GUIDANCE NOTES

After studying this chapter, you will be able to:

- Comprehend the concept of Guidance Notes.
- Understand the status of Guidance note
- Differentiate between Accounting Standard and Guidance Note
- Understand the provisions of the specified Guidance Notes.
2.2 FINANCIAL REPORTING

CHAPTER OVERVIEW

Introduction and Nature of Guidance Notes
- Accounting Aspects
- Auditing Aspects

Status of Guidance Notes
- Recommendatory
- Guidance Notes vis-a-vis Accounting Standards

Guidance Notes on Accounting Aspects
- Guidance Note on Applicability of AS 25 to Interim Financial Results.
- Guidance Note on Accounting for Real Estate Transactions (for entities to whom Ind AS is applicable)
- Guidance Note on Accounting for Derivative Contracts.

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1. INTRODUCTION

Accounting Standards have been formulated by the Institute of Chartered Accountants of India (ICAI) to bring comparability in financial statements not just across periods but also regions. At the same time, Guidance Notes have also been issued by the Council of the ICAI to reinforce the general principles laid down in the Accounting Standards as well as uniformity in accounting for areas where currently Standards are being formulated.

Guidance Notes on accounting aspects issued by the ICAI occupy an important position in the generally accepted accounting principles prevailing in India since these establish principles to be followed thereby promoting uniformity in accounting practices on the concerned subject. In fact, while discharging his attest function, a member of ICAI needs to examine whether in view of the recommendations contained in a Guidance Note relating to an accounting matter, a disclosure is necessary in his report.

In recent years several Guidance Notes on accounting aspects have been issued promptly responding to the need for accounting guidance on contemporary issues, which arise due to amendments in laws and other developments related to economic reforms in the country.

2. NATURE OF GUIDANCE NOTES

The ICAI issues Guidance Notes both on accounting aspects and auditing aspects. Guidance Notes on auditing aspects are followed by the auditors while discharging their auditing functions. However, Guidance notes on accounting is followed (if required) at the time of preparation and presentation of financial statements.

The Guidance Notes on accounting aspects are primarily of two types:

1. General application of accounting principles laid down in the Accounting Standards or
2. General guidance setting out principles to be applied on areas not covered by an Accounting Standard.
3. STATUS OF GUIDANCE NOTES

Guidance Notes are recommendatory in nature.

A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so. Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.

In a situation where certain matters are covered both by an Accounting Standard and a Guidance Note, issued by the Institute of Chartered Accountants of India, the Guidance Note or the relevant portion thereof will be considered as superseded from the date of the relevant Accounting Standard coming into effect, unless otherwise specified in the Accounting Standard.

4. ACCOUNTING STANDARDS VIS-À-VIS GUIDANCE NOTES

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Particulars</th>
<th>Accounting Standards</th>
<th>Guidance Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Nature</td>
<td>Accounting standards are the statements issued by ICAI which are mandatory in nature</td>
<td>These are recommendatory in nature. It is at the discretion of the professional to take the note into consideration. He may even seek to not abide by the Guidance Note, if the situation so warrants.</td>
</tr>
<tr>
<td>2.</td>
<td>Deal with</td>
<td>Accounting Standards seeks to describe the accounting principles, the valuation techniques and methods of applying the accounting principles in the preparation and presentation of financial statements so that they give true and fair view.</td>
<td>Guidance notes seeks to provide guidance in some specific matters which may or may not have been dealt with by any of the accounting standards.</td>
</tr>
<tr>
<td>3.</td>
<td>Qualification of report</td>
<td>The auditor may qualify the report if the deviation is material.</td>
<td>No qualification needed in the report if one does not follow guidance note.</td>
</tr>
</tbody>
</table>
5. GUIDANCE NOTES ON ACCOUNTING ASPECTS

The following is the list of guidance notes on accounting aspects applicable at Final level of Chartered Accountancy Course:

2. Guidance Note on Applicability of AS 25 to Interim Financial Results
3. Guidance Note on Accounting for Real Estate Transactions (for entities to whom Ind AS is applicable)
5. Guidance Note on Accounting for Derivative Contracts
6. Guidance Note on Accounting for Expenditure on Corporate Social Responsibility Activities
7. Guidance Note on Accounting for Self-Generated Certified Emission Reductions (CERs)
8. Guidance Note on Accounting by Dot-Com Companies

Note:
1. The students are advised to go through the full text of all the applicable Guidance Notes from the following link of our Institute’s website: http://www.icai.org/post.html?post_id=1399
2. Following Guidance Notes are discussed in the specific chapters and hence not discussed in this chapter:
   (i) Guidance Note on Accounting for Self-Generated Certified Emission Reductions (CERs) is discussed in the chapter on Accounting for Carbon Credits
   (ii) Guidance Note on Accounting by Dot-Com Companies is discussed in the chapter on Accounting for E-commerce business
   (iii) Guidance Note on Accounting for Expenditure on Corporate Social Responsibility Activities is discussed in the chapter on Corporate Social Responsibility Reporting.

However, the above guidance notes are applicable at Final level.
6. GUIDANCE NOTE ON MEASUREMENT OF INCOME TAX EXPENSE FOR INTERIM FINANCIAL REPORTING IN THE CONTEXT OF AS 25

 Income tax expense is an important item of interim and annual financial reports. Hence, correct measurement of income tax expense is very important for reporting purposes. This Guidance Note deal with various aspects in the measurement of income tax expense for the purpose of interim financial reporting.

6.1 General principles for recognition and measurement as per AS 25

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

- Requiring an enterprise to follow the same accounting principle in interim financial statement as in its annual financial statements suggest that each interim period may be considered as standalone reporting period.

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

6.2 Measurement of income tax expense

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

Step 1: Estimate the Annual Accounting Income

- Estimate the annual accounting income.

- Take into account all the probable future events and transactions expected to occur during the financial year.

  Such an estimate would be on prudent basis, for eg.- depreciation on expected expenditure on acquisition of fixed assets, profits from sale of fixed assets/investments, etc.
Such future events and transactions should be taken into account only if there is a reasonable certainty that the same would take place during the financial year.

**Step 2: Estimate the Net Tax Liability for the Financial Year**

- Estimate the taxable income for the year.
- Apply the enacted or the substantively enacted tax rate on the taxable income, to arrive at an estimate of the current tax for the year.
- The estimates of tax liability should be based on the estimated deductions, allowances, etc., provided there is a reasonable certainty for the same.
- Estimate deferred tax assets/liabilities as per AS 22

**Special considerations**

(a) **Where brought forward losses exist from the previous financial year (when deferred tax asset was not recognised on considerations of prudence as per AS 22):**

In such a situation, for estimating the current tax liability, the brought forward losses would have to be deducted from the estimated annual accounting income.

Since such carried forward losses will get set-off during the year, these would not have any tax consequence in future periods.

(b) **Where brought forward losses exist (when deferred tax asset was recognised on the considerations of prudence as per AS 22):**

In such a situation, current tax would be computed in the same manner as explained in (a) above.

However, in the determination of deferred tax, the tax expense arising from the reversal of the deferred tax asset recognised previously, to the extent of reversal of deferred tax asset in the current year, would also be considered.

**Step 3: Calculate the Weighted Average Annual Effective Tax Rate**

- Determine the weighted average annual effective tax rate by dividing the estimated tax expense (calculated in Step 2 above) by the estimated annual accounting income (calculated in Step 1 above).
- Where different tax rates are applicable to different portions of the estimated annual accounting income, e.g., normal tax rate and a different tax rate for capital gains, calculate the weighted average annual effective tax rate separately for such portions of estimated annual accounting income.
Step 4: Determine Income Tax Expense for Interim Financial Reports

Apply the weighted average annual effective tax rate to the accounting income for the interim period for determining the income tax expense to be recognised in the interim financial reports.

Note:

Tax expense recognised under AS 25 ‘Interim Financial Statement’ is based on Integral approach i.e. the interim period is part of the whole accounting year. According to this approach, the said rate is determined on the basis of the taxable income for the whole year, and applied to the accounting income for the interim period in order to determine the amount of tax expense for that interim period.

