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SUBJECT- ELECTIVE PAPER (GFRS)

BRANCH - () (Date :)

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ANSWER TO CASE STUDY 1

1. (C) Rs. 6,00,000
2. (C) Rs. 20,00,000 goodwill
3. (B) It is an embedded derivative closely related to the loan.
4. (C) Annual depreciation charge will be Rs. 13,000 and an annual transfer of Rs. 3,000 may be made from revaluation surplus to retained earnings
5. (D) It will be apportioned between the parent company and the NCI where the NCI is valued using the proportionate method

(2 X 5 = 10 marks)

6. **Accounting treatment for**

i. First Grant

The first grant for 'Clear River Project' involving research into effects of various chemicals waste from the industrial area in Madhya Pradesh, seems to be unconditional as no details regarding its refund has been mentioned in the question. Even though the research has not been started nor any major steps have been completed by Rainbow Limited to commence the research, the grant will be recognised immediately in profit or loss for the year ended 31st March, 2019.

Alternatively, in case, the grant is conditional as to expenditure on research, the grant will be recognised over the year the expenditure is being incurred and recognised in the books of Rainbow Limited.

ii. Second Grant

The second grant related to commercial development of a new equipment is a grant related to depreciable asset. As per the information given in the question, the equipment will be available for sale in the market from April, 2020. Hence, by that time, grant relates to the construction of an asset and should be initially recognised as deferred income.

The deferred income should be recognized as income on a systematic and rational basis over the asset's useful life.

The entity should recognize a liability on the balance sheet for the years ending 31st March, 2019 and 31st March, 2020. Once the equipment starts being used in the manufacturing process, the deferred grant income of Rs. 100,000 should be recognised over the asset's useful life to compensate for depreciation costs.

Alternatively, as per Ind AS 20, Rainbow Limited would also be permitted to offset the deferred income of Rs. 100,000 against the cost of the equipment as on 1st April, 2020.

iii. For flood related compensation

Rainbow Limited will be able to submit an application form only after 31st May, 2019 ie in the year 2019-2020. Although flood happened in September, 2018 and loss was incurred due to flood related to the year 2018-2019, the entity should recognise the

income from the government grant in the year when the application form related to it is submitted and approved by the government for compensation.

Since, in the year 2018-2019, the application form could not be submitted due to adoption of financials with respect to sales figure before flood occurred, Rainbow Limited could not recognise the grant income as it has not become receivable as on 31st March, 2019.

(6 Marks)

7. **Classification**

The investment property will be bifurcated for developing of units which will be sold in the ordinary course of business. Hence, the investment property will be reclassified as inventory on 1st January, 2019.

However, as per para 59 of Ind AS 40, transfers between investment property, owner-occupied property and inventories do not change the carrying amount of the property transferred and they do not change the cost of that property for measurement or disclosure purposes. Hence, the carrying value of the reclassified property as inventory will be Rs. 40 crore only.

Measurement

The additional costs of Rs. 12 crore for developing the units which were incurred up to and including 31st March, 2019 would be added to the cost of inventory to give a closing cost of Rs. 52 crore.

The total selling price of the units is expected to be Rs. 100 crore (10 units x Rs. 10 crore). Since the further costs to develop the units total Rs. 8 crore, the net realisable value of inventory (consisting of 10 units) would be Rs. 92 crore (Rs. 100 crore - Rs. 8 crore). The inventory (consisting of 10 units) will be measured at a cost of Rs. 52 crore (cost Rs. 52 crore or NRV Rs. 92 crore whichever is less).

Disclosure

"During the year, the operating lease has been cancelled with respect to investment property. On the date of cancellation of the operating lease, the company has started the process of bifurcating the property into 10 identical units of equal size to sell in the ordinary course of business. Hence, Rainbow Limited has reclassified as the property as inventory on the date of cancellation and measured it at the reporting date on cost or NRV whichever is less. The units are shown as inventory under current assets in the Balance Sheet."

