Change is inevitable
IFRS - Financial Instruments

Green house gas emission
Await accounting standard setters
Please find enclosed the May 2010 edition of the Accounting and Auditing Update.

The clarifications provided by the Ministry of Corporate Affairs on 4 May 2010 on IFRS adoption in India include bold steps such as – no requirements to publish comparatives as per IFRS converged standards in the year of adoption. It is evident that the regulators are motivated to make the initial IFRS adoption a painless process for the Indian adopters. While this step provides administrative relief, the lack of meaningful comparatives would make it hard for investors to distinguish year-on-year changes arising from adopting new standards from those arising from regular business operations. Further, the ability of the Phase II and III adopters to voluntarily early adopt IFRS converged standards on or after 1 April 2011 is again a step in the right direction and is expected to put peer pressure and thus, accelerate early adoption of IFRS in India.

Green House Gas (GHG) reduction projects, once approved by the United Nations Framework Convention on Climate Change (UNFCCC) are eligible for carbon credits. Such carbon credits generated in emerging countries like India can be sold to developed countries which have mandated emission reduction targets. One of the least understood areas is how to account for these carbon credits as there is no available authoritative literature or consensus. Few of the accounting issues include – (1) whether carbon credit is an asset – if yes, inventory or an intangible?; and (2) Should the assets be accounted at fair value or historical costs?. Additionally, significant Information Technology systems would need to be created to ensure that these credits are tracked and accounted for. In this publication, some of these next generation accounting challenges have been discussed.

IAS 39 Financial Instruments: Recognition and Measurement, acknowledged to be one of the most abstruse and complex accounting standards, is being replaced by the IASB in a phased manner. Some of the key changes which have been incorporated at the behest of the G-20 recommendations are discussed in this publication. These new standards are expected to become mandatory only in the middle of 2011 and are currently in Exposure Draft stage. Given that IASB itself is reworking the accounting for financial instruments, the not yet mandatory Indian Accounting Standard 30 which is based on IAS 39 principles, would be potentially required to be abandoned. Notwithstanding whether India moves on with AS 30 or implements a new standard in line with the IASB thought process, Indian corporates would need to gear up to the ever increasing disclosure requirements by implementing appropriate ERP/ IT systems.

We hope you enjoy reading this publication. We would look forward to receiving your feedback on what you would like us to cover in our future publications at aaupdate@in.kpmg.com.
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Financial statements provide a snapshot of a company’s financial condition and performance at a certain date and a period of time. In reality, its assets, liabilities and net worth are constantly changing. What happens when, after your financial statements are prepared, events occur that have a material impact on the numbers? In a constantly changing world, filtering those events that influence the financial statements and those that don’t, can be tricky. Accounting guidance has, therefore, evolved to equip management and accountants with principles and rules to deal with such 'subsequent events'.

In India, in conjunction with its efforts to converge its standards with International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISAs), the Institute of Chartered Accountants of India (ICAI) issued a Statement of Auditing (SA) 560 (Revised), Subsequent Events (corresponding to ISA 560 similarly titled) and has recently issued an exposure draft of Accounting Standard (AS) 4 (Revised), Events after the Reporting Period (corresponding to IAS 10 similarly titled and IFRS Interpretations Committee (IFRIC) 17, Distributions of Non-cash Assets to Owners). SA 560 and the AS4 exposure draft unite the Indian auditing and accounting requirements relating to subsequent events with international principles.

When effective, the proposed AS4 (Revised) would supersede the existing Indian AS4, Contingencies, and Events Occurring After the Balance Sheet Date. Its effective date is proposed to be from accounting periods commencing on or after 1 April 2011. SA 560 has been applicable from 1 April 2009.

The focus of this article is to explore the changes (though limited) that the AS4 exposure draft has proposed and to evaluate matters that may be of interest during its implementation. Although SA 560 has been put into practice for over a year now, it has introduced some interesting concepts which are also explored in this article.

“Filtering subsequent events into those that impact financial statements and those that do not could be challenging”
Dividends

From the effective date of AS4 (Revised), a company will no longer recognise a liability for dividend until such dividends are approved by the shareholders of the company.

Presently, when the dividends are declared by the Board of Directors after the reporting period but before the financial statements are authorised for issue, the existing AS4 requires that such a dividend is to be recognised in the financial statements as of the reporting date to help ensure compliance with Schedule VI of the Companies Act, 1956 (the Companies Act). Such recognition is expressly prohibited by the AS4 exposure draft.

Impact and our comments

The requirements of the AS4 exposure draft are contrary to the requirements of the Companies Act. The principle that “law overrides accounting standards” under Indian Generally Accepted Accounting Principles (I GAAP) would preclude accounting for dividend in accordance with the requirements of the AS4 (Revised). It is, therefore, essential that the Companies Act be amended suitably to align itself with the proposed accounting guidance.

“Under the revised guidance, accrual for proposed dividends pending shareholder approval may no longer be appropriate”

Distribution of non-cash assets to owners

The exposure draft introduces guidance on the recognition, measurement and presentation of the non-cash distributions to owners and this guidance is converged with IFRIC 17. Hitherto, I GAAP did not contain any guidance for such transactions.

We see the inescapable introduction of the concept of ‘fair value’ in this standard as well! The measurement of dividend to be settled through the distribution of non-cash assets is at the fair value of the assets to be distributed.

At the settlement date, the carrying amount of the dividend payable is reviewed and adjusted to its fair value at that date. Any change in its carrying value is recognised in equity as an adjustment to the amount of the distribution.

For example, Company A declares a dividend of 100 units of an available-for-sale security (which it carries on its balance sheet) to each of its 100 equity shareholders. At the balance sheet date (31 March 2xx1), the fair value of each unit of the security was INR 50. Assuming that the approval from the shareholders for the distribution of dividend is received on 31 March 2xx1, Company A would recognise a dividend liability of INR 500,000 (INR 50 * 100 *100) with a corresponding debit to equity at 31 March 2xx1.

If the fair value of the individual security is INR 60 on the date of actual settlement (say August 2xx1), Company A would be required to recognise the additional dividend liability of INR 100,000 with a corresponding adjustment to equity and then make the distribution. (The AS4 exposure draft also requires that the securities be marked up to their fair value with a corresponding adjustment to the income statement prior to the distribution).

This guidance does not apply to a distribution of a non-cash asset that is ultimately controlled by the same parties before and after the distribution. Therefore, a distribution of non-cash assets to individual shareholders who contractually have control over the entity will make such distribution outside the scope of this guidance.

Impact and our comments

At present, the applicability of this guidance in the Indian context is limited.

Companies in India are required to pay dividends in cash as per the requirements of section 205 of the Companies Act. Any other form of dividend distribution (except by way of capitalisation of reserves for the issue of bonus shares) is prohibited.

However, when regulations in India are amended to allow non-cash distributions, AS4 (Revised) would provide the guidance required to account for and report such transactions in the financial statements.
Authorised for issue

The AS4 exposure draft defines the term ‘events after the reporting period’ as those events that occur between the end of the reporting period and the date when the financial statements are authorised for issue. This is the date on which the recognised authority asserts that they have taken responsibility for the financial statements. Even if the shareholders are required to approve the financial statements, the date of authorisation for issue is the date of authorisation by the management.

Though the existing AS4 does not use the term ‘authorised for issue’, it specifies this date as the date on which the financial statements are approved by the Board of Directors in case of a company, and by the corresponding approving authority in case of any other entity. There is, therefore, principally no difference between the existing AS4 and the exposure draft of the revised standard on this account.

What would one do if the facts become known after the financial statements are approved for issuance by the Board of Directors? Such events are outside the scope of the existing AS4 as well as the exposure draft of the revised standard.