Illustration 1

ABC Ltd. is preparing its interim financial report on quarterly basis. It has earned INR 210 lakhs pretax profit in the first quarter but expects to incur losses of INR 70 lakhs in each of the three remaining quarters and its estimated tax rate is 30%. Calculate the tax expense for each of the quarter.

Solution

It will have zero income in the year. First quarter will report INR 63 lakhs tax expense and other three quarters will report INR 21 lakhs tax saved.

Illustration 2: When progressive rates of tax are applicable

<table>
<thead>
<tr>
<th>Estimated annual income</th>
<th>₹ 1 lakh</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Rates:</td>
<td></td>
</tr>
<tr>
<td>On first ₹ 40,000</td>
<td>30%</td>
</tr>
<tr>
<td>On the balance income</td>
<td>40%</td>
</tr>
<tr>
<td>Estimated income of each quarter is</td>
<td>₹ 25,000</td>
</tr>
</tbody>
</table>

Determine the amount of tax expense to be recognised in each of the quarterly financial reports.

Solution

Tax expense = 30% of ₹ 40,000 + 40% of ₹ 60,000 = ₹ 36,000

Weighted average annual effective tax rate = \( \frac{36,000}{100,000} \times 100 = 36\% \)

Tax expense of ₹ 9,000 (36% of ₹ 25,000) would be recognised in each of the quarterly financial reports.
Illustration 3: When different rates of tax are applicable to different portions of the estimated annual accounting income

Estimated annual income  ₹1 lakh
(inclusive of Estimated Capital Gains (earned in Quarter II) ₹20,000)
Tax Rates On Capital Gains  10%
    On other income:
        First ₹40,000  30%
        Balance income  40%
Estimated income of each quarter is ₹25,000
Income of ₹25,000 for 2nd Quarter includes capital gains of ₹20,000.
Assuming there is no difference between the estimated taxable income and the estimated accounting income, calculate the tax expense for each quarter.

Solution

Tax Expense:

<table>
<thead>
<tr>
<th>Part</th>
<th>Calculation</th>
<th>Tax Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>On Capital Gains portion of annual income = 10% of ₹20,000</td>
<td>₹2,000</td>
<td></td>
</tr>
<tr>
<td>On other income = 30% of ₹40,000 + 40% of ₹40,000</td>
<td>₹28,000</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>₹30,000</td>
</tr>
</tbody>
</table>

Weighted Average Annual Effective Tax Rate:

\[
\text{On Capital Gains portion of annual income} = \frac{2,000}{20,000} \times 100 = 10\% \\
\text{On other income} = \frac{28,000}{80,000} \times 100 = 35\%
\]

Calculation of Tax expense for each quarter:

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Income</th>
<th>Tax Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quarter I:</td>
<td>₹25,000</td>
<td>35% of ₹25,000</td>
</tr>
<tr>
<td>Quarter II:</td>
<td>Capital Gains: ₹20,000</td>
<td>10% of ₹20,000</td>
</tr>
<tr>
<td></td>
<td>Other: ₹5,000</td>
<td>35% of ₹5,000</td>
</tr>
</tbody>
</table>
7. GUIDANCE NOTE ON APPLICABILITY OF AS 25 TO INTERIM FINANCIAL RESULTS

7.1 Applicability of AS 25 to Interim Financial Statements

This Guidance Note deals with the issue whether AS 25 ‘Interim Financial Reporting’ is applicable to interim financial results presented by an enterprise pursuant to the requirements of a statute/regulator.

The Guidance Note recommends that the presentation and disclosure requirements contained in AS 25 should be applied only if an enterprise prepares and presents an ‘interim financial report’ as defined in AS 25. Accordingly, presentation and disclosure requirements contained in AS 25 are not required to be applied in respect of interim financial results (which do not meet the definition of ‘interim financial report’ as per AS 25) presented by an enterprise.

For example, quarterly financial results presented under Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) do not meet the definition of ‘interim financial report’ as per AS 25. However, the recognition and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in such interim financial results.

Example: Period of Reporting of Interim Financial Reporting

<table>
<thead>
<tr>
<th>Nature</th>
<th>Particulars</th>
<th>Current Period</th>
<th>Previous Period</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Half yearly Reporting for Enterprise FY ended 31st March 20X2</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance Sheet</td>
<td>As at</td>
<td>30 Sep 20X2</td>
<td>31 Mar 20X2</td>
</tr>
<tr>
<td>Profit &amp; Loss</td>
<td>6 months ending</td>
<td>30 Sep 20X2</td>
<td>30 Sep 20X1</td>
</tr>
<tr>
<td>Cash Flow Statement</td>
<td>6 months ending</td>
<td>30 Sep 20X2</td>
<td>30 Sep 20X1</td>
</tr>
<tr>
<td><strong>Quarterly Reporting for Enterprise FY ended 31st March 20X2</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
8. GUIDANCE NOTE ON ACCOUNTING FOR REAL ESTATE TRANSACTIONS (FOR ENTITIES TO WHOM IND AS IS APPLICABLE)

8.1 Objective and Scope

- This Guidance Note recommends accounting treatment for entities dealing in Real Estate as Sellers or Developers.
- The term ‘real estate’ refers to land as well as buildings and rights in relation thereto.
- Entities who undertake such activity are generally referred to by different terms such as ‘real estate developers’, ‘builders’ or ‘property developers’.
- The Accounting treatment of Real Estate prescribed herein is as enunciated in Ind AS 11 Construction Contracts, which provides for Application of percentage of Completion Method.
- The Accounting treatment of transaction which are in the nature of sale of goods is in accordance with the principles enunciated in Ind AS 18 Revenue.
- An illustrative list of transactions which are covered by this Guidance Note is as under
  (a) Sale of plots of land (including lease of land on finance lease under Ind AS 17, Leases) without any development or with development which includes common facilities like laying of roads, drainage lines and water pipelines, electrical lines, sewage tanks, water storage tanks, sports facilities, gymnasium, club house, landscaping etc.
  (b) Development and sale of residential and commercial complex, row houses, independent houses, with or without undivided share in land
  (c) Acquisition, utilisation and transfer of development rights.
  (d) Redevelopment of existing buildings and structures.
  (e) Joint development agreements for any of the above activities.
- Guidance note on Real Estate does not cover the real estate transactions in the nature covered by-
  - Ind AS 16: Property, Plant and Equipment
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- Ind AS-20: Accounting for Government Grants and Disclosure of Government Grants
- Ind AS 38: Intangible Assets
- Ind AS 40: Investment Property

8.2 Definitions

(a) **Project**: Project is the smallest group of units/plots/saleable spaces which are linked with a common set of amenities. A larger venture can be split into smaller projects, if the basic conditions as set out above are fulfilled.

**Example**
A project may comprise a cluster of towers or each tower can also be designated as a project. Similarly, a complete township can be a project or it can be broken down into smaller projects.

(b) **Project Costs**: Project costs in relation to a project ordinarily comprise

(i) **Cost of land and cost of development rights**: It includes all the costs related to acquisition of land.

(ii) **Borrowing costs**: It includes costs incurred directly in relation to a project or which are apportioned to a project. Ind AS 23 is to be applied in respect to it.

(iii) **Construction and development costs**: It includes costs incurred directly in relation to the specific project and costs that may be attributable to project activity in general and can be allocated to the project.

**Construction costs and development costs that relate directly to a specific project include:**

(a) land conversion costs, betterment charges, municipal sanction fee and other charges for obtaining building permissions;

(b) site labour costs, including site supervision;

(c) costs of materials used in construction or development of property;

(d) depreciation of plant and equipment used for the project;

(e) costs of moving plant, equipment and materials to and from the project site;

(f) Costs of hiring plant and equipment;

(g) costs of design and technical assistance that is directly related to the project;

(h) Estimated costs of rectification and guarantee work, including expected warranty costs; and
(i) Claims from third parties.