(4 Marks)

8. **Scenario A**

Since the loan is repayable on demand, it has fair value equal to cash consideration given. Rainbow Ltd. and Canyons Ltd. should recognize financial asset and liability, respectively, at

the amount of loan given (assuming that loan is repayable within a year). Upon, repayment, both the entities should reverse the entries that were made at the origination.

Journal entries in the books of Rainbow Ltd

At origination		
Loan to Canyons Ltd. A/c Dr. To Bank A/c	Rs. 20,00,000	Rs. 20,00,000
On repayment		
Bank A/c Dr. To Loan to Canyons Ltd. A/c	Rs. 20,00,000	Rs. 20,00,000

Journal entries in the books of Canyons Ltd.

At origination		
Bank A/c Dr. To Loan from Rainbow Ltd. A/c	Rs. 20,00,000	Rs. 20,00,000
On repayment		
Loan from Rainbow Ltd. A/c Dr. To Bank A/c	Rs. 20,00,000	Rs. 20,00,000

Scenario B

Applying the guidance in Ind AS 109 'Financial Instruments', a 'financial asset' shall be recorded at its fair value upon initial recognition. Fair value is normally the transaction price. However, if a long-term loan or receivable that carries no interest while similar instruments if exchanged between market participants carry interest, then fair value for such loan receivable will be lower from its transaction price owing to the loss of interest that the holder bears. The difference in fair value and transaction cost will treated as investment in Subsidiary Canyons Ltd.

Both Rainbow Ltd. and Canyons Ltd. should recognise financial asset and liability, respectively, at fair value on initial recognition, i.e., the present value of Rs. 20,00,000 payable at the end of 5 years using discounting factor of 12%. The difference between the loan amount and its fair value is treated as an equity contribution to the subsidiary. This represents a further investment by the parent in the subsidiary.

Journal entries in the books of Rainbow Ltd. (for one year)

At origination		
Loan to Canyons Ltd. A/c (20,00,000 x 0.5674) Dr. Investment in Canyons Ltd. A/c Dr. To Bank A/c	Rs.11,34,800 Rs.8,65,200	Rs. 20,00,000

During periods to repayment- to recognise interest *Year 1 – Charging of Interest*		
Loan to Canyons Ltd. A/c (Rs. 11,34,800 x 12%) Dr. To Interest income A/c	Rs. 1,36,176	 Rs. 1,36,176
Transferring of interest to Profit and Loss		
Interest income A/c Dr. To Profit and Loss A/c	Rs. 1,36,176	 Rs. 1,36,176
Note : Interest needs to be recognised in Statement of profit and loss. The same cannot be adjusted against capital contribution recognised at origination.		

Journal entries in the books of Canyons Ltd. (for one year)

At origination		
Bank A/c Dr. To Loan from Rainbow Ltd. A/c To Equity Contribution in Rainbow Ltd. A/c	Rs. 20,00,000	 Rs.11,34,800 Rs.8,65,200
During periods to repayment- to recognise interest Year 1		
Interest expense A/c Dr. To Loan from Rainbow Ltd. A/c	Rs. 1,36,176	 Rs. 1,36,176

Note: Further, there may be variation in figures on account of discounting factor taken.

(5 Marks)

ANSWER TO CASE STUDY 2

1. (a)-Variable and requires allocation to distinct performance obligation

Reason

Para 85 of IFRS 15 Revenue from contracts with customers,

Variable amount should be allocated entirely to a performance obligation or to a distinct good or service as part of single performance obligation if both the following conditions are satisfied:

a) Variable payment relates specifically to entity's efforts to satisfy performance obligation or transfer the distinct good or service
b) Such allocation is consistent with the object of Para 73 keeping in mind all of the

performance obligations and payment terms in the contract.

Since performance bonus and attrition penalty both are variable in nature, the company needs to allocate the consideration separately for each variable element.