Interestingly, SA 560 broadens the scope of the subsequent event period for the auditor. The period extends up to the date of the auditors’ report. Although practically the auditor’s report date coincides with the Board approval date, in theory it can be later – maybe even after a month! The auditors’ responsibility, therefore, extends beyond the date of financial statement issuance and up to the date of his report.

Let’s consider a practical situation in which the Board approves the financial statements of a Company at their meeting which is held in Country A. The Company and its auditors are located in Country B and the authorised financial statements physically reach the auditor after one week. When the auditor issues his report, he is required by SA 560, to consider events that have occurred during the additional week after the date of Board approval as well.

SA 560 also requires the auditor to respond to the facts that become known to the auditor after the date of issuance of his report (and even after the issuance of the financial statement) if such events may have caused him to amend his report.

Such situations warrant discussions between the auditors and the management and depending on the circumstances, may also involve an amendment to the financial statements and the auditor’s report.

Subsequent periods within the scope of the accounting and auditing standards are depicted in the diagram below.

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**AS 4 exposure draft & SA 560**

- Balance sheet date
- Date Board authorised the issue

**SA 560**

- Auditor’s report date
- After date of issuance of auditor’s report/financials

Source: Accounting and Auditing Update, May 2010

“If facts are known to the auditor after the issuance of his report, he may be required to evaluate whether those facts warrant an amendment to his report”
The AS4 exposure draft requires the disclosure of the date through which an entity has evaluated subsequent events. This disclosure should alert users of financial statements that an entity has not evaluated subsequent events after that date in the set of financial statements being presented.

With detailed guidance on situations where financial statements and the report of the auditor can be revised, one cannot but ponder over the question "are these changes in the Indian accounting and reporting framework going to usher the era of ‘restatements’ in India?"
Going concern

Financial statements are prepared based on the fundamental accounting assumption that an entity is likely to continue its operations in the foreseeable future - generally understood as a minimum of one year from the balance sheet date. However, if after the reporting date, if it is determined that this assumption is no longer appropriate, the AS4 exposure draft requires a fundamental change in the basis of accounting, coupled with the following disclosures by reference to AS1 (revised).

Presentation of financial statements:
- The fact that the financial statements are not prepared on a going concern basis
- Details of the basis on which the financial statements are prepared
- The reason why the entity is not regarded as a going concern.

Although the existing AS4 requires assets and liabilities to be adjusted for the events occurring after the balance sheet date that indicate that the going concern assumption is not appropriate, it does not require the specific disclosures which are now being proposed.

The impact of the AS4 exposure draft on this topic is expected to be limited to additional disclosure requirements and more specific guidance.

Adjusting and non-adjusting events

Financial statements are adjusted to reflect the events that occur after the reporting date, but before the financial statements are authorised for issue, if either they provide evidence of conditions that existed at the reporting date (adjusting events) or they indicate that the going concern basis of preparation is inappropriate.

Financial statements are not to be adjusted for non-adjusting events. These are events that are a result of conditions that arose after the reporting date. However, material non-adjusting events merit disclosure in the financial statements because the knowledge of these events could influence the economic decisions of the users of the financial statements. Examples of such events are: business combinations after the reporting period, announcement of a plan to discontinue an operation, commencement of a major litigation and so on.

Consistent with the existing AS4, the exposure draft carries forward the requirement to disclose material non-adjusting subsequent events.

The categorisation of events as adjusting and non-adjusting may not always be clear-cut and often requires the application of judgment. Take, for example an ongoing litigation against a company to which the company makes an offer to settle subsequent to the year end.

An airplane manufacturer, Company A, has several legal suits pending at the year-end. One of these is a class action suit that claims that a defect in the design of one of the models has been responsible for several accidents, many of them serious, over the past few years. The company’s position is that the suit has no merit, and it plans a vigorous defence. Therefore, the company has not recognised a provision in its financial statements.

On reviewing the minutes of a meeting of the Board of Directors held subsequent to the year-end, it is observed that the item was discussed in a meeting. The chairperson of the Board received an offer to settle the claim out of court. Even though the Company believes it is likely to win in a court of law, the proposed settlement is less than half of what it would cost in legal fees for the company to defend itself. The Board unanimously accepted the settlement offer and the final agreement was being drafted when the financial statements were authorised for issue.

Would you adjust the financial statements at year-end to reflect a provision for the likely settlement amount? Tricky isn’t it?

In some cases, an event after the reporting date actually may have been triggered by an event that occurred prior to the reporting date. In such cases, it is necessary to determine the underlying causes of the event and its timing in order to determine the appropriate accounting.

One would need to assess the following:
- Is there a triggering event
- Why did it happen i.e. causes for the triggering event
- Time-period when this triggering event took place?

We believe an adjustment would be required in the previous periods for the subsequent events that provide evidence of the conditions existing at the date of the financial statements.

“To distinguish adjusting events from those which are non-adjusting, careful consideration of all pertinent facts and application of judgment would be required”
Continuing with the above example, let’s discuss the accounting treatment by the counterparty, Company X, which has filed the lawsuit against Company B.

Company X’s financial statements are authorised for issue after the Board of Directors of Company B has accepted the settlement offer which has been communicated to Company X. Company X considers whether the favourable settlement is an adjusting or non-adjusting event in respect of its claim, which has been treated as a contingent asset because its realisation was probable but not virtually certain at the reporting date.

In our view, the change in probability of the recovery of the contingent asset due to the settlement agreement is an event that should be reflected in the financial statements of the period in which the change occurs and should not be treated as an adjusting event in the prior period financial statements - even though this is not symmetrical with the accounting by the counterparty (Company B).

Current vs. non-current classification:

Generally, the classification of long-term debt as current or non-current reflects circumstances at the reporting date. Refinancings, amendments, waivers, etc. signed after the reporting date, are not considered in determining the classification of debt. However, if an entity expects, and has the discretion, at the reporting date to refinance or to reschedule payments on a long-term basis, then the debt is classified as non-current.

For example, when an entity breaches a proviso of a long-term loan arrangement 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 date and before the authorisation of the financial statements for issue, not to demand payment as a consequence of the breach. The entity classifies the liability as current because, at the end of the reporting period, it does not have an unconditional right to defer its settlement for at least 12 months after that date.

However, the entity would classify the liability as non-current if the lender agreed by the end of the reporting period to provide a period of grace, ending at least 12 months after the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment.

Identifying the key event

In some cases an event after the reporting date actually may have been triggered by an event that occurred prior to the reporting date. In such cases it is essential to determine the underlying causes of the event and its timing in order to determine the appropriate accounting.

For example, Company Z receives notice after the reporting date that one of its major customers has gone into liquidation. The bankruptcy of a customer after the reporting date usually confirms that a loss existed at the reporting date. Therefore, Company Z should assume that the bankruptcy is an adjusting event unless evidence to the contrary exists (e.g., the customer became bankrupt because its main operating plant was destroyed in a fire that occurred after the reporting date).

The discovery of fraud after the reporting period.

How would one deal with the discovery of fraud after the financial statements have been authorised for issue or after the end of the reporting period but before the financial statements are authorised for issue?

In our view, if information about the fraud could not reasonably be expected to have been obtained and taken into account when the financial statements were authorised for issue, then subsequent discovery of such information is not an evidence of a prior period error in those financial statements. However, when after the reporting date but before the financial statements are authorised for issue, the discovery of a fraud raises issues relating to the existence of financial assets involved, then it should be treated as an adjusting event. This is because the discovery of the fraud provides additional information regarding the existence of financial assets at the reporting date.