The below costs should not form part of the Construction Costs if they are material:

(a) General administration
(b) Selling costs;
(c) research and development costs;
(d) Depreciation of idle plant and equipment;
(e) Cost of unconsumed or uninstalled material delivered at site; and
(f) Payments made to sub-contractors in advance of work performed.

The below costs are incurred on specific or general basis to the project. These are allocated to the project on rational and consistent basis.

(a) Insurance;
(b) Costs of design and technical assistance that is not directly related to a specific project;
(c) Construction or development overheads; and
(d) Borrowing costs

(c) Project Revenues: Project revenues include revenue on sale of plots, undivided share in land, sale of finished and semi-finished structures, consideration for construction, consideration for amenities and interiors, consideration for parking spaces and sale of development rights.

♦ Under Ind AS 18, Revenue and Ind AS 11, Construction Contracts, project revenues are measured at fair value of the consideration received or receivable.

♦ The measurement of project revenues is affected by a variety of uncertainties that depend on the outcome of future events.

♦ The estimates often need revision as events occur and uncertainties are resolved.

♦ Therefore, the amount of project revenue may increase or decrease from one reporting period to the next.

8.3 Accounting for Real Estate Transactions

8.3.1 Contract for sale of Land (Without any development)

- All the principles of Ind AS 18 Revenue are to be applied to completed sale
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- The application of principles of Ind AS 18 in respect of sale of goods requires recognition of revenues on completion of the transaction/activity when the revenue recognition process in respect of a real estate project is completed.

- All the conditions of Ind AS 18 Revenue are to be satisfied:
  - The point in time where all the risk and rewards are transferred from buyer to seller.
  - The entity does not retain managerial involvement usually associated with ownership.
  - The amount of revenue can be measured reliably;
  - It is probable that the economic benefits associated with the transaction will flow to the entity;
  - The costs incurred or to be incurred in respect of the transaction can be measured reliably.

8.3.2 Contract for construction, development or sale of units

Contract for construction, development or sale of units that are not complete at the time of entering into agreements for construction, development or sale and also for sale of plot with development.

- In case of construction sales, the seller usually enters into an agreement for sale with the buyer at initial stages of construction.

- This agreement for sale is also considered to have the effect of transferring all significant risks and rewards of ownership to the buyer provided the agreement is legally enforceable and subject to the satisfaction of conditions which signify transferring of significant risks and rewards even though the legal title is not transferred or the possession of the real estate is not given to the buyer.

- Revenue in such cases is recognised by applying the percentage of completion method on the basis of the methodology explained in Ind AS 11, Construction Contracts.

- Where many contracts are entered for a single construction, when a component is completed, but significant performance in respect of remaining components of the project is pending, revenue in respect of such an individual contract should not be recognised until the performance in respect of remaining components of the project is pending.

8.3.3 Application of Percentage Completion Method

- The percentage completion method should be applied in the accounting of all real estate transactions/activities in the situations described i.e., where the economic substance is similar to construction contracts and also for the sale of developed plots.

- This method is applied when the duration of the project is beyond 12 months i.e. commencement and completion fall in different accounting period.
This method is applied when the outcome of a real estate project can be estimated reliably and when all the following conditions are satisfied:

i. total project revenues can be estimated reliably;

ii. it is probable that the economic benefits associated with the project will flow to the entity;

iii. the project costs to complete the project and the stage of project completion at the reporting date can be measured reliably; and

iv. The project costs attributable to the project can be clearly identified and measured reliably so that actual project costs incurred can be compared with prior estimates.

v. Further there is a rebuttable presumption that the outcome of a real estate project can be estimated reliably and that revenue should be recognised under the percentage completion method only when the events in (a) to (d) below are completed.

(a) All the critical approvals necessary for commencement of the project have been obtained

(b) If the expenditure incurred on the construction and development costs is less than 25%, nothing is recognised as in the profit and loss A/C of the contract.

(c) At least 25% of the saleable project area is secured by contracts or agreements with buyers.

(d) At least 10% of the contract consideration as per the agreements of sale or any other legally enforceable documents are realised at the reporting date in respect of each of the contracts and it is reasonable to expect that the parties to such contracts will comply with the payment terms as defined in the contracts.

Example:

If there are 10 Agreements of sale and 10% of gross amount is realised in case of 8 agreements, revenue can be recognised with respect to these 8 agreements only.

The recognition of project revenue by reference to the stage of completion of the project activity should not at any point exceed the estimated total revenues from ‘eligible contracts’/other legally enforceable agreements for sale.

When it is probable that total project costs will exceed total eligible project revenues, the expected loss should be recognised as an expense immediately. The amount of such a loss is determined irrespective of:

(a) Commencement of project work; or

(b) The stage of completion of project activity.
Illustration 4

**Facts**
- Total saleable area: 20,000 sqft
- Land cost: ₹ 300 lacs
- Estimated construction and development cost: ₹ 300 lacs
- Total area sold: 5000 sqft
- Total sale agreement value: ₹ 200 lacs
- Amount realized: ₹ 50 lacs
- Construction cost incurred including land cost: ₹ 360 Lacs

**Details**

**Whether revenue to be recognised as threshold limit is achieved or not?**

**Solution**

Percentage of completion for threshold limit is 20%

Area sold is 25% of total saleable area

Amount realized exceeds 10% of agreement value

Final answer – No revenue to be recognized as threshold limit not achieved

Illustration 5

**Facts**
- Total saleable area: 20,000 sqft
- Land cost: ₹ 300 lacs
- Estimated construction and development cost: ₹ 300 lacs
- Total area sold: 5,000 sqft
- Total sale agreement value: ₹ 200 lacs
- Amount realized: ₹ 50 lacs
- Cost incurred including land cost: ₹ 390 lacs

**Details**

**Compute profit.**

**Solution**

Percentage of completion for threshold limit is 30%

Area sold is 25% of total saleable area

Amount realized exceeds 10% of agreement value
Revenue to be recognized at 65% of ₹ 200 lacs i.e. ₹ 130 lacs

Cost [5000/20,000 x 390] ₹ 97.50 lacs

• Work in progress = ₹ 292.50 lacs
• Profit = ₹ 32.50 lacs

### 8.3.4 Transferable Development Rights

<table>
<thead>
<tr>
<th>Acquisition of Development Rights</th>
<th>Cost of Acquisition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Purchase</td>
<td>Cost of purchase</td>
</tr>
<tr>
<td>Development and Construction of built up area</td>
<td>Amount spent on development or construction of built-up area</td>
</tr>
<tr>
<td>Giving up of rights over existing structures or open land</td>
<td>The development rights should be measured in accordance with the principles of exchange of assets enunciated in paragraphs 45 to 47 of Ind AS 38, Intangible Assets.</td>
</tr>
</tbody>
</table>

When development rights are sold or transferred, revenue should be recognised when the following conditions are fulfilled:

(a) the entity has transferred to the buyer the significant risks and rewards of ownership of development rights;

(b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the development rights sold;

(c) the amount of revenue can be measured reliably;

(d) it is probable that the economic benefits associated with the transaction will flow to the entity; and

(e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.

**Note:**

In application of the above mentioned methods it is significant to determine the economic substance of the transaction. Economic substance is not influenced by the substance or legal form of the transaction or agreement.

### 8.4 Disclosure

An entity should disclose:

(a) the amount of project revenue recognised as revenue in the reporting period;
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(b) The methods used to determine the project revenue recognised in the reporting period; and
(c) The method used to determine the stage of completion of the project.

An entity should also disclose each of the following for projects in progress at the end of the reporting period:

(a) the aggregate amount of costs incurred and profits recognised (less recognised losses) to date;
(b) the amount of advances received;
(c) the amount of work in progress and the value of inventories; and
(d) Excess of revenue recognised over actual bills raised (unbilled revenue)

9. GUIDANCE NOTE ON COMBINED AND CARVE-OUT FINANCIAL STATEMENTS

9.1 Applicability of the Guidance Note

When one enterprise exercises control or Significant Influence over the other enterprise, Accounting Standard 21 and 23 is applicable for preparation and presentation of Consolidated Financial Statements. Occasions of take-overs of entities and/or divisions/segments/businesses, demergers, spin-offs, initial public offerings, etc. or loan arrangement which requires preparation of Group Financial Statements- Accounting Standard not applicable as there is no control or significant influence, Thus Guidance notes on Combined and Carve out Financial Statements is applicable.