2. (b)USD 2,31,000

Reason

Monthly billing rate per FTE for standard hours is USD 4400, so for 500 FTEs the billing per quarter would be USD 4400 x 500 x 3 = 66,00,000. Based on the attrition penalty table, applicable percentage for 7% attrition would be 3.5%. So, 66,00,000 x 3.5% = 231,000

3. (b)Head of the R2R team is right. It needs to be reported as a separate segment

Reason

As per para 5 of IFRS 8,

An operating segment is a component of an entity:

a) That engages in business activities from which it earns revenues and incur expenses
b) Whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance and
c) For which discrete financial information is available.

Looking at the substance of the case, this contract calls for a treatment of separate operating segment.

4. (a)USD 0.72 million

Reason

Hourly bill rate as per standard hours = USD 4400 x 12 /1920 = USD 27.5 per hour. No. of billed hours as per final approval = 262319

Billing for the quarter = 2,62,319 x USD 27.5 = USD 72,13,772.5

Performance bonus at the rate of 10% = USD 7,21,377.25 or USD 0.72 million

5. (b) - Performance bonus and attrition penalty

Reason

The performance bonus and attrition penalty affect the certainty cash flows from the contract which also make the contract significantly different from other customer contracts of the company.

(2 X 5 = 10 marks)

6. **Notes to Accounts for adjustments on account of variable components:**

Contract Value		xxxxxxx
Adjustments on account of variable components:		
Less: Attrition Penalty	(4,83,02,719)	
Add: Performance Bonus	4,68,89,521	
Net adjustments		(14,13,198)

Working Note: (not part of disclosure)

Quarter (1)	Billable hours in ODC (2)	ODC invoice amount (3)	Performance Bonus (4)	Attrition Penalty (5)
1	160 x 500 x 3 = 2,40,000	240000 x 27.5 x 65 = 42,90,00,000	Not eligible	42,90,00,000 x 3.5% = 150,15,000
2	2,62,319 (as per final approval)	2,62,319 x 27.5 x 65 = 46,88,95,213	(3) x 10% = 4,68,89,521	Not liable
3	160 x 500 x 3 = 2,40,000	2,40,000 x 27.5 x 65 = 42,90,00,000	Not eligible	42,90,00,000 x 4.5% = 193,05,000
4	2,23,500 (as per final approval)	2,23,500 x 27.5 x 65 = 39,95,06,250	Not eligible	39,95,06,250 x 3.5% = 139,82,719
		1,72,64,01,463	**4,68,89,521**	**483,02,719**

[6 marks]

7. Since invoice cannot be raised without final approval, the bonus element can't be treated as revenue. However, based on the substance of the case, the company can treat the same as unbilled revenue and show it as part of current assets in the balance sheet as on the end of Quarter 2 Financial Year 2019-2020. However, the unbilled amount and final billed revenue may vary since Kapsch many times approve less hours then the hours approved by SasTech.

Facts of the case:

There's a contractual right of the company to be entitled for performance bonus since the company has in-principle satisfied the basic condition and thus has fulfilled its performance obligation under the contract.

Requirement of relevant IFRS:

Para 105 of IFRS 15, when either party to the contract has performed, an entity shall present the contract in the balance sheet as a contract asset or a contract liability, depending on the relationship between the entity's performance and the customer's payment. An entity shall present any unconditional rights to consideration separately as a receivable.

Application and justification:

Since the company has already provided the services and met the basic conditions of eligibility for performance bonus the same can be recognized as unbilled revenue. The act of getting the formal approval is only a matter of time and hence does not impair the substance of the case. As per the principles of IFRS 15, the company has fulfilled its performance obligations by rendering the required services to the customer and also satisfied the criteria for performance bonus by keeping the attrition lower than the threshold and also by making its employees more than the standard number of working hours.

