducted from the cost of the asset to which it relates; the adjusted depreciable amount of the asset is then depreciated prospectively over its remaining useful life. A first-time adopter need not comply with these requirements for changes in such liabilities that occurred before the date of transition to IFRSs.	
10	**Leases (IFRIC 4)**	
	A first-time adopter may apply the transitional provisions in IFRIC 4 *Determining whether an Arrangement contains a Lease*. Therefore, a first-time adopter may determine whether an arrangement existing at the date of transition to IFRSs contains a lease on the basis of facts and circumstances existing at that date.	

11	**Fair value measurement of financial assets or financial liabilities at initial recognition.**	
	Notwithstanding the requirements of paragraphs 7 and 9, an entity may apply the requirements in the last sentence of IAS 39 paragraph AG76 and in paragraph AG76A, in either of the following ways: (a) prospectively to transactions entered into after 25 October 2002; or (b) prospectively to transactions entered into after 1 January 2004.	
12	**Insurance contracts (IFRS 4)**	
	IFRS 4 restricts changes in accounting policies for insurance contracts, including changes made by a first-time adopter.	
13	**Borrowing costs (IAS 23)**	
	A first-time adopter may apply the transitional provisions set out in paragraphs 27 and 28 of IAS 23, as revised in 2007. In those paragraphs references to the effective date shall be interpreted as 1 July 2009 or the date of transition to IFRSs, whichever is later.	
14	**Service concession arrangements.**	
	A first-time adopter may apply the transitional provisions in IFRIC 12.	
4 (B)	**EXCEPTIONS TO RETROSPECTIVE APPLICATIONS: (Mandatory)**	
1	**Hedge accounting**	
	As required by IAS 39, at the date of transition to IFRSs, an entity shall: (a) measure all derivatives at fair value; and (b) eliminate all deferred losses and gains arising on derivatives that were reported in accordance with previous GAAP as if they were assets or liabilities. An entity shall not reflect hedging relationship on the date of transition if does not qualify for hedge accounting as per IAS 39. Transactions entered into before the date of transition to IFRSs shall not be retrospectively designated as hedges.	
2	**Derecognition of financial assets and financial liabilities.**	

	If a first-time adopter derecognised non-derivative financial assets or non-derivative financial liabilities in accordance with its previous GAAP as a result of a transaction that occurred before 1 January 2004, it shall not recognise those assets and liabilities in accordance with IFRSs (unless they qualify for recognition as a result of a later transaction or event). An entity may apply the derecognition requirements in IAS 39 retrospectively from a date of the entity's choosing, provided that the information needed to apply IAS 39 to financial assets and financial liabilities derecognised as a result of past transactions was obtained at the time of initially accounting for those transactions.	
3	**Non controlling interests.**	
	Entity to apply the following requirements of IAS 27 **prospectively** from the date of transition to IFRSs: (a) total comprehensive income attributed to the owners of the parent and to the non-controlling interests (b) accounting for changes in the parent's ownership interest in a subsidiary that do not result in a loss of control; and (c) accounting for a loss of control over a subsidiary, and the related requirements of paragraph 8A of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. However, if a first-time adopter elects to apply IFRS 3 (as revised in 2008) retrospectively to past business combinations, it shall also apply IAS 27 (as amended in 2008) in accordance with paragraph C1 of this IFRS.	
5	**Accounting of Difference between I GAAP and IFRS?**	
	All assets and liabilities are to be reflected as per IFRS. Whether the difference between carrying value of Indian GAAP and carrying value under IFRS accounted in the retained earnings in the statement of financial position?	
6	**Presentation and Disclosure**	
	No exemptions from the presentation and disclosure requirements in other IFRS provided by IFRS -1.	
7	**Comparative information**	

	Whether first IFRS financial statements include at least one year of comparative information under IFRS?	
8	**Historical summaries and additional previous GAAP comparative Information**	
	If (i) historical summaries of selected data that does not comply with the recognition or measurement requirements of IFRSs for periods before the first period for which it presents full comparative information under IFRSs, or (ii) comparative information under previous GAAP in addition to the comparative information required by IAS 1 *Presentation of Financial Statements* are presented than, a) Whether the previous GAAP information prominently labelled as not being prepared under IFRS? and b) Whether the nature of the main adjustments that would make the previous GAAP information comply with IFRS are disclosed?	
9	**Explanation of transition to IFRS (Reconciliations)**	
	An entity shall explain how the transition from previous GAAP to IFRSs affected its reported financial position, financial performance and cash flows and shall include the following reconciliations. The reconciliation shall be provided for both of the following dates: a) the date of transition to IFRSs; and b) the end of the latest period presented in the entity's most recent annual financial statements under previous GAAP. 1. Reconciliations of its equity reported under previous GAAP to its equity under IFRSs. 2. Reconciliation of the profit or loss reported under previous GAAP to its profit or loss under IFRSs 3. Explain the material adjustments to the cash flow statement.	
10	**Impairment Loss**	
	When the impairment loss has been recognised or reversed for the first time in preparing its opening IFRS statement of financial position, whether the	