Summary

The AS4 exposure draft does not make significant changes to the principles that apply to subsequent events. It does, however, underscore the management’s responsibility for identifying and disclosing such events.

The revised standard is likely to introduce the concept of accounting for non-cash distributions and is likely to provide additional clarity to the existing concepts. Its successful implementation requires limited amendments to the existing regulations that would otherwise prevent a full convergence.
To address the issue of global warming, the United Nations Framework Convention on Climate Change (UNFCCC) was adopted by 154 countries in 1992, with the objective of limiting the concentration of GHGs in the atmosphere. Subsequently, to supplement the Convention, the Kyoto Protocol came into force in February 2005, which sets limits to the maximum amount of emission of GHGs by the countries. The Kyoto Protocol is a voluntary treaty signed and ratified by 187 countries for reducing GHG emission. However, the United States of America which accounts for one-third of the total GHG emission has signed but not ratified the Kyoto Protocol. Until ratified, the United States of America is not committed to the Kyoto Protocol.

Of the total 187 countries, the Kyoto Protocol at present commits 41 developed countries to reduce their GHG emissions by at least 5 percent below their 1990 baseline emission by the commitment period of 2008-12 and the remaining developing and least-developed countries are not bound by the amount of GHG emissions that they can release in the atmosphere, though they too generate GHG emissions.

Under the Kyoto Protocol, developed countries with binding emission reduction targets in order to meet the assigned reduction targets are issued allowances (carbon credits) equal to the amount of emissions allowed. An allowance (carbon credit) represents an allowance to emit one metric tonne of carbon dioxide equivalent. To meet the emission reduction targets, binding countries in turn set limits on the GHG emissions by their local businesses and entities.

Further, in order to enable the developed countries to meet their emission reduction targets, the Kyoto Protocol provides three market-based mechanisms to acquire carbon credits:

Over the last century, anthropogenic activities carried out in the developed countries and economies in transition have contributed towards the increase in the concentration of Green House Gases (GHGs) in the atmosphere. It has been estimated that 60-70 percent of GHG emissions are through fuel combustion in industries such as power, cement, steel, textile and fertilizers. Some GHGs like hydro fluorocarbons, methane and nitrous oxide are released as by-products of certain industrial process. These GHGs adversely affect the ozone layer and are the primary cause of global warming leading to climate change.

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1 Joint Implementation (JI) - Under JI, a developed country with a relatively high cost of domestic GHG reduction can set up a project in another developed country that has a relatively low cost and earn carbon credits that may be applied to their emission targets.

2 Clean Development Mechanism (CDM) - Under CDM, a developed country can take up a GHG reduction project activity in a developing country where the cost of GHG reduction is usually much lower and the developed country would be given carbon credits for meeting its emission reduction targets. Examples of projects include reforestation schemes and investment in clean technologies. In the case of CDM, entities in developing/least developed countries can set up a GHG reduction project, get it approved by the UNFCCC and earn carbon credits. Such carbon credits generated can be bought by entities of developed countries with emission reduction targets. The unit associated with CDM is Certified Emission Reduction (CER) where one CER is equal to one metric tonne of carbon dioxide equivalent.

3 International Emission Trading (IET) - Under IET, developed countries with emission reduction targets can simply trade in the international carbon credit market. This implies that entities of developed countries exceeding their emission limits can buy carbon credits from those whose actual emissions are below their set limits. Carbon credits can be exchanged between businesses/entities or bought and sold in the international market at the prevailing market price. Currently, carbon credits can be exchanged at the Chicago Climate Exchange, the European Climate Exchange, the Nord Pool, the PowerNext, the European Energy Exchange and the Multi Commodity Exchange (MCX) of India. These mechanisms serve the objective of both the developed countries with emission reduction targets, who are the buyers of the carbon credits as well as of the developing and least developed countries with no emission targets (at present), who are the sellers/suppliers of the carbon credits. The non-polluting companies from less developed countries can sell the quantity of carbon dioxide emissions they have reduced (carbon credits) and have earned extra money in the process. This mechanism of buying and selling carbon credits is known as carbon trading.
India

India is not currently obligated to reduce GHG emissions under the Kyoto Protocol. As a result, the Joint Implementation and International Emission Trading mechanism are not relevant. However, under the Clean Development Mechanism, entities in India can set up GHG reduction project to generate carbon credits and earn revenue.

Clean Development Mechanism

The Clean Development Mechanism is a flexible mechanism to enable countries with GHG emission reduction commitments to meet their commitments by paying for GHG emission reductions in developing countries. Such CDM projects earn saleable Certified Emission Reduction (CER) units, each equal to one metric tonnes of carbon dioxide equivalent, which can be counted towards meeting the Kyoto emission reduction targets. This mechanism encourages the developing and least developed countries which at present are not bound by the Kyoto Protocol to reduce the GHG emissions.

An entity desirous of undertaking a CDM project activity to generate carbon credits and in turn earn revenue needs to go through several stages. These are described below:

1. The entity desirous of setting up a CDM project needs to develop a Project Design Document (PDD) which should be approved by the Designated National Authority (DNA).

2. Once approved by the DNA, the proposed project is required to be validated by a Designated Operational Entity (DOE).

3. The DOE submits the validation report and all the other necessary documents to the CDM Executive Board along with the request for project registration. All the documents are hosted on the UNFCCC’s website and if within eight weeks no request for review of the proposed CDM project is received, the project is automatically registered.

4. Once the project is registered and becomes operational, the performance of the CDM project is monitored and verified periodically (usually once a year) by the DOE (different from the one involved in the first stage) appointed by the entity in order to determine whether emission reductions have taken place.

5. The DOE submits the verification report and other relevant documents to the Executive Board and requests for issuance of the CERs.

6. The UNFCCC hosts these documents on its website and if within 15 days from the date of making the request for issuance no request for the issuance, review is received, then the CERs are certified and issued to the entity which represents a written assurance by the UNFCCC that a project activity achieved the emission reductions as verified. These CERs can be traded by the entity.

The ITC Sonar, the luxury property of ITC Hotels in Kolkata is the first hospitality chain in the world to have earned carbon credits. The ITC Sonar which switched to energy efficient Compact Fluorescent Lamps (CFL) bulbs as part of its energy saving drive and is issued 1,996 carbon credits per annum for a period of 10 years. The project has been registered as a clean development mechanism project (CDM) at the United Nations Framework Convention on Climate Change (UNFCCC).

“Carbon credits generated in emerging countries like India can be sold to developed countries which have mandated emission reduction targets”
Key accounting considerations

In relation to accounting for the CERs, there is no definitive accounting literature prescribed under the Indian GAAP. The Institute of Chartered Accountants of India (ICAI) has issued an exposure draft on accounting for self-generated Certified Emission Reductions in June 2009. As per the exposure draft, the following needs to be evaluated while accounting for CERs:

1. Is CER an asset?
   An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise. CER can be treated as an asset when the communication of credit of CER is received by the generating entity since only at this stage the CER becomes a resource controlled by the generating entity and therefore leads to expected future economic benefits in the form of cash and cash equivalent which would arise on the future sale of CER.

2. Can CER be treated as an asset prior to communication of credit of CER is received by the generating entity?
   CER cannot be treated as an asset prior to the communication of credit of CER is received by the generating entity, since there is no resource in existence for the generating entity and hence the question of ‘resource controlled’ and ‘expected future economic benefits’ does not arise.

3. When should a CER be recognised as an asset in the financial statements?
   An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it are expected to flow to the enterprise and the asset has a cost or value that can be measured reliably. Since the market for CERs is relatively new, the future economic benefits may not always be assured. The entity needs to make an assessment of the probability of the future economic benefits and if benefits are considered to be probable because there is a market for the self generated CERs, CERs should be recognised. Further, there are certain costs which are incurred to generate CERs, and therefore the cost of CERs can be measured reliably (see detailed discussion later).