[4 marks]

8. Segment Information: Special Contracts:

This segment consists of contracts with customers which have special performance obligations which are different from other contracts in terms of nature, timing, amount and certainty of revenues and cash flows from the contracts.

Particulars	**Rs. in Crores**
Segment Revenue	181.08
Segment Assets	1.29
Segment Liabilities	1.40

Working Notes (not part of disclosure)

a. Segment Revenue

Onsite 10 (FTEs) x 12 (months) x USD 11,000 x 65 (Rs. per USD) =		858,00,000
ODC (as per working notes in answer for Q.6 above) –		
Invoice Value	Rs. 172.64 crore	
Less: Adjustments (net) on account of variable components	(Rs. 0.14 Crore)	

Net ODC revenue (as per para 50-54 of IFRS 15)		Rs. 172.50 Crore
Total Contract Revenue		Rs. 181.08 Crore

b. Segment Assets refer to ODC's carrying value of assets as given in the case i. e Rs. 129 lacs.

Segment liability is the provision for Attrition Penalty for Q4FY19-20 which has been worked out as per working notes in answer for Q.6 above ie. 1,39,82,719

[5 marks]

ANSWER TO CASE STUDY 3

1. (D) All are reportable segments
2. (C) INR 5,87,935
3. (D) Deferred tax assets will have a balance of INR 45,000
4. (D) The entity is required to test the trademark for impairment every year and accordingly, the carrying amount will be reduced to Rs. 6,00,000
5. (B) Acquiring 65% of total shares with decisions requiring unanimous consent of all shareholders.

(2 X 5 = 10 marks)

6. The entity applies the requirements in Ind AS 115 to the portfolio of 10,000 moulds because it reasonably expects that the effects on the financial statements to the portfolio would not differ materially from applying the requirements to the individual contracts within the portfolio. Since the contract allows a customer to return the products, the consideration received from the customer is variable.

The entity considers on constraining estimates of variable consideration to determine whether the estimated amount of variable consideration of Rs. 43,65,000 (Rs. 450 x 9700 moulds not expected to be returned) can be included in the transaction price. The entity determines that although the returns are outside the entity's influence, it has significant experience in estimating returns for this product and customer class. In addition, the uncertainty will be resolved within a short time frame (ie the 30-day return period). Thus, the entity concludes that it is highly probable that a significant reversal in the cumulative amount of revenue recognised (i.e. Rs. 43,65,000) will not occur as the uncertainty is resolved (i.e. over the return period).

The entity estimates that the costs of recovering the moulds will be immaterial and expects that the returned moulds can be resold at a profit.

Upon transfer of control of the 10,000 moulds, the entity does not recognise revenue for the 300 moulds that it expects to be returned. Consequently, in accordance with paragraphs 55 and B21 of Ind AS 115, the entity recognises the following:

(a) Revenue of Rs. 43,65,000 (Rs. 450 × 9700 moulds not expected to be returned);

(b) A refund liability of Rs. 1,35,000 (Rs. 450 refund × 300 moulds expected to be returned); and

(c) An asset of Rs. 1,20,000 (Rs. 400 × 300 moulds for its right to recover products from customers on settling the refund liability).

(4 Marks)

7. Initial carrying amount of loan in books

Loan amount received = 60,00,000 FCY

Less: Incremental issue costs = (2,00,000) FCY

= 58,00,000 FCY

Ind AS 21 "The Effect of Changes in Foreign Exchange Rates" states that foreign currency transactions are initially recorded at the rate of exchange in force when the transaction was first recognized.

Loan to be converted in Rs. = 58,00,000 FCY x Rs.2.50/FCY

= Rs.1,45,00,000

Therefore, the loan would initially be recorded at Rs. 1,45,00,000

Calculation of amortized cost of loan (in FCY) at the year end:

Period	Opening Financial Liability (FCY) A	Interest at 12% (FCY) B	Cash Flow (FCY) C	Closing Financial Liability (FCY) A+B-C
2018-2019	58,00,000	6,96,000	6,00,000	58,96,000

The finance cost in FC is 6,96,000

The finance cost would be recorded at an average rate for the period since it accrues over a period of time.