	disclosures of IAS 36 *Impairment of Assets* are included in financial statements if the entity had recognised those impairment losses or reversals in the period beginning with the date of transition to IFRS?	
11	**Interim financial reports (IAS 34)**	
	Whether Interim financial report during first year of transition, for the comparable interim period of the immediately preceding financial year, include reconciliations of: a) its equity under previous GAAP at the end of that comparable interim period to its equity under IFRSs at that date; and b) its profit or loss under previous GAAP for that comparable interim period (current and year-to-date) to its profit or loss under IFRSs for that period.	

Chapter XXV

CASE STUDY

XYZ Limited presented its financial statements under the Indian GAAP until 2009. It adopted IFRS from April 1, 2010 and is required to prepare an opening IFRS statement of financial position as at April 1, 2010.

In preparing the IFRS opening Statement of financial position XYZ Limited noted:

1. Under its previous GAAP, had classified proposed dividend of Rs.5, 00,000 as a current liability.

2. It had not made a provision for warranty of Rs. 200,000 in the financial statements presented under previous GAAP since the concept of "constructive obligation" was not recognized under its previous GAAP.

3.In arriving at the amount to be capitalized as part of costs necessary to bring an asset to its working condition, XYZ Limited had not included Professional fees of Rs. 300,000 paid to architects at the time when the building it currently occupies as its head office was being constructed

4. The cumulative adjustment on account of difference in methods of depreciation - increase in the carrying amount of PPE by 200000

5. Intangible assets acquired in a business combination included 300000 for items that do not qualify as intangible assets under IFRS

6. Financial assets costing 7000000 and with a fair value of 7800000 are all classified as available for sale under IAS 39

7. Unrealised gains of Rs. 500000 on unmatured forward foreign exchange contracts now recognized under IFRS

8. In order to comply with IAS 2, fixed and variable production overhead of Rs.1000000 should be included in Inventories

9. Retirement Benefit liability of Rs. 100000 should be recognized under IFRS

10. A restructuring Provision of Rs 30000 relating to Head office activities which was recognised earlier does not qualify for recognition as liability under IFRS

11. The Tax rate is assumed to be 30%

M/s XYZ Public Limited Company

Consolidated Statement of Financial Position

(All amounts in nearest '000 Rs. unless otherwise stated)

As at 31st March 2010

	Previous Indian GAAP	**Effect of transition to IFRS**	**IFRS**
Assets			
Non Current Assets			
Plant Property Equipment (3) &(4)	8000	500	8500

Goodwill	**(5)**	2000	300	2300
Intangible Assets	**(5)**	1000	(300)	700
Available for Sale				
Financial Assets	**(6)**	7000	800	7800
Total Non Current Assets (A)		18000	1300	19300
Current Assets				
Inventories	**(8)**	5000	1000	6000
Short-Term Trade Receivables		3000	0	3000
Other Receivables	**(7)**	600	500	1100
Cash and Cash Equivalent		700	0	700
Total Current Assets (B)		9300	1500	10800
Total Assets (A) +(B)		**27300**	**2800**	**30100**

Liability			
Non Current Liability			
Long Term Borrowings	9000	0	9000
Deferred Tax liability	600	909	1509
Retirement Benefit Obligations (9)	0	100	100

			0
Provisions for other liability (2)	30	(30)	0
Provision for warranty	0	200	200
Total Non-Current Liability (D)	**9630**	**1179**	**10809**
Current Liability			
Trade and other Short Term Payables	4000	0	4000
Current Income Tax Liability	40	0	40
Proposed dividend (1)	500	(500)	0
Total Current Liability (E)	**4540**	**(500)**	**4040**
Total Liability (D) + (E)	**14170**	**679**	**14849**
Total Assets less Total Liabilities	**13130**	**2121**	**15251**
Equity			
Portion of Equity attributable to Shareholders			
Equity Shares	6500	0	6500
Share Premium			
Other Reserves	0	560	560
(70% of 800)			

Retained Earnings	6630	1561	8191
Non-Controlling Interest			
Total Equity (D)	**13130**	**2121**	**15251**

Workings

1. Retained earnings

Depreciation	200
Production overhead	1000
Foreign exchange contract	500
Pension Liability	(100)
Restructuring Provision (10)	30
Proposed dividend	500
Provision for warranty	(200)
Architects fees	300

	2230
Tax effect on above	(669)

Total adjustments to retained earnings	**1561**

2.Deferred Tax Liability

Revaluation surplus- 30% of 800	240
Retained earnings	669

	909