4. What type of asset is a CER i.e. is it a tangible asset or an intangible asset?
   An intangible asset is an identifiable non-monetar asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. Further, the intangible asset also includes assets which are development by an entity for sale. CERs are treated as intangible assets since they are non-monetary assets without a physical form held for sale.

5. Are CERs within the scope of AS 26 Intangible Assets?
   AS 26 scopes out those intangible assets from its purview which are specifically dealt with in another Accounting Standard and require them to be accounted for in accordance with that Standard. For instance, intangible assets held for the purpose of sale in the ordinary course of business are excluded from the scope of AS 26 and are to be accounted for as per AS 2, Valuation of Inventories.
   Inventories are assets:
   (a) held for sale in the ordinary course of business
   (b) in the process of production for such sale

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

CERs are inventories of the generating entity as they are generated and held for the purpose of sale in the ordinary course of business. Even though, CERs are intangible assets, they are not within the scope of AS 26 and hence need to be accounted for as per the requirements of AS 2.

6. How should the CER be measured?
   CERs should be measured at cost or net realisable value, whichever is lower.
   Cost of inventories comprises all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition. Various costs are incurred by the generating entity to set up a CDM project activity, operate the CDM project and generate CERs. However, not all costs incurred by the generating entity give rise to CERs and therefore not all costs can be considered as the cost of bringing CERs into existence.

“Due to the evolving nature of this concept of emission credits, the accounting alternatives appear equally compelling”
The cost incurred by the generating entity and the accounting treatment has been explained in the below table:

<table>
<thead>
<tr>
<th>Cost</th>
<th>Accounting treatment</th>
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<tbody>
<tr>
<td>Research cost arising from exploring alternative ways to reduce emissions</td>
<td>Research and development costs are pre-implementation costs of CDM projects. Such costs should be capitalised as intangible asset when they bring into existence any patent of a process to reduce carbon emissions (as per AS 26, Intangible assets).</td>
</tr>
<tr>
<td>Cost incurred in developing the selected alternative as a process/device to reduce emissions</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cost</th>
<th>Accounting treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost incurred to prepare the Project Design Documents</td>
<td></td>
</tr>
<tr>
<td>Fees paid to DOE for validation and verification and to the National Authority for approval</td>
<td>These costs do not result in CERs coming into existence, and therefore, these costs need to be expensed as incurred.</td>
</tr>
<tr>
<td>Fees for registering with the UNFCCC</td>
<td></td>
</tr>
<tr>
<td>Costs incurred for monitoring and reduction of emissions</td>
<td></td>
</tr>
<tr>
<td>Cost incurred for certification of CERs</td>
<td>These costs bring CERs into existence by way of credit of the same by the UNFCCC to the generating entity and therefore, these costs are treated as part of the inventory.</td>
</tr>
</tbody>
</table>

The net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. While determining the net realisable value of CERs, one of the most reliable evidence available at the time the estimates must be considered, for example exchange quoted price. The estimated must take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date.

7 How should the underlying assets related to CERs be measured?

In case the entities use tangible assets for pollution control/reduction of emission such as incinerators, such assets are recorded as per the AS 10 Fixed Assets. Further, in case these assets generate CERs, the depreciation shall not be included in the cost of the inventory of the principal product of the generating entity as they do not contribute to bringing the inventory of the principal product to their present location and condition.

For example, if an entity in a chemical business installs incinerators to reduce emissions, the depreciation of the incinerators should not be added in the cost of producing chemicals. Further, the depreciation of these devices should also not be included in the cost of inventory of CERs as the depreciation is incurred at the stage before CERs come into existence. Also as discussed in the preceding question, only costs incurred towards the certification are the costs of the inventory of CERs as they bring the CERs into existence. Accordingly, depreciation of the pollution control/emission reduction devices should be expensed in the period to which it relates.

“Sufficient rigours and controls need to be instituted to ensure that costs which do not result in CERs coming into existence are expensed”
European Union

Cap and trade schemes

Cap and trade schemes are by far predominant, with the European Union Greenhouse Gas Emission Trading Scheme (EU ETS), which started in 2005.¹

In a cap and trade scheme, a ‘scheme administrator’ (e.g., a governmental agency) sets an overall cap on the amount of emissions that may be released during the specified time periods. In the EU ETS, the current ‘commitment period’ runs from 2008 through 2012. The commitment period is divided into annual ‘compliance years’. The overall cap is implemented by issuing emission allowances to emit. Each ‘emission allowance’ grants a right to emit a certain amount of regulated pollutant.

Before a specified deadline following the compliance year, participants must offset their emissions by remitting to the scheme administrator emission allowances equal to their actual emissions. The issuance of emission allowances is governed by ‘allocation plans’. The allocation plans determine the number of emission allowances that are granted for free to the participants and the number that are sold or auctioned in the market place. An example of emission trading is as follows:

Company A is granted an emission allowance of 200 metric ton as a part of its annual compliance plan and it intends to achieve emission targets as stated above. Company B is granted a similar emission allowance of 300 metric ton as a part of its annual compliance plan. At the end of the year, on assessment and verification of actual emission of Company A, it has confirmed an emission of 185 metric ton. This has been possible due to the installation of certain renewable energy devices during the year. On verification of the actual emission of Company B, it had confirmed an emission of 310 metric ton. The surplus of allowance of Company A is tradable in an active market which in turn can be purchased by Company B to offset its additional emission.

Baseline and credit schemes

Baseline and credit schemes differ from cap and trade schemes in one important aspect. Instead of issuing emission allowances equal to the cap before or near the beginning of the compliance year, the scheme administrator assigns a ‘baseline’ to each participant in the scheme. The baseline establishes the emissions limit.

A participant may emit without incurring additional costs up to the level of the baseline. At the end of the compliance year, each participant’s emissions for the year are measured. If a participant’s emissions are below its baseline, it receives ‘credits’ equal to the difference. If a participant has exceeded its baseline, it has to purchase and surrender ‘credits’ equal to the difference. The period of time between the issuance of credits and the deadline for remitting them is relatively short (usually only a few months), and thus the trading activity is limited. The baseline itself is assigned to a specific source of emission and is not tradable.

Other schemes

Many emissions trading schemes provide entities, added flexibility in fulfilling a part of their scheme obligation by allowing them to remit project-based certificates. A project might involve, for example, upgrading equipment at a foreign plant (outside the jurisdiction of the emissions scheme) to make it more efficient. Once a project is approved, validated, registered and verified, certificates are issued that may be traded or remitted in lieu of standard scheme allowances.

““The terms and conditions of the applicable schemes would govern the timing and manner of asset/liability recognition for emission rights/compliance obligations”

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¹ ttp://ec.europa.eu/environment/climat/emission/mrg_en.htm
² http://ec.europa.eu/environment/climat/emission/index_en.htm
Key accounting considerations - IFRS

In December 2004, the International Financial Reporting Interpretations Committee (IFRIC) released IFRIC 3, Emission Rights, in an attempt to address how participants should account for cap and trade emission trading schemes. IFRIC 3 concluded that emission allowances, whether issued by government or purchased in the market, are intangible assets to be accounted for in accordance with IAS 38, Intangible Assets, as follows:

- On initial recognition, allowances issued for less than their fair value should be measured at fair value, with the difference between the amount paid and fair value reported as a government grant, in accordance with IAS 20, Accounting for Government Grants and Disclosure of Government Assistance. This grant should be recognised as deferred income and subsequently recognised as income, on a systematic basis over the compliance period for which the associated allowances are issued, regardless of whether those allowances continue to be held or are sold. An entity may subsequently choose to measure them under either the cost or revaluation model in IAS 38.
- As the entity actually emits GHGs or carbon-equivalents, a liability should be recognised for the obligation to deliver allowances equal to those actual emissions. This liability is a provision within the scope of IAS 37, Provisions, Contingent Liabilities and Contingent Assets, and is required to be measured at the best estimate of the expenditure required to settle the present obligation at the balance sheet date. This should usually be the present market price of the number of allowances required to cover emissions made up to the balance sheet date.