This Guidance Note provides the meaning of combined/carve-out financial statements, indicative situations in which these may be required to be prepared and procedure for preparation of the same and required disclosures. This Guidance note is applicable only for Combined and Carved Out Financial Statements i.e Only for Specific Purpose Financial Statements. The Guidance Note is thus not applicable where Accounting Standard prevails i.e in General Purpose Financial Statement

Important Terms

- **Carved Out Business**: For the purpose of this Guidance Note and notwithstanding the definition of ‘business’ as contained in Ind AS 103, Business Combinations, the term ‘carve out business’ refers to an identifiable set of assets and liabilities, pertaining to an economic activity carved out of the aggregate activities of an entity. A division, segment, or business activity of an entity may also signify a carve-out business.

- **Carve-out Financial Statements**: Carve-out financial statements are the financial statements pertaining to a carve-out business.
• **Combined Financial Statements**: Combined financial statements are the financial statements that present the combined historical financial information of combining businesses that do not comprise a group for which the consolidated financial statements can be prepared.

• **Combining businesses**: For the purpose of this Guidance Note and notwithstanding the definition of ‘business’ as contained in Ind AS 103, Business Combinations, the term ‘combining businesses’ refers to two or more entities and/or divisions/segments/ businesses of the same or different entities, historical financial information in respect of which are being aggregated for the purpose of preparation of combined financial statements.

• **Common Control**: Combining businesses are said to be under common control when all the combining entities are ultimately controlled by the same party or parties and that control is not transitory.

• ** Remaining Group**: Entities or part of entities other than the carve-out business in respect of which carve-out financial statements are prepared.

### 9.2 Applicability of the Guidance Note

The terms used in this Guidance Note and not defined in this Guidance Note have the same meaning as those defined in the relevant Accounting Standards, and, in absence thereof, those defined in the Guidance Notes issued by the Institute of Chartered Accountants of India, unless the context requires otherwise.

### 9.3 Circumstances in which Combined/ Carve-out Financial Statements are prepared

Circumstances in which Combined/Carve-out Financial Statements may be prepared

(a) Two or more entities are combined in their entirety;

(b) Two or more carve-out businesses of the same or different entities are combined;

(c) One or more entities are combined with one or more carve-out businesses.

Examples where combined Financial Statements are prepared

• Acquisition, amalgamation, disposition of the group entities

• Initial Public offerings

• Combined financial statements of commonly controlled entities are likely to be of more value than their individual statements

• When borrowings from banks two or more entities under the same group are required to prepare the combined statements.
9.4 Carve out and Combined Financial Statements

Carve out Financial Statements means statements of a division or branch of the whole entity. This may be prepared in situations where there is demerger or hiving off of the branch or division of the whole entity.

9.5 Preparation of Combined Financial statements

9.5.1 Procedure for Preparation of Combined Financial Statements for two or more entities

- The Procedure is same as those applicable to the Consolidated Financial Statement as per relevant accounting standard.
- Thus, the treatment of elimination of intercompany Owings and inter group profit and loss remains as per AS
- Also non-controlling interests, foreign operations, different financial reporting periods, accounting policies or income taxes should be treated in the same manner as in consolidated financial statements prepared under the applicable Accounting Standards.
- In case the combining entities or any one of the combining entities are under common control, the carrying amounts pertaining to a subsidiary, as reflected in the consolidated financial statements of the parent, should be used for the purpose of preparing combined financial statements.

Example:

A Ltd. has three subsidiaries viz. X Ltd, Y Ltd. and Z Ltd. X Ltd. has better creditworthiness and approaches the bank for loan which will be used by both X Ltd. and Y Ltd. Bank requires combined financial statements of X Ltd. and Y Ltd. to be prepared for loan appraisal purposes. Combined financial statements of X Ltd. and Y Ltd. should be prepared using the amounts contained in A Ltd.’s consolidated financial statements pertaining to subsidiaries X Ltd. and Y Ltd.

9.5.2 Procedure for preparation of combined financial statements where at least one of the combining businesses is a carve-out business

Combined financial statements can be prepared reflecting aggregate historical financial information of:
• Situation 1: Two or more Carve out business of Different entities

Example:
A toll road project of company A Ltd. having various other projects is sought to be combined with a toll road project of another Company B; each of the companies has remaining projects which continue to operate independently.

• Situation 2: Two or more Carve out business of same entities

Example:
A toll road project of company A Ltd. having various other projects is sought to be combined with a wind-mill project of the same company; remaining projects continue to operate independently.

• Situation 3: One or more entities with one or more carve-out businesses.

Example:
X. Ltd. which is a subsidiary of A. Ltd. is sought to be combined with a toll road project of A Ltd; remaining projects of A. Ltd continue to operate independently.

9.6 Procedure for preparation of Carve-Out Financial Statements

Situation where Financial Statements of two branches or two divisions is combined is known as Carved out Financial Statements.

Example:
Where two branches (A and B) in a particular geographic segment (i.e. Mumbai) is to be compared with the branches (C and D) in Kolkata, this requires preparation of Carve Out Financial Statement Group A plus B and Group C plus D.

9.6.1 Basis for allocating transaction amounts and balances

• A method is developed to allocate the amount of asset and liabilities and income and expenses to the carve out business when transactions or balances are not directly identifiable. This amount is the fairest approximation of the amount actually attributable.

• Appropriate basis for allocating common income and expenditure to a carve-out business will vary according to the circumstances
  1. Salaries Accounted at HO, may be allocated to Branches on the Head Office also taking the employees turnover into consideration
  2. Costs of Advertisement may be allocated on the basis of sales of each branches
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- Allocation of Assets: Allocated on the basis of control, usage, legal ownership or any other appropriate basis
- Finance lease liabilities: Allocated in line with the allocation of the related assets
- Exceptional Items: Allocated to the carve-out business and accounted for in accordance with the applicable Accounting Standards.

Note:
In the carved out statements efforts have been made to allocate the common income, expense, assets and liabilities on a reasonable basis. Here we do not recognise or measure as if the carve out business had always been a standalone entity.

9.7 Aspects common to Combined/Carve-out Financial Statements

<table>
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</table>

**Taxation**
- Depends on whether separate Tax returns have been files or it has been dealt with on the larger level i.e at HO.
- Generally Combined/ Carve out business should be treated as standalone entity for Taxation Purpose.
- Approach involves aggregation of income and subtraction of expenses pertaining to the combined or carved out business.
- If separate returns not available allocation of tax expense must be determined on appropriate basis.

**Impairment**
- Impairment implies erosion in the value of asset. All the assets of Combined and carved business should be independently tested for impairment.
- All provisions with respect to measurement, recognition and disclosure of impairment should be governed by the applicable accounting standard.

**Transaction Costs**
- Transaction costs which are incurred for acquisition, amalgamation, demerger, hiving off, costs of registering and issuing debt and equity securities should be recognised as expenses in the periods in which the costs are incurred and the services are received.

**Capital**
- If there is capital issued for combining and carved out it will be specifically form part of capital.
- However, in other case, it will not possible for allocation of capital to combined or carve-out group.
Thus in this case the difference between the Assets and liabilities allocated to the group is taken as Capital of the group.

- A cash flow statement is prepared in accordance with the applicable Accounting Standards.
- Direct or indirect method may be adopted for preparation of cash flow statement depending upon the information available.

### 9.8 Disclosures required in the Combined/Carve-out Financial Statements

- Disclosure is required in the notes to the combined/carve-out financial statements of the fact that the information presented may not be representative of the position which may prevail after the transaction. Similarly, the fact that resulting financial position may not be that which might have existed if the carve-out business/combining businesses had been a stand-alone business should also be disclosed.