Hence, the finance cost for FY 2018-2019 in Rs. is Rs. 16,84,320 (6,96,000 FC x Rs. 2.42/FCY) The actual payment of interest would be recorded at 6,00,000 x 2.75 = Rs. 16,50,000

The loan balance is a monetary item so it is translated at the rate of exchange at the reporting date.

So, the closing loan balance in Rs. is 58,96,000 FC x Rs. 2.75/FC = Rs. 1,62,14,000

The exchange differences that are created by this treatment are recognized in profit or loss. In this case, the exchange difference is Rs. [1,62,14,000 - (1,45,00,000 + 16,84,320 – 16,50,000)] = Rs. 16,79,680

(5 Marks)

8. Computation of Goodwill / Capital reserve on consolidation as per Ind AS 103

Particulars	**INR**
Cost of investment:	
Share exchange (50,000 x 25)	12,50,000
Cash consideration	50,00,000
Contingent consideration	9,80,000
Consideration transferred at date of acquisition [A]	72,30,000
Fair value of non-controlling interest at date of acquisition (1,00,000 x 35% x 12) [B]	4,20,000
Total [C] = [A] + [B]	76,50,000
Net assets acquired at date of acquisition [D]	(80,00,000)
Capital Reserve [D] – [C]	3,50,000

In a business combination, acquisition-related costs (including stamp duty) are expensed in the period in which such costs are incurred and are not included as part of the consideration transferred. Therefore, Rs. 1,50,000 incurred by D Ltd. in relation to acquisition, will be ignored by Makers Ltd.

Journal entry at the date of acquisition by Makers Limited as per Ind AS 103:

	Rs.	**Rs.**
Identifiable net assets Dr.	80,00,000	
To Equity share capital (50,000 x 10)		5,00,000
To Securities Premium (50,000 x 15)		7,50,000
To Cash		50,00,000
To Provision for contingent consideration to D Ltd.		9,80,000
To Non-controlling Interest		4,20,000
To Capital Reserve		3,50,000

Note: Since Rs.1,50,000 is incurred by D Ltd., no entry is passed for it in the books of Makers Ltd.

(6 Marks)

ANSWER TO CASE STUDY 4

1. (c) : Factory - Rs. 14,400 thousand and Head office- Rs. 20,000 thousand

Hints

Dep on factory PPE= Rs. 1,600 thousand,

WDV as on 31st March 2017 = Rs. 14,400 thousand

Recoverable amount = Rs. 15,000 thousand

Carrying amount = Lower of recoverable amount and WDV
= Rs. 14,400 thousand

Dep on Head office PPE = Rs. 1,100 thousand,

WDV as on 31 March 2017 = Rs. 20,900 thousand

Recoverable amount = Rs. 20,000 thousand

Carrying amount = Lower of recoverable amount and WDV

= Rs. 20,000 thousand

2. (a) : (i) and (ii)
3. (c) : Item A- Rs. 5 lac and Item B- Rs. 2.30 Lac

Hints

Item A should be recognised at cost, which is Rs 5 lacs. Replacement cost is irrelevant for item A. This is because material was purchased for a profitable order, the net realisable value will be any way higher than the cost so no write - down is required. Item B should be recognized at Rs. 2.30 Lac being the net realisable value (Rs.2.60 Lac - Rs. 0.30 Lac) i.e. lower from cost Rs. 2.5 lac.