Reservations were expressed by companies due to different bases for measuring and presenting changes in the component assets and liabilities of the proposed accounting model. The main area of concern was around the fact that under IAS 38, changes in the market value of intangibles (i.e., emissions allowances held) are recognised in equity. However, the change in the value of the emissions obligation is recognised through profit and loss. Consequently, at its June 2005 meeting, the International Accounting Standards Board (IASB) withdrew IFRIC 3 to address the underlying accounting in a more comprehensive manner than originally envisaged by the IFRIC.

Currently, there is no authoritative literature in respect of accounting for emission rights under International Financial Reporting Standards which has resulted in diverse views. Divergent practices currently being followed by companies is as outlined below:

<table>
<thead>
<tr>
<th>Accounting option 1</th>
<th>Accounting option 2</th>
<th>Accounting option 3</th>
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<tbody>
<tr>
<td>Follow IFRIC 3 in its entirety, on the basis that IFRIC 3 is consistent with current endorsed IFRSs, specifically IAS 38, IAS 20, and IAS 37.</td>
<td>Recognise the intangible asset initially at fair value, together with a government grant in line with IFRIC 3, but recognise a provision on the following basis: • To the extent that the entity holds a sufficient number of allowances, the provision should be recognised based on the carrying value of those allowances (i.e., the cost to the entity of extinguishing their obligation) • To the extent that the entity does not hold a sufficient number of allowances, the provision should be recognised based on the market value of emission rights required to cover the shortfall.</td>
<td>No asset or deferred income is recognised when the allowances are initially received as IAS 20’s accounting policy choice of recognising the grant at nominal amount is applied (nominal amount being zero in this case). Allowances granted to an entity are used to offset any liability arising as a result of carbon emissions. Hence, no entries are required so long as the entity holds sufficient allowances to meet its emission obligations. Where the entity has no allowances or a shortfall in allowances to meet its emission obligations, a provision should be made for the best estimate of the cost to be incurred to meet its emission obligation, i.e., at the present market price of the number of allowances required to cover the shortfall at the balance sheet date (e.g., for the cash cost of obtaining allowances to meet its obligation at market value).</td>
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Our comments

Emission allowances received by a participant in a ‘cap and trade’ scheme, whether purchased or issued by the government, are intangible assets. Non-monetary government grants can be recognised either at fair value or at a nominal amount. The liability arising in an emission allowance scheme from producing pollution may be measured based on the carrying amount of the allowances held to the extent that an entity holds sufficient allowances to satisfy its current obligations, as this represents the best estimate of the expenditure required to settle the obligation. Otherwise, a provision should be recognised based on the current market value of the emission certificate at the reporting date. Recognition of a non-monetary government grant at the amount paid (often zero) would result in no liability being recognised if the liability is measured at the carrying amount (zero) of the related assets. Therefore, the preferable approach is to measure the allowances initially at fair value.

Subsequently, if the allowances are accounted for using the revaluation model for intangible assets, then any balance on the revaluation reserve in respect of the allowances derecognised when the entity settles its obligation under the scheme may be transferred directly to retained earnings within equity. This accounting treatment precludes any recycling of fair value increments related to the allowances through profit or loss at the date that the entity settles its obligations under the scheme. Conversely, if the entity accounts for its allowances under the cost method, then any difference between the carrying amount of the asset and the liability will be recognised in profit or loss upon settlement of the obligation.

For many allowances traded in an active market no amortisation will be required as the condition of the asset does not change over time, and therefore the residual value is likely to be the same as cost. As a result, the depreciable amount will be zero.

IFRS is silent on how an entity should determine the carrying amount of an allowance for the purposes of calculating a gain or loss on disposal. Therefore, the hierarchy for selecting accounting policies should be applied and accordingly, the guidance for determining the cost of inventories should be applied by analogy. In some cases, the certificates will have unique identification numbers, and therefore it is possible to apply the specific identification method if the holder tracks cost on an individual certificate basis. Otherwise, any reasonable cost allocation method, e.g., average cost or first-in first-out (FIFO), may be used. The method used should be applied consistently and disclosed in the accounting policy notes when appropriate.

An entity may receive emission allowances in a cap and trade scheme that are surplus to its expected usage requirements. The income from the sale of such allowances should be recognised as “other income”.

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Key accounting considerations

The guidance contained in the Federal Energy Regulatory Commission’s (FERC) Uniform System of Accounts is the only accounting guidance available in the US that explicitly addresses emissions allowances. Many of the US entities generally account for emission allowances in a manner similar to that required by FERC regulations. FERC requires entities to recognize emission allowances on a historical cost basis and to expense them as “consumed” on a weighted-average cost basis.

In November 2003, the Emerging Issues Task Force (EITF) attempted to address the accounting for emissions allowances in Issue No. 03-14, Participants’ Accounting for Emissions Allowances under a ‘Cap and Trade’ Program. However, after one meeting, the Task Force decided to remove Issue 03-14 from its agenda. Some Task Force members observed that any consensus reached on the issue might have implications beyond cap and trade emissions trading schemes, and they did not perceive a practice issue or diversity in the accounting for emission allowances.10

After the FASB Statement No. 153, Exchanges of Nonmonetary Assets, was issued in December 2004, questions arose in practice as to whether vintage year swaps should be accounted for at fair value or based on the recorded amount. On 8 August 2006, the Technical Application and Implementation Activities (TA&I) Committee approved a recommendation for the Financial Accounting Standard Board (FASB) to add a project to its agenda to address the nature of emission allowances and clarify the accounting for vintage year swaps.11 The staff exposed a draft proposed FASB Staff Position for external review that stated that the emission allowances are not inventory. Reviewers of the draft commented that the focus of the proposed FSP was too narrow and recommended that the Board address the accounting for emission allowances comprehensively. That proposed FSP was never finalised, and on 12 October 2006, the TA&I Committee instructed the staff to prepare an agenda request for the Board to consider whether to address the accounting for emission allowances in a comprehensive manner.10

Current developments

In December 2007, the IASB activated a joint project with the FASB to address the underlying accounting for emission trading schemes. An exposure draft is expected in the first half of 2010.11

United States of America

In a typical US cap and trade scheme, each individual emissions allowance has a vintage year designation, indicating the first year an allowance may be used. Unused allowances may be carried forward to future years. Allowing allowances with the same vintage year designation are fungible and may be remitted by any party to cover its emissions from any source. In these schemes, vintage year swaps among participants are common, as government agencies typically issue allowances for multiple years at a time. For example, an entity may expect to install equipment to reduce its emissions in 2009 but may need additional allowances in 2008 to cover a projected shortfall. This entity might exchange some of its allowances with a 2010 vintage year designation (when it expects to have reduced emissions) for allowances with a 2008 designation with another entity that has an opposite exposure.

Summary

Accounting for greenhouse gas emissions remains a challenge, and market participants continue to wait for clear guidance from accounting standard setters.