- Comparatives are not necessarily required to be given for the combined/carve-out financial statements.

- The following should also be disclosed in the combined/carve-out financial statements apart from the disclosures specified in the other paragraphs:
  
  a) The purpose of preparation of combined/carve-out financial statements;
  b) A list of combining businesses together with brief description of activities;
  c) Statement of compliance with the applicable Accounting Standards;
  d) The principal accounting policies followed in preparing the combined/carve-out financial statements;
  e) The basis for allocation, critical assumptions, judgments, and estimates involved in the preparation of combined/carve-out financial statements;
  f) Other disclosures as per the requirements of applicable Accounting Standards to the extent relevant;
  g) Where the accounting policies are not uniform in respect of the combining businesses, disclosure of that fact along with the accounting framework followed;
  h) Extent of balances (not having the characteristics of debt) treated as part of equity
  i) The basis of pricing inter-group transfers and any change therein.

**Note:** The above disclosures are not exhaustive and specific disclosures that will assist users’ understanding of combined/carve-out financial statements should also be made.
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Example-Combined Financial Statements
Owner B has three separate businesses comprising separate legal entities that each prepare stand-alone financial statements. B ‘combines’ the standalone financial statements into a single set of combined financial statements in preparation for an IPO.

Example: Carve-Out Financial Statements:
Owner D has a cable and telephone business that is part of a single legal entity. D ‘carves out’ the cable division into a set of carve-out financial statements in preparation for an IPO.
10. GUIDANCE NOTE ON ACCOUNTING FOR DERIVATIVE CONTRACTS

10.1 Introduction

Business transactions involving derivatives contracts is a novel concept. Such transactions are complex and are ever evolving. Currently, the relevant source of guidance for accounting of foreign currency forward exchange contracts is AS 11, which is notified under the Companies (Accounting Standards) Rules, 2006. AS 11 lays down accounting principles for foreign currency transactions and foreign exchange forward contracts and in substance similar contracts. However, it does not cover all types of foreign exchange forward contracts since contracts used to hedge highly probable forecast transactions and firm commitments are outside the scope of AS 11.

This Guidance Note will apply to all entities that do not apply Indian Accounting Standards (Ind AS).

10.2 Objective and Scope of the Guidance Note

10.2.1 Objective

The objective of this Guidance Note is to provide guidance on recognition, measurement, presentation and disclosure for derivative contracts so as to bring uniformity in their accounting and presentation in the financial statements. This Guidance Note also provides accounting treatment for such derivatives where the hedged item is covered under notified Accounting Standards, e.g., a commodity, an investment, etc., because except AS 11, no other notified Accounting Standard prescribes any accounting treatment for derivative accounting. This Guidance Note, however, does not cover foreign exchange forward contracts which are within the scope of AS 11. This Guidance Note is an interim measure to provide recommendatory guidance on accounting for derivative contracts and hedging activities considering the lack of mandatory guidance in this regard with a view to bring about uniformity of practice in accounting for derivative contracts by various entities

10.2.2 Scope

(1) This Guidance Note covers all derivative contracts that are not covered by an existing notified Accounting Standard. Hence, it does not apply to the following:

(i) Foreign exchange forward contracts (or other financial instruments which in substance are forward contracts covered) by AS 11.

(ii) Derivatives that are covered by regulations specific to a sector or specified set of entities.
(2) Entities such as banking, non-banking finance companies (‘NBFCs’), housing finance companies and insurance entities are required to follow the accounting treatment for derivative contracts, if any, prescribed by the concerned regulators such as the Reserve Bank of India (RBI) in case of banking entities and the NBFCs, National Housing Bank (NHB) in case of housing finance companies and Insurance Regulatory and Development Authority (IRDA) in case of insurance entities. In case the concerned regulator has not prescribed any accounting treatment for derivative contracts, the recommendations contained herein should be followed.

(3) This Guidance Note also provides guidance on accounting of assets covered by Accounting Standard (AS) 2, Valuation of Inventories, Accounting Standard (AS) 10, Accounting for Fixed Assets, Accounting Standard (AS) 13, Accounting for Investments, etc., which are designated as hedged items, since such notified Accounting Standards are silent on hedge accounting using derivative instruments for items covered by these Standards. In contrast, AS 11 provides guidance specific to foreign currency forward contracts. Accordingly, guidance for accounting for derivatives and hedging relationships which pertain to hedged items covered under such notified Accounting Standards, e.g., commodities stock, fixed assets, investments etc., is provided in this Guidance Note. However, this Guidance Note does not provide guidance on accounting for items and transactions covered in AS 11, which is a notified Standard. Similarly, accounting for embedded derivative contracts is not part of the scope of this Guidance Note since there are potential conflicts with the requirements of certain other notified Accounting Standards such as AS 2, AS 13 etc. Further, this Guidance Note does not deal with macro-hedging and accounting for non-derivative financial assets/liabilities which are designated as hedging instruments since its objective is to provide guidance on accounting for derivative contracts only and not hedge accounting in its entirety.

(4) This Guidance Note, thus, applies to following derivative contracts whether or not used as hedging instruments:

(i) Foreign exchange forward contracts (or other financial instruments that are in substance forward contracts) that are hedges of highly probable forecast transactions and firm commitments (therefore outside the scope of AS 11);

(ii) Other foreign currency derivative contracts such as cross currency interest rate swaps, foreign currency futures, options and swaps if not in the scope of AS 11;

(iii) Other derivative contracts such as traded equity index futures, traded equity index options, traded stock futures and option contracts; and

(iv) Commodity derivative contracts;

This list is meant to be illustrative only and is not exhaustive.

(5) Examples of contracts covered within the scope of AS 11 and thus not covered within the scope of this Guidance Note include:
• Foreign currency forward or future contract entered into to hedge the payment of a monetary asset or a monetary liability recognised on balance sheet, e.g., a debtor, creditor, loan, borrowing etc.

• A currency swap contract (principal only; no interest rate element) that hedges the repayment of the principal of a foreign currency loan.

This list is meant to be illustrative only and is not exhaustive.

10.3 Definitions

**Derivative:** A derivative is a financial instrument or other contract with all three of the following characteristics:

- 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”);

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

- it is settled at a future date

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

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

**Hedging Instrument:** A hedging instrument is a designated derivative whose fair value or cash flows are expected to offset changes in the fair value or cash flows, of a designated hedged item.

For the purposes of applying hedging in consolidated financial statements, the counterparty of a derivative instrument needs to be outside the consolidated group.

**Hedged Item:** A hedged item is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged. A hedged item could also be a portfolio or group of identified assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations.

**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 Ratio:** The ratio between the hedging instrument(s) and the hedged item(s) that is maintained during the course of a hedging relationship.
The other terms which are used in the Guidance Note and are not defined above would be deemed to have the same definitions as those contained in the Framework for Preparation and Presentation of Financial Statements and Accounting Standards issued by the ICAI.

10.4 Key Accounting Principles

- If an entity decides to apply hedge accounting as described in this Guidance Note, it should be able to clearly identify its risk management objective, the risk that it is hedging, how it will measure the derivative instrument if its risk management objective is being met and document this adequately at the inception of the hedge relationship and on an on-going basis.

- If any entity decides not to use hedge accounting as described in this Guidance Note, it should account for its derivatives at fair value with changes in fair value being recognised in the statement of profit and loss. All derivative contracts should be recognised on the balance sheet and measured at fair value.

- Adequate disclosures of accounting policies, risk management objectives and hedging activities should be made in its financial statements.

10.5 Synthetic Accounting not permitted

This Guidance Note does not permit synthetic accounting, i.e., accounting of combining a derivative and the underlying together as a single package. For instance, if any entity has a foreign currency borrowing that it has hedged by entering into a cross currency interest rate swap, it would require the entity to recognise the loan liability separately from the cross currency interest rate swap and not treat them as a package (synthetic accounting) as INR loan. Alternatively, if any entity has borrowed in terms of INR which it swaps with foreign currency borrowing it would not treat such a loan as a foreign currency borrowing.