4. (b) : Increase inventory by Rs 2 lacs in the prior year comparative statement of financial position along with the opening retained earnings

   Hints

   The adjustment should be made retrospectively i.e. the prior year comparative financial statements are adjusted, alongside the opening retained earnings. The adjustment will increase the closing inventory of previous year. This will increase assets in previous year and also increase profits as higher amount would have been deducted from cost of sales

5. (a) : ABC Ltd. recognizes a liability and an expense of 1.5% of profit

(2 X 5 = 10 marks)

6. **Computation of goodwill on consolidation**

(a) Goodwill on consolidation	Rs. in '000
Cost of investment:	
Share exchange (90 million x 8/9 x Rs.2·80)	2,24,000
Contingent consideration	25,000
Fair value of non-controlling interest at date of acquisition (30 million x Rs.2·60)	78,000

	3,27,000
Net assets at 1 April 2016 (Refer W.N.)	(2,38,000)
Goodwill	89,000
(b) Non-controlling interest in PQR Limited	Rs. in '000
Fair value at date of acquisition	78,000
25% of post-acquisition increase in net assets [(2,64,000 – 2,38,000 x 25%] (Refer W.N))	6,500
	84,500

Working Note – Net assets – PQR Limited

	1 April, 2016	**31 March, 2017**
	Rs. in '000	**Rs. in '000**
Share capital	120,000	120,000
Other components of equity	2,400	4,000
Retained earnings	86,000	115,000
Property adjustment	20,000	20,000
Extra depreciation ((92,000 – 80,000)/16)		(750)
Plant and equipment adjustment	9,000	9,000
Extra depreciation ((120,000 –111,000)/3)		(3,000)
Intangible asset adjustment	8,000	8,000
Extra amortisation (8,000/4)		(2,000)
Deferred tax on fair value adjustments		
(20,000+9,000+8,000) x 20%	(7,400)	
(20,000+9,000+8,000)- (750+3,000+2,000) x 20%		(6,250)
Net assets for the consolidation	2,38,000	2,64,000

(10 Marks)

7. The initial measurement of the loan in FC is FC 49 million (FC 50 million – FC 1 million).

The finance cost in FC is FC 4·9 million (FC 49 million x 10%).

The closing balance of the loan in FC is FC 49·9 million (FC 49 million + FC 4·9 million – FC 4 million).

IAS 21 – *The Effect of Changes in Foreign Exchange Rates* – states that foreign currency transactions are initially recorded at the rate of exchange in force when the transaction was first recognised.

Therefore, the loan would initially be recorded at Rs.68·6 million (FC 49 million x 1·40).

The finance cost would be recorded at an average rate for the period since it accrues over a period of time.

The finance cost would be Rs.6·958 million (FC 4·9 million x 1·42).

The actual payment of interest would be recorded at Rs.5·8 million (FC 4 million x 1.45).

The loan balance is a monetary item so it is translated at the rate of exchange at the reporting date.

So the closing loan balance is Rs.72·355 million (FC 49·9 million x 1·45).

The exchange differences that are created by this treatment are recognised in profit or loss.

In this case, the exchange difference is ((Rs.68·6 million + Rs.6·958 million –

Rs.5·8million) – Rs.72·355 million) = Rs.2·597 million.

This exchange loss is taken to profit or loss.

(5 Marks)

ANSWER TO CASE STUDY 5

1. (C) Debentures convertible into a fixed number of instruments, at the option of the issuer
2. (D) A qualitative and quantitative assessment may be needed. If there is substantial modification, the old loan must be derecognized and the renegotiated loan has to be recognized.
3. (C) The carrying amount is a reasonable approximation of fair value.
4. (B) LIBOR linked debentures
5. (A) Continuing involvement asset must be recognized along with the associated liability.