The impact of various accounting treatments followed is that the effect on the different components of financial statements (i.e., balance sheet, profit or loss or cash flow statements) may be different depending on the treatment adopted. Companies will therefore need to explain its accounting policy to help ensure that the impact of their emission rights accounting on financial performance is understood.
IAS 39, Financial Instruments: Recognition and Measurement sets out the requirements for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. The International Accounting Standards Board (IASB) inherited IAS 39 from its predecessor body, the International Accounting Standards Committee.

Many users of financial statements and other interested parties have told the IASB that the requirements in IAS 39 are difficult to understand, apply and interpret. They have urged the IASB to develop a new standard for financial reporting for financial instruments that is principle-based and less complex. Although the IASB has amended IAS 39 several times to clarify requirements, add guidance and eliminate internal inconsistencies, it has not previously undertaken a fundamental reconsideration of reporting for financial instruments.

In April 2009, in response to the inputs received on its work responding to the financial crisis, and following the conclusions of the Group of Twenty (G20) leaders and the recommendations of international bodies such as the Financial Stability Board, the IASB announced an accelerated timetable for replacing IAS 39.

As a result, in July 2009 the IASB published an exposure draft Financial Instruments: Classification and Measurement, followed by IFRS 9 Financial Instruments in November 2009.

The approach to replace IAS 39

The IAS 39 replacement project, and in particular its timeline, is driven in part by requests for reform from the G20 and other constituents. Following the conclusion of their September 2009 summit, the G20 leaders reiterated this message and called on the accounting setters to complete their convergence project by June 2011.

A phased approach has been adopted in order to accelerate the replacement of IAS 39 and address the consequences of the financial crisis as speedily as possible, while giving interested parties an opportunity to comment on the proposals in accordance with the IASB’s commitment to due process. The three main phases are:

- Classification and measurement of financial instruments IFRS 9 Financial Instruments on classification and measurement of financial assets. IFRS 9 addresses at present only financial assets. An exposure draft (ED) on classification and measurement of financial liabilities is expected in the near future. On 11 May 2010 an exposure draft on proposed changes to the fair value option (FVO) for financial liabilities has been published.
- Impairment of financial assets
  ED/2009/12 Financial Instruments: Amortised Cost and Impairment was published on 5 November 2009 with a comment deadline of 30 June 2010.
- Hedge accounting
  The IASB expects to publish an ED in time to allow for finalisation by the end of 2010.

A final standard incorporating all the three phases is scheduled for the fourth quarter of 2010.

Scope of IFRS 9

The objective of IFRS 9 is not to dramatically change the accounting for financial instruments, but to simplify the accounting. Hence, the standard has not modified the scope of financial assets in IAS 39.
Measurement principle for financial assets

Initial measurement
Like IAS 39, at initial recognition, all financial assets under IFRS 9 are recognised at fair value plus directly attributable transaction costs, except when the financial asset is classified as at ‘fair value through profit or loss’ (FVTPL).

Subsequent measurement
As proposed in the ED, IFRS 9 retains a mixed measurement model, with some financial assets measured at amortised cost and others at fair value. Retaining but simplifying the mixed measurement model was an important recommendation of the Financial Crisis Advisory Group. The distinction between the two measurement models is based on the business model of each entity and a requirement to assess whether the cash flows of an individual instrument are only principal and interest. This business model approach is a fundamental building block of IFRS 9 and aims to align the accounting with the way that management deploys assets in its business, while also considering the characteristics of the assets.

Amortised cost
A financial asset qualifies for amortised cost measurement only if it meets both of the following conditions:
- the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows; and
- the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

If a financial asset does not meet both of these conditions, then it is measured at fair value.

Our comments
The existing categories under IAS 39 of “held-to-maturity”, “loans and receivables” and “available-for-sale” are eliminated. Financial assets that meet the conditions stated above, qualify for amortised cost measurement even if they are quoted in an active market.

IFRS 9 eliminates the previous exception in IAS 39 to measure certain investments in unquoted equity instruments at cost if their fair value cannot be measured reliably. Similarly, the exemption for derivative assets that are linked to and settled by delivery of such unquoted equity instruments has been eliminated. However, as IFRS 9 deals only with assets, the parallel exception in paragraph 47 of IAS 39 for financial liabilities, is retained. Therefore, derivative liabilities that are linked to and settled by delivery of unquoted equity instruments whose fair value cannot be reliably measured, are measured at cost.

Business model
The IASB clarified that an entity’s business model does not relate to a choice (i.e., it is not a voluntary designation) but rather, it is a matter of fact that can be observed by the way an entity is managed and information is provided to its management. IFRS 9 requires the key managerial personnel as defined in IAS 24, Related Party Disclosures to determine the objective of the business model. The entity’s business model is not determined at the level of every instrument, but is determined at a higher level. An entity may also have more than one business model for managing financial assets. For example, a bank’s retail banking division may hold its loan assets and manage the same in order to collect contractual cash flows while its investment banking business has the objective to realise fair value changes through the sale of loan assets prior to their maturity.

Our comments
In implementing the standard, an entity would have to consider at what level of its business activities the business model should be assessed. There may be circumstances in which it is not clear whether a particular activity involves one business model with some infrequent sale of assets, or whether these anticipated sales mean that in fact an entity has two different business models and only one qualifies as held to maturity. Similarly, there is no bright line in the standard as to what frequency of anticipated sales would preclude a single business model from qualifying as held to maturity. In many cases, entities may have to exercise significant judgement to determine the appropriate classification of financial assets.
Cash flow characteristics

For amortised cost measurement, the cash flows from financial asset should represent solely payments of principal and interest on the principal amount outstanding on specified dates. Interest here means the consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time.

Leverage is not consistent with the ‘solely payments of principal and interest’ criterion. Leverage is described as increasing the variability of the contractual cash flows such that they do not have the economic characteristics of interest. IFRS 9 lists freestanding swaps, options and forwards as instruments that contain leverage.

The following are examples when both the above conditions are met and hence the financial asset is subsequently remeasured at amortised cost:
• a bond with variable interest rate and an interest cap
• a fixed interest rate loan
• variable interest loans including an element of fixed credit spread which is determined at inception e.g., LIBOR + 300 bps
• purchase of impaired / discounted loans which are then held to collect the contractual cash flows.

On the other hand, an investment in a convertible loan note would not qualify for amortised cost measurement because of the inclusion of the conversion option which is not deemed to represent payment of principal and interest. Similarly, an inverse floating interest loan which has an inverse relationship consideration for the time value of money and credit risk will also not be considered.

Our comments

The standard states that interest is compensation for the time value of money and credit risk, which may be fixed at initial recognition. It appears that the standard contemplates that compensation for credit risk may not be fixed at inception and can vary to reflect changes in the creditworthiness of the borrower. If there are variations in the contractual cash flows of an instrument relating to credit risk, then entities will have to consider whether the variation can be regarded as compensation for credit risk and therefore whether the instrument may meet the ‘solely payments of principal and interest’ criterion.

Equity investments do not give rise to cash flows that are solely principal and interest. In addition, the dates of cash flows usually are not specified. Derivatives also do not have cash flows that are solely principal and interest since they are leveraged.

Entities may need to exercise judgement to determine whether cash flows from an instrument are leveraged, that is, whether they increase the variability of the contractual cash flows in a manner inconsistent with the ‘solely payments of principal and interest’ criterion.

Option to designate financial assets at fair value through profit or loss

An entity can choose to designate a financial asset which otherwise would qualify for amortised cost accounting as measured at fair value through profit or loss (FVTPL). This optional designation is permitted only if it eliminates or significantly reduces a measurement or recognition inconsistency (an “accounting mismatch”). That otherwise would arise from measuring assets or liabilities, or recognising gains or losses on them, on different bases. The election is available only on initial recognition of the asset and is irrevocable.
Our comments

The IASB concluded that the two other fair value designation conditions available currently in IAS 39 are rendered redundant for financial assets by the requirements of IFRS 9. The two conditions that are eliminated with respect to financial assets relate to:

- Assets that are managed on a fair value basis. Under IFRS 9, financial assets managed on a fair value basis cannot qualify for amortised cost measurement and therefore are required to be measured at fair value.