10.6 Recognition of derivatives on the balance sheet date

This Guidance Note requires that all derivatives are recognised on the balance sheet and measured at fair value since a derivative contract represents a contractual right or an obligation. Fair value in the context of derivative contracts represents the ‘exit price’ i.e. the price that would be paid to transfer a liability or the price that would be received when transferring an asset to a knowledgeable, willing counterparty. The fair value would also incorporate the effect of credit risk associated with the fulfilment of future obligations. The extent and availability of collateral should be factored in while arriving at the fair value of a derivative contract.
10.7 Hedge Accounting

10.7.1 Where it designates a derivative contract as a hedging instrument, it needs to, as a minimum:

Where it designates a derivative contract as a hedging instrument, it needs to, as a minimum:

(a) identify its risk management objective;

(b) demonstrate how the derivative contract helps meet that risk management objective;

(c) specify how it plans to measure the fair value of the derivative instrument if the derivative contract is effective in meeting its risk management objective (including the relevant hedge ratio);

(d) document this assessment (of points (a) (b) (e) (f) (g) of this paragraph) at inception of the hedging relationship and subsequently at every reporting period;

(e) demonstrate in cases of hedging a future cash flow that the cash flows are highly probable of occurring;

(f) conclude that the risk that is being hedged could impact the statement of profit and loss; and

(g) adequately disclose its accounting policies, risk management objectives and hedging activities (as required by this Guidance Note) in its financial statements.

In India, for a large number of derivative contracts that are undertaken in the Over The Counter (OTC) market, authorised dealers (generally banks) are required by the concerned regulator (e.g. the Reserve Bank of India (RBI)) to determine whether all or some of the above criteria are met before permitting an entity to enter into such a contract. The permissibility of a contract under RBI regulations, whilst persuasive, is not a sufficient condition to assert that it qualifies for hedge accounting under this Guidance Note. Certain derivative instruments that are traded on stock exchanges such as foreign exchange futures contracts or equity options / equity futures do not have such requirements and in those cases, in particular, it will be important to demonstrate compliance with the above criteria before hedge accounting can be applied.

In case a derivative contract is not classified as a hedging instrument because it does not meet the required criteria or an entity decides against such designation, it will be measured at fair value and changes in fair value will be recognised immediately in the statement of profit and loss. It is clarified that derivatives cannot be designated for a partial term of the derivative instrument. A derivative may be used in a hedging relationship relating to a portion of a non-financial item as long as the hedged portion is clearly identifiable and capable of being measured reliably. Examples of such non-financial components include exchange (for instance London Metal Exchange) traded prices components of metal inventory and crude oil components of aviation turbine fuel.
10.7.2 Need for hedge accounting

Hedge accounting may be required due to accounting mismatches in:

- **Measurement** – some financial instruments (non-derivative) are not measured at fair value with changes being recognised in the statement of profit and loss whereas all derivatives, which commonly are used as hedging instruments, are measured at fair value.

  An example of measurement mismatch is the hedge of interest rate risk on fixed rate debt instruments that are not held with the intention of trading. Another example of a measurement mismatch could be a derivative undertaken to hedge the price risk associated with recognised inventory.

- **Recognition** – unsettled or forecast transactions that may be hedged are not recognised on the balance sheet or are included in the statement of profit and loss only in a future accounting period, whereas all derivatives are recognised at inception.

- Recognition mismatches include the hedge of a contracted or expected but not yet recognised sale, purchase or financing transaction in a foreign currency and future committed variable interest payments.

10.8 Types of hedge accounting

10.8.1 Fair value hedge accounting model

- A fair value hedge seeks to offset the risk of changes in the fair value of an existing asset or liability or an unrecognised firm commitment that may give rise to a gain or loss being recognised in the statement of profit and loss.

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

- The fair value changes of the hedged item and the hedging instrument will offset and result in no net impact in the statement of profit and loss except for the impact of ineffectiveness.

- An example of a fair value hedge is the hedge of a fixed rate bond with an interest rate swap, changing the interest rate from fixed to floating. Another example is the hedge of the changes in value of inventory using commodity futures contracts.

- The adjusted carrying amounts of the hedged assets in a fair value hedging relationship are subject to impairment testing under other applicable Accounting Standards such as Accounting Standard 28, Impairment of Assets, Accounting Standard 2, Valuation of Inventories, Accounting Standard 13, and Accounting for Investments etc.
10.8.2 Cash flow hedge accounting model

A cash flow hedge seeks to offset certain risks of the variability of cash flows in respect of an existing asset or liability or a highly probable forecast transaction that may be reflected in the statement of profit and loss in a future period.

- A cash flow hedge is a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction or a firm commitment in respect of foreign currency and (ii) could affect the statement of profit and loss. An example of a cash flow hedge is the hedge of future highly probable sales in a foreign currency using a forward exchange contract. Another example of a cash flow hedge is the use of a swap to change the future floating interest payments on a recognised liability to fixed rate payments.

- Under a cash flow hedge, the hedging instrument is measured at fair value, but any gain or loss that is determined to be an effective hedge is recognised in equity, e.g., cash flow hedge reserve. This is intended to avoid volatility in the statement of profit and loss in a period when the gains and losses on the hedged item are not recognised therein.

- In order to match the gains and losses of the hedged item and the hedging instrument in the statement of profit and loss, the changes in fair value of the hedging instrument recognised in equity must be recycled from equity and recognised in the statement of profit and loss at the same time that the impact from the hedged item is recognised (recycled) in the statement of profit and loss. The manner in which this is done depends on the nature of the hedged item:

  (A) if the hedged forecast transaction results in a financial asset or a financial liability being recognised, the gains or losses are recycled from equity as and when the asset acquired or liability incurred affects the statement of profit and loss, e.g., when interest income or expense is recognised.

  (B) if the hedged forecast transaction results in a non-financial asset or non-financial liability being recognised, either of the following two approaches may be applied:

  (C) the gains or losses are recycled from equity as and when the impact of asset acquired or liability incurred affects or is recognised in the statement of profit and loss, e.g., as depreciation or cost of sales is recognised.

  (D) the gains or losses are recycled from equity and included as a separate adjustment that is clubbed for financial statement presentation purposes with carrying amount of the asset acquired or liability incurred (referred to as the “basis adjustment”).

  (E) In all other cases the gains or losses are recycled from equity as and when the hedged forecast transaction affects statement of profit and loss.
An example of a forecast transaction that results in the recognition of a financial liability is a forecast issuance of a bond, which is hedged for interest rate risk using a forward-starting interest rate swap. The fair value gains or losses on the swap would be deferred in equity until the bond is issued and the swap starts, after which date they would remain in equity until amortised into the statement of profit and loss over the life of the bond.

10.8.3 Net investment hedging

- An investor in a non-integral operation is exposed to changes in the carrying amount of the net assets of the foreign operation (the net investment) arising from the translation of those assets into the reporting currency of the investor.

Principles relating to the hedge of a net investment in a foreign operation are:

- Foreign exchange gains and losses on a net investment in a non-integral foreign operation are recognised directly in equity. This occurs through the translation of the non-integral foreign operation’s net assets for purposes of consolidation;
- Gains and losses on foreign currency derivatives used as hedging instruments are recognised directly in equity to the extent that the hedge is considered to be effective;
- The ineffective portion of the gains and losses on the hedging instruments (and any proportion not designated in the hedging relationship) is recognised in the statement of profit and loss immediately;
- Any net deferred foreign currency gains and losses, i.e., arising from both the net investment and the hedging instruments are recognised in the statement of profit and loss at the time of disposal of the foreign operation.
- This Guidance Note does not override the principles of AS 11. However, it introduces the hedge accounting criteria for hedging of net investment

10.9 Formal Documentation at Inception of Hedge

At inception of a hedge, formal documentation of the hedge relationship must be established. The hedge documentation prepared at inception of the hedge must include a description of the following:

- the entity’s risk management objective and strategy for undertaking the hedge;
- the nature of the risk being hedged;
- clear identification of the hedged item (asset, liability or cash flows) and the hedging instrument;
- demonstrate how the derivative contract helps meet that risk management objective
- identify how it plans to measure the derivative if the derivative contract is effective in meeting its risk management objective;
• demonstrate in cases of hedging a future cash flow that the cash flows are highly probable of occurring; and

• Conclude that the risk that is being hedged could impact the statement of profit and loss.