(2 X 5 = 10 marks)

6. Fair Value of securitised component of the loan

	Rs.	Rs.
Fair value of loan		11,000
Less: Fair value of servicing asset	350	
Fair value of interest strip	650	1,000
Fair value of securitised component of loan		10,000

Apportionment of carrying amount based on relative fair values

Particulars	**Fair Values**	**% age based on Total Fair Value**	**Carrying Amount / Cost**
Securitised component of loan	10,000	90.91	9,091
Servicing Asset	350	3.18	318
Interest Strip Receivable	650	5.91	591
	11,000	100	10,000

3.	**The profit arising on securitisation should be computed as follows:**	Rs.
	Net proceeds of securitisation	10,000
	Less: Cost (apportioned carrying amount) of securitised component of loan	9,091
	Profit on securitisation	909

4.	**Based on the above, the following journal entries would be passed in the books of the Originator:**			
			Rs.	Rs.
(a)	To record securitisation of principal plus right to 14% interest			
	Cash A/c	Dr.	10,000	
	To Loans A/c (cost of securitised component)			9,091
	To Profit on Securitisation			909
(b)	To record the creation of servicing asset and interest strip receivable			
	Servicing asset A/c	Dr.	318	
	Interest strip A/c	Dr.	591	
	To Loans A/c			909

(6 Marks)

Calculation of loss rate approach

Group	Number of loans	Estimated per client gross carrying amount at default	Total estimated gross carrying amount at default	Historic per annum average defaults	Estimated total gross carrying amount at default	Present value of observed loss*	Loss rate
	A	B	C = A x B	D	E = B x D	F	G = F / C
Individual	1,000	2,000	20,00,000	4	8,000	7,272	0.36%
Non-Individual	1,000	3,000	30,00,000	2	6,000	5,454	0.18%

* Expected credit losses have been discounted using the effective interest rate at 10%.

(4 Marks)

Hedge accounting may be helpful to Main Bank's corporate clients:

Corporates regularly enter into derivatives (mainly forward contracts and options) to manage the volatility on their cash inflows / outflows which may arise typically from forecast sale or purchase transactions. A purchase order placed for import of materials or assets (or, purchase order received for export transactions), is typically a trigger for a company to enter into a foreign exchange derivative (such as a forward or option). This helps the company to protect any ups and downs in the currency markets and lock in the value of sale or purchase and thereby protect the revenues and limit the costs. This is commonly known as economic hedging.

While these purchase and sale transactions will happen in future and are (rightly) not yet accounted for in the books of account, the derivative contract must be measured at fair value through profit and loss account. Any gains and losses must be recognized. However, the offsetting purchase or sale is yet to happen and there is no matching loss or gain. Therefore, there is a misconception that derivatives cause volatility.

In order to mitigate this, may entities choose to reflect their economic hedging activity in the books of account by adopting hedge account. In order to defer the gains and losses arising from the fair value movement of a derivative and match the timing of gains and losses to the appropriate asset / liability or receivable / payable, entities need to comply with the requirements of hedge accounting as described in Ind AS 109. These include detailed risk management policies, hedge documentation with the qualifying criteria, effectiveness testing and measurement of ineffectiveness.

In respect of External Commercial Borrowings (ECB loans), the variable rate loan and the floating-to-fixed interest rate swap are often structured with the same contract. In line with the offsetting requirements of Ind AS 109, these would be considered as two separate instruments – i.e. the borrowing separately and the interest rate swap separately and accounted for at amortised cost and FVTPL respectively. Once again, in order to mitigate the mismatch in the measurement basis of the two instruments, it would be beneficial for a company to adopt hedge accounting. This would also mean that the finance cost line item in the company's profit and loss would effectively comprise the variable rate interest expense and the fair value gains / losses from the interest rate swap.

Requirements of CVA and DVA for derivative contracts:

Assets and liabilities managed by an entity would be affected by its market risk i.e., interest rate risk, currency risk and credit risk relating to its respective counterparties. In respect of derivatives, as provided by Ind AS 113, entities need to consider the non-performance risk and credit risk of both counterparties involved. Valuation techniques include the use of credit valuation adjustment and other internal / external information in order to arrive at the credit valuation adjustment and debit valuation adjustment (CVA and DVA) for derivatives. Accordingly, the fair value of a derivative in accordance with Ind AS 113 is determined after considering CVA and DVA.

(5 Marks)