- Hybrid financial instruments containing an embedded derivative that otherwise might require separation. Under IFRS 9, embedded derivatives with a financial asset host are not subject to separation.

The IASB has indicated that the eligibility conditions for the fair value option will be reconsidered in the context of the hedge accounting phase of the IAS 39 replacement project.

Recognition of dividends from equity investments, in respect of which the OCI election has been made, avoids an accounting mismatch to the extent that finance costs are reflected in profit or loss. Entities will have to consider when a dividend clearly represents a repayment of part of the cost of the investment. In many cases, for example when a dividend paid is less than the increase in the investee’s retained earnings since acquisition, it may be easier to conclude that a dividend does not clearly represent a repayment of part of the cost of the investment.

For instance, an entity may have issued foreign currency convertible bonds that are measured at fair value in entirety. These funds were utilised in investment of fixed rate bonds and met the amortised cost criteria in accordance with IFRS 9. This would lead to an accounting mismatch as the liability is measured at fair value while the asset is measured at amortised cost. This accounting mismatch can be significantly reduced by designating the financial asset at fair value through profit or loss as per IFRS 9.

This option is retained from IAS 39 and the application guidance in IAS 39 continues to apply.

Designation of investments in equity instruments

The standard allows an entity, at initial recognition only, to elect to present changes in the fair value of an investment in an equity instrument that is not held for trading in other comprehensive income (FVOCI). The election is irrevocable and can be made on an instrument-by-instrument (e.g., individual share) basis.

The amounts recognised in Other Comprehensive Income (OCI) are not recycled to profit or loss on disposal of the investment or in any other circumstances, although they may be reclassified within equity. Accordingly, there is no need for impairment testing for these assets. Dividend income on investments classified as FVOCI is recognised in profit or loss in accordance with IAS 18, Revenue unless the dividend clearly represents a repayment of part of the cost of the investment. In this case, the dividend is recognised in OCI.

IFRS 9 modifies the scope exemptions in IAS 28 Investments in Associates and IAS 31 Interests in Joint Ventures for venture capital organisations, mutual funds, unit trusts and similar entities, which allows investments in associates and joint ventures held by those entities to be accounted for under IAS 39. Currently, this exemption is available if the eligible entity upon initial recognition, designates the investments as at FVTPL or classifies the investments as trading. The consequential amendment makes the exemption available in respect of all equity investments held by eligible entities, as under IFRS 9, all equity investments may be accounted for as at FVTP.
Reclassifications

Change in business model
Classification of financial instruments is determined on initial recognition. Subsequent reclassification is prohibited. However, when an entity changes its business model in a way that is significant to its operations, a re-assessment is required of whether the initial classification remains appropriate. IFRS 9 expects such changes to be very infrequent and demonstrable to external parties.

New carrying value
If a financial asset is reclassified from fair value measurement to amortised cost measurement, then the fair value at the reclassification date becomes the new carrying amount. Conversely, if a financial asset is reclassified from amortised cost measurement to fair value measurement, then the fair value at reclassification date becomes the new carrying amount and the difference between amortised cost and fair value is recognised in the profit or loss.

Reclassification date
The reclassification date is the first day of the next reporting period. The reason the reclassification date is different from the actual date of change in the business model is that the IASB did not want entities to choose a reclassification date to achieve an accounting result. Thus, from the date of change in business model until the reclassification date, financial assets continue to be accounted as if the business model has not changed.

Embedded derivatives

Embedded derivatives on financial asset host
Under IAS 39, embedded derivatives on financial assets hosts are assessed whether they need to be accounted separately. If the embedded derivative is separated from the host contract, the embedded derivative is measured at fair value while the host could be measured at amortised cost. IFRS 9 requires an entity to assess whether the hybrid instrument (i.e., host with embedded derivative) being a financial asset within the scope of the standard meets the criteria provided for amortised cost measurement. If the amortised cost measurement criteria are fulfilled, the entire hybrid instrument is measured at amortised cost. Else, the entire hybrid instrument is measured at fair value. However, in both cases, the embedded is not separated.

Embedded derivatives on non-financial asset host
IFRS 9 does not change the accounting prescribed under IAS 39 for embedded derivatives with host contracts that are not financial assets within the scope of IFRS 9. For example, rights under leases, insurance contracts, financial liabilities and other non-financial assets.

Effective date
The standard is effective for annual periods beginning on or after 1 January 2013. Early application is permitted. The standard requires retrospective application with certain exemptions and there are detailed transition requirements. If an entity adopts the standard before 1 January 2012, then it does not have to restate comparative information.
Conclusion

Given the far-reaching nature of the IAS 39 replacement project, many entities may need to undertake changes in systems and internal reporting in order to comply with its requirements. For this reason the IASB’s decision has taken a longer term time horizon for mandatory adoption of the new standard (2013). This also can allow preparers to adopt all phases of the project at once. Importantly, however, the new standard will be available for the early adoption before 2012 without the need to restate comparatives.

Early adoption will be a big step for any entity and it remains to be seen how many will choose this route. In some jurisdictions new standards have to be formally adopted before they can be applied. In others there may be specific restrictions on early application. In any event, we expect that many companies are likely to wait until the entire package, including impairment, hedge accounting and financial liabilities, has been finalised before making the change.

Furthermore, although there is close dialogue between the IASB and the US Financial Accounting Standards Board (FASB) on changes to financial instruments accounting, it is not as yet clear to what extent full convergence will be achieved on some of the issues.

Indian Accounting Standard 30, Financial Instruments – Recognition and Measurement becomes mandatory for financial periods commencing on or after 1 April 2011, is based on IAS 39 principles. With the IASB in the process of amending the provision of IAS 39, it remains to be seen how AS 30 is to be implemented in India in the transitional period.

The flow chart below provides an overview of the Classification and Measurement model in IFRS 9:

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The flow chart below provides an overview of the Classification and Measurement model in IFRS 9:

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* IFRS 9 has not modified the scope of financial assets in IAS 39
Regulatory Updates

MCA’s clarifications on IFRS convergence

The Ministry of Corporate Affairs (MCA) had earlier announced the roadmap for achieving convergence with IFRS by companies on 22 January 2010 and a separate roadmap on 31 March 2010 for the convergence of Indian Accounting Standards by the banking companies, insurance companies and non-banking finance companies.

As per the roadmap, in phase I, the following categories of companies (other than banking companies, insurance companies and NBFCs) are required to convert their opening balance sheet as at 1 April 2011 in compliance with the first set of Accounting Standards (i.e. the converged Accounting Standards)

• Companies which are part of NSE – Nifty 50

• Companies which are part of BSE – Sensex 30

• Companies whose shares or other securities are listed on stock exchanges outside India

• Companies, whether listed or not, which have a net worth in excess of Rs.1,000 crores

Further, the roadmap in respect of insurance companies, banking companies and non-banking financial companies (NBFCs) have the following convergence deadlines:

• Insurance companies will converge with effect from 1 April 2012

• Scheduled commercial banks will converge with effect from 1 April 2013

• A phased approach effective from 1 April 2013 has been prescribed for Urban Co-operative Banks

• Certain NBFCs (i.e. NBFCs which are part of Nifty 50, Sensex 30 or with net-worth more than INR 1000 crores) will converge with effect from 1 April 2013

• Other NBFCs (other than unlisted NBFC’s with a net-worth of INR 500 crores or less) will converge with effect from 1 April 2014

On 4 May 2010, the MCA has vide press release number 4/2010, issued a consolidated statement on clarifications sought on these roadmaps.