This Guidance Note does not mandate a specific format for the documentation and in practice hedge documentation may vary in terms of lay-out, technology used etc. Various formats may be acceptable as long as the documentation includes the contents identified above.

A hedging relationship is effective if it meets all of the following requirements:

(I) There is an economic relationship between the hedged item and the hedging instrument.

(II) The effect of credit risk does not dominate the value changes that result from that economic relationship.

(III) The hedging relationship is expected to be highly effective in achieving the stated risk management objective and the entity is in a position to reliably measure the achievement of this objective both at inception and on an ongoing basis during the tenure of the hedging relationship.

10.9.1 Hedge Effectiveness Testing and Measurement of Ineffectiveness

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

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

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

An entity may consider the costs associated with a hedging instrument e.g. forward premium or time value of an option contract as a period cost (for example akin to interest costs when hedging an interest bearing asset or liability) or at a point in time (for example when hedging a forecasted sale or purchase) depending on the manner of designation and how the hedged item impacts the statement of profit and loss.

Hedge effectiveness is the extent to which changes in the fair value or the cash flows of the hedging instrument offset changes in the fair value or the cash flows of the hedged item.

Hedge ineffectiveness is the extent to which the changes in the fair value or the cash flows of the hedging instrument are greater or less than those on the hedged item. This Guidance Note does not prescribe bright line tests for effectiveness assessments but instead requires disclosure of the entity’s risk management objectives and measures for assessing if these objectives are met.
Hedging relationship will meet the hedge effectiveness requirements if:

(a) there is an economic relationship between the hedged item and the hedging instrument.
(b) the effect of credit risk does not dominate the value changes that result from the economic relationship.
(c) the hedge ratio of the hedging relationship is the same as that resulting from the quantities of
   - the hedged item that the entity actually hedges; and
   - the hedging instrument that the entity actually uses to hedge that quantity of hedged item; and
(d) the hedged item and the hedging instrument are not intentionally weighted to create hedge ineffectiveness - whether or not it is recognised - to achieve an accounting outcome that would be inconsistent with the purpose of hedge accounting.

- If the critical terms of the hedging instrument and the hedged item - e.g. the nominal amount, maturity and underlying - match or are closely aligned, then it may be possible to use a qualitative methodology to determine that an economic relationship exists between the hedged item and the hedging instrument.
- If a hedging relationship ceases to meet the hedge effectiveness requirement relating to the hedge ratio but the risk management objective for that designated hedging relationship remains the same, an entity should adjust the hedge ratio of the hedging relationship so that it meets the qualifying criteria again.

This Guidance Note does not also prescribe a single method of how ineffectiveness measurement should be conducted other than to require an entity to consider how ineffectiveness could affect a hedging relationship and require immediate recognition of such ineffectiveness. When measuring hedge ineffectiveness, an entity is required to consider the time value of money. Consequently, the entity determines the value of the hedged item on a present value basis and therefore the change in the value of the hedged item also includes the effect of the time value of money.

In certain situations, ineffectiveness is required to be recognised. These include:

- In a cash flow hedge, when the forecasted hedged transaction is no longer probable of occurring;
- In a fair value hedge, when the hedging instrument is no longer considered to be an effective hedge of the hedging instrument; and
- In any hedge relationship, if the risk management objective is changed or no longer expected to be met.

The recognition of ineffectiveness does not necessarily require hedge accounting to be discontinued if the risk management objective and criteria set out by the entity for the specific hedge relationship continues to be met.
10.9.2 Termination of hedge accounting / reclassification of hedge reserves

An entity is not permitted to stop applying hedge accounting voluntarily unless the risk management objective of the entity, as was originally defined by the entity when first applying hedge accounting, is no longer met.

(A) If an entity terminates a hedging instrument prior to its maturity / contractual term, hedge accounting is discontinued prospectively.

Any amount previously recognised in the hedge reserve (in the case of cash flow or net investment hedges) is reclassified into the statement of profit and loss only in the period when the hedged item impacts earnings, e.g., when a forecasted purchase / sale actually impacts earnings or when a net investment is disposed off in the case of a net investment hedge.

(B) In case of hedges of highly probable forecast transactions or commitments, if the forecasted transaction is no longer highly probable of occurring. Hedge accounting is discontinued prospectively but the amount recognised previously in the hedge reserve is reclassified into the statement of profit and loss only in the period when the hedged item impacts earnings (as specified in paragraph 35 of this Guidance Note). ‘Probable’ for the purpose of this assessment is based on whether the forecasted transaction is ‘more likely than not’ (or greater than 50% probability) of occurring.

(C) In case of hedges of forecast transactions, if the forecasted transaction is no longer probable of occurring

Hedge accounting is discontinued and all amounts recognised in the hedge reserve are recognised immediately in the statement of profit and loss. ‘Probable’ for the purpose of this assessment is based on whether the forecasted transaction is ‘more likely than not’ (or greater than 50% probability) of occurring. Judgment may need to be exercised in situations where a forecasted transaction is delayed to determine if the delayed transaction is the one that was subject to the original hedging designation or not.

Example: Call Options – Calculation of Profit & Loss

Exercise price as $100, call option premium $10, Lot size 200 equity shares. Now we will find out pay off and profit/loss of the buyer and seller of option if the settlement price is $90, $105, $110 and $120

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<tr>
<th>Exercise Price $100</th>
<th>Scenario-1</th>
<th>Scenario-2</th>
<th>Scenario-3</th>
<th>Scenario-4</th>
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<tr>
<td>Settlement price (under different scenarios)</td>
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</table>

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### Example Put Options – Calculation of Profit & Loss

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<thead>
<tr>
<th>Exercise price = $100</th>
<th>Scenario-1</th>
<th>Scenario-2</th>
<th>Scenario-3</th>
<th>Scenario-4</th>
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<td>Settlement price (under different scenarios)</td>
<td>80</td>
<td>90</td>
<td>100</td>
<td>110</td>
</tr>
<tr>
<td>Call option premium ($7 x 200)</td>
<td>1,400</td>
<td>1,400</td>
<td>1,400</td>
<td>1,400</td>
</tr>
<tr>
<td>Payment to be made by put option buyer= (Exercise price - settlement price) x lot size L</td>
<td>4,000</td>
<td>2,000</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>
Profit or loss to put buyer (payment made minus premium paid)

<table>
<thead>
<tr>
<th></th>
<th>2,600</th>
<th>600</th>
<th>-1,400</th>
<th>-1,400</th>
</tr>
</thead>
</table>

Payoff for put writer = Max (Exercise price-settlement price) x lot size

<table>
<thead>
<tr>
<th></th>
<th>-4,000</th>
<th>-2,000</th>
<th>0</th>
<th>0</th>
</tr>
</thead>
</table>

Pay off of call writer = Pay off minus premium paid

<table>
<thead>
<tr>
<th></th>
<th>-2,600</th>
<th>-600</th>
<th>1,400</th>
<th>1,400</th>
</tr>
</thead>
</table>

10.10 Presentation in Financial Statements

Derivative assets and liabilities recognised on the balance sheet at fair value should be presented as current and non-current based on the following considerations:

- Derivatives that are intended for trading or speculative purposes should be reflected as current assets and liabilities.
- Derivatives that are hedges of recognised assets or liabilities should be classified as current or non-current based on the classification of the hedged item.
- Derivatives that are hedges of forecasted transactions and firm commitments should be classified as current or non-current based on the settlement date / maturity dates of the derivative contracts.
- Derivatives that have periodic or multiple settlements such as interest rate swaps should not be bifurcated into current and non-current elements. Their classification should be based on when a predominant portion of their cash flows are due for settlement as per their contractual terms.

This Guidance Note does not permit any netting off of assets and liabilities except where basis adjustment is applied under cash flow hedges and hence all the amounts presented in the financial statements should be gross amounts. Amounts recognised in the statement of profit and loss for derivatives not designated as hedges may be presented on a net basis.

10.11 Disclosures in Financial Statements

An entity should satisfy the broader disclosure requirements by describing its overall financial risk management objectives, including its approach towards managing financial risks. Disclosures should explain what the financial risks are, how the entity manages the risk and why the entity enters into various derivative contracts to hedge the risks. An entity should disclose the methodology used to arrive at the fair value of derivative contracts (whether used for hedging or
not) and the extent of fair value gains/losses recognized in the statement of profit and loss and in equity.

The entity should disclose its risk management policies. This would include the hedging strategies used to mitigate financial risks. This may include a discussion of:

- How specific financial risks are identified, monitored and measured;
- What specific types of hedging instruments are entered into and how these instruments modify or eliminate risk; and
- Details of the extent of transactions that are hedged.

An entity is also required to make specific disclosures about its outstanding hedge accounting relationships. The following disclosures are made separately for fair value hedges, cash flow hedges and hedges of net investments in foreign operations:

- a description of the hedge;
- a description of the financial instruments designated as hedging instruments for the hedge and their fair values at the balance sheet date;
- the nature of the risks being hedged;
- for hedges of forecast transactions, the periods in which the transactions are expected to occur, when they are expected to affect the statement of profit and loss, and a description of any forecast transactions that were originally hedged but now are no longer expected to occur. This Guidance Note does not specify the future time bands for which the disclosures should be made. Entities should decide on appropriate groupings based on the characteristics of the forecast transactions;

If a gain or loss on derivative or non-derivative financial assets and liabilities designated as hedging instruments in cash flow hedges has been directly recognised in the hedging reserve:

- the amount recognised in hedge reserve during the period.
- the amount recycled from the hedge reserve and reported in statement of profit and loss.
- the amount recycled from hedge reserve and added to the initial measurement of the acquisition cost or other carrying amount of a non-financial asset or non-financial liability in a hedged forecast transaction.

Insofar as disclosure of derivatives designated for hedging foreign currency risks are concerned, the same should be disclosed in the Format attached as Appendix I to the Guidance Note, which also requires disclosure of all foreign exchange assets and liabilities including contingent liabilities, both hedged and unhedged.
Illustration 6

Mr A written a call option (i.e Sold Call option) details are as follows with a lot size of 1,000 shares of X Limited shares on 1st Feb 20X1 with premium of ₹ 5 per share. Exercise date is 31st Dec 20X1 and Exercise price is ₹ 102 per share.

Market price on 1st Feb 20X1 = 100 per share
Market price on 31st Mar 20X1 = 104 per share
Market price on 31st Dec 20X1 = 105 per share.

Calculate the fair value of the option and pass necessary journal entries.

Solution

In this contract “A” Agrees to Buy shares at $ 102 despite whatever is the price on 31st Dec 20X1.

So fair value of option in this case is as follows:

On 1st Feb 20X1 (Date on which contract entered) Fair value of option = ₹ 5,000
On 31st March 20X1 (Reporting date) = 5,000-(104-102) x 100 = ₹ 3,000
On 31st Dec 20X1 (Expiry date) = 5,000-(105-102) x 100 = ₹ 2,000

Accounting Entries

<table>
<thead>
<tr>
<th>Date</th>
<th>Particulars</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/02/20X1</td>
<td>Bank A/c Dr. To Call Option Obligation</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td></td>
<td>(Option premium received for writing call options)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31/3/20X1</td>
<td>Call Option Obligation Dr. To Fair Value Gain A/c</td>
<td>2,000</td>
<td>2,000</td>
</tr>
<tr>
<td></td>
<td>(Increase in fair value ₹ 5000-3000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31/12/20X1</td>
<td>Call Option obligation Dr. To Fair Value Gain A/c</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td></td>
<td>(Increase in fair value ₹ 3,000-2,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31/12/20X1</td>
<td>Call Option Obligation Dr. To Bank A/c (5,000-2,000-1,000)</td>
<td>2,000</td>
<td>2,000</td>
</tr>
</tbody>
</table>
2.40 FINANCIAL REPORTING

TEST YOUR KNOWLEDGE

Practical Questions

1. Mr A purchased a call option (i.e. Bought call option) details are as follows with a lot size of 1000 shares of X Limited shares on 1st Feb 20X1 with premium of ₹ 5 per share. Exercise date is 31st Dec 20X1 and Exercise price is ₹ 102 per share.

   Market price on 1st Feb 20X1 =100 per share
   Market price on 31st Mar 20X1 =104 per share
   Market price on 31st Dec 20X1 =105 per share.

   Calculate the fair value of the option and pass necessary journal entries.

2. Financial year for B Ltd. is 30th September and it reports quarterly. Tax year ends 31st March. For the financial year 20X1-20X2 it earns Rs 200 Lakhs pre-tax each quarter and tax rate is 30% in 20X2 and 40% in 20X3. Calculate tax expense.

3. An enterprise reports quarterly, estimates an annual income of ₹ 10 lakhs. Assume tax rates on first ₹ 5 lakhs @ 30% and on the balance income @ 40%. The estimated quarterly income are ₹ 75,000, ₹ 2,50,000, ₹ 3,75,000, and ₹ 3,00,000. Calculate tax expense.

Answers to Practical Questions

1. In this contract “A” purchased a call option to buy shares of X Ltd at ₹ 102 per share despite whatever is the price on 31st Dec 20X1. If price of X Ltd is more than 102 A will buy shares at ₹ 102 otherwise if the shares are operating below ₹ 102 he can deny buying shares at ₹ 102.

   So fair value of option in this case, is as follows

   On 1st Feb 20X1 (Date on which contract entered) Fair value of option= ₹ 5,000
   On 31st March 20X1 (Reporting date) = 5,000-(104-102) x 100= ₹ 3,000
   On 31st Dec 20X1 (Expiry date) = 5,000-(105-102) x 100= ₹ 2,000

   Accounting Entries

<table>
<thead>
<tr>
<th>Date</th>
<th>Particulars</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/02/20X1</td>
<td>Call Option Asset A/c Dr. To Bank A/c</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td></td>
<td>(Option premium received for buying call options)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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2. Tax expense for Q1 (ended Dec 20X1) & Q2 will be ₹ 60 lakhs each and for Q3 and Q4, ₹ 80 Lakhs each. For year ending Sep 20X2, total tax expense is ₹ 280 lakhs.

3. Calculation of Weighted Average Annual Tax Rate

<table>
<thead>
<tr>
<th>Outcome (1)</th>
<th>Weights (2)</th>
<th>(1) x (2)</th>
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<tbody>
<tr>
<td>30%</td>
<td>75,000</td>
<td>22,50,000</td>
</tr>
<tr>
<td>30%</td>
<td>2,50,000</td>
<td>75,00,000</td>
</tr>
<tr>
<td>30%</td>
<td>1,75,000</td>
<td>52,50,000</td>
</tr>
<tr>
<td>40%</td>
<td>2,00,000</td>
<td>80,00,000</td>
</tr>
<tr>
<td>40%</td>
<td>3,00,000</td>
<td>1,20,00,000</td>
</tr>
<tr>
<td></td>
<td>10,00,000</td>
<td>3,50,00,000</td>
</tr>
</tbody>
</table>

Tax Rate = 3,50,00,000/10,00,000 = 35%

<table>
<thead>
<tr>
<th></th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td>PBT</td>
<td>75,000</td>
<td>2,50,000</td>
<td>3,75,000</td>
<td>3,00,000</td>
</tr>
<tr>
<td>Tax expense</td>
<td>26,250</td>
<td>87,500</td>
<td>1,31,250</td>
<td>1,05,000</td>
</tr>
<tr>
<td>PAT</td>
<td>48,750</td>
<td>1,62,500</td>
<td>2,43,750</td>
<td>2,19,000</td>
</tr>
</tbody>
</table>