““The ability of the Phase II and III adopters to voluntarily early adopt IFRS converged standards on or after 1 April 2011 is expected to put peer pressure and thus accelerate adoption of IFRS in India””

1. The Ministry of Corporate Affairs website
The summary of these clarifications made by the MCA is as follows:

**Presentation of comparatives by companies covered in Phase I:**

The companies, covered in the phase I, would be required to convert their opening balance sheet as at 1 April 2011 in compliance with the first set of Accounting Standards (i.e., the converged Accounting Standards). Accordingly, companies are not required to provide comparative figures for the year 2010-11 as a first set of Accounting Standards (i.e., the converged Accounting Standards).

The MCA has clarified that such companies, preparing their financial statements for financial year 2011-12 in accordance with converged accounting standards, will present the previous years’ figures i.e., for financial year 2010-11, as per non-converged accounting standards.

However, such companies may voluntarily present previous years’ figures as per converged accounting standards as an additional column in the financial statements. In this case, therefore, the opening balance sheet shall be converted as on 1 April 2010.

**Voluntary earlier adoption**

The MCA has clarified the position relating to companies covered in II or III phase, who wish to voluntarily adopt the converged accounting standards earlier. As per the clarification, these companies shall have an option to early adopt the converged accounting standards on or after 1 April 2011.

However, while such voluntary early adoption is permitted for companies covered in II or III phase, it is not clear yet, whether such companies will be allowed to issue comparatives as per the converged standards.

**Discontinuing the use of converged accounting standards**

The MCA has also clarified that once the company starts following the converged accounting standards based on the eligibility criteria, it will be required to follow such standards for all subsequent financial years, even if it no longer satisfies the specified criteria. Such a company will not be allowed to revert to existing Indian accounting standards.

**Cut-off date for determination of criteria specified for adoption of converged accounting standards**

As explained above, two separate roadmaps for convergence with IFRS were issued by the MCA. The first roadmap was for companies (other than banking companies, insurance companies and NBFCs). The second roadmap explained the convergence timelines for banking companies, insurance companies and NBFCs. Both roadmaps specify criteria relating to net worth and listing requirements.

In this regard, the MCA has clarified that for companies, other than banking companies and NBFCs, such criteria shall be determined on the basis of audited balance sheet as on 31 March 2009.

For Banking Companies and NBFCs such criteria shall be determined on the basis of audited balance sheet as on 31 March 2011.

From the above clarification, it is, however, not clear that if an entity meets the criteria for Phase I on 31 March 2009 but then ceases to do so by 1 April 2011, or vice versa, whether it will still be covered in Phase I.

**Manner of calculating net worth**

The MCA has defined net worth for the eligibility criteria, as share capital plus reserves less revaluation reserve, miscellaneous expenditure and debit balance of the profit and loss account.

**Applicability to group entities**

The MCA has clarified that companies covered in a particular phase, having subsidiaries, joint ventures or associates, shall prepare consolidated financial statements as per the converged accounting standards.

It has been further clarified that the eligibility criteria is to be considered for each company’s stand alone financial statements. That is, if a company falls in any phase which is other than the phase applicable to the parent company, then such a company shall continue to prepare stand alone financial statements according to the phase applicable to them. However, such companies may voluntarily adopt converged accounting standards from an earlier date.

**Removal of options**

The MCA has clarified that the companies will follow the converged Accounting Standards and not the IFRS as issued by the International Accounting Standards Board (IASB), even if the converged accounting standards are not fully consistent with the IFRS as issued by the IASB.

An unanswered related question is with regard to companies that currently prepare IFRS compliant financial statements (as issued by the IASB) either because they are listed overseas or their parent company has already adopted IFRS. The MCA would need to clarify, as to how such companies transition from IFRS financial statements as issued by the IASB to the converged standards.

“While there is clarity to the effect that comparatives are not required it would be interesting to see how ICAI finally develops the transitional provisions for first time adopters”
Status of issuance of Indian Accounting Standards to meet the IFRS convergence timetable

The table summarises the status of the exposure drafts of the converged Indian accounting standards corresponding to IFRS. The final Indian converged standards are expected to be released on 30 June 2010.

| Standards cleared by the Council of the ICAI | AS 1 corresponding to IAS 1, Presentation of Financial Statements |
|                                           | AS 2 corresponding to IAS 2, Inventories                         |
|                                           | AS 3 corresponding to IAS 7, Statement of Cash Flows             |
|                                           | AS 4 corresponding to IAS 10, Events after the Reporting Period |
|                                           | AS 5 corresponding to IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors |
|                                           | AS 7 corresponding to IAS 11, Construction Contracts            |
|                                           | AS 12 corresponding to IAS 20, Accounting for Government Grants and Disclosure of Government Assistance |
|                                           | AS 16 corresponding to IAS 23, Borrowing Costs                  |
|                                           | AS 19 corresponding to IAS 17, Leases                          |
|                                           | AS 25 corresponding to IAS 34, Interim Financial Reporting      |
|                                           | AS 34 corresponding to IAS 29, Financial Reporting in Hyperinflationary Economies |
|                                           | IAS 35 corresponding to IFRS 6, Exploration for and Evaluation of Mineral Resources |

| Exposure drafts issued by the ICAI         | AS 9 corresponding to IAS 18, Revenue                           |
|                                           | AS 10 corresponding to IAS 16, Property, Plant and Equipment   |
|                                           | AS 11 corresponding to IAS 21, The Effects of Changes in Foreign Exchange Rates |
|                                           | AS 14 corresponding to IFRS 3, Business Combinations          |
|                                           | AS 15 corresponding to IAS 19, Employee Benefits              |
|                                           | AS 17 corresponding to IFRS 8, Operating Segments             |
|                                           | AS 18 corresponding to IAS 24, Related Party Disclosures       |
|                                           | AS 20 corresponding to IAS 33, Earnings per Share              |
|                                           | AS 21 corresponding to IAS 27, Consolidated and Separate Financial Statements |
|                                           | AS 22 corresponding to IAS 12, Income Taxes                    |
|                                           | AS 23 corresponding to IAS 28, Investment in Associates        |
|                                           | AS 24 corresponding to IFRS 5, Non-current Assets Held for Sale and Discontinued Operations |
|                                           | AS 26 corresponding to IAS 38, Intangible Assets              |
|                                           | AS 27 corresponding to IAS 31, Interest in Joint Ventures     |
|                                           | AS 28 corresponding to IAS 36, Impairment of Assets           |
|                                           | AS 29 corresponding to IAS 37, Provisions, Contingent Liabilities and Contingent Assets |
|                                           | AS 33 corresponding to IFRS 2, Share-based Payment            |
|                                           | AS 36 corresponding to IAS 26, Accounting and Reporting by Retirement Benefit Plans |
|                                           | AS 37 corresponding to IAS 40, Investment Property            |
|                                           | AS 38 corresponding to IAS 41, Agriculture                    |
|                                           | AS 39 corresponding to IFRS 4, Insurance Contracts            |

| Cleared by the ASB to be issued as exposure drafts | AS 30 corresponding to IAS 39, Financial Instruments: Recognition and Measurement |
|                                                   | AS 31 corresponding to IAS 32, Financial Instruments: Presentation |
|                                                   | AS 32 corresponding to IFRS 7, Financial Instruments: Disclosure |
|                                                   | AS __ corresponding to IFRS 9, Financial Instruments |
|                                                   | AS __ corresponding to IFRS 1, First-time Adoption of International Financial Reporting Standards